Third Avenue Value Fund

Third Avenue Small-Cap Value Fund

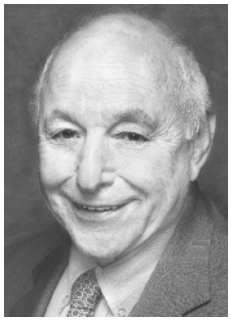
Third Avenue Real Estate Value Fund

Third Avenue International Value Fund

FOURTH QUARTER PORTFOLIO MANAGER COMMENTARY

31 OCTOBER 2012

Letter from the Founder
(Unaudited)



Martin J. Whitman
Founder,
Third Avenue Management, LLC

Dear Fellow Shareholders:

The Third Avenue Management ("Third Avenue") mode of operation is to emphasize Fundamental Finance ("FF"), rather that trading strategies. FF encompasses Value Investing, Control Investing, Distress Investing, Credit Analysis and First and Second Stage Venture Capital Investing. Third Avenue is, of course, primarily a Value Investor that is a passive, non-control investor.

FF approaches matters quite differently than do short run traders. In FF in 2012, the emphasis is on credit worthiness, rather than earnings or cash flows. In FF, managements are appraised not only as operators, but also as investors and financiers; as Value Investors, the bulk of Third Avenue efforts are directed toward investing in equities of financially strong companies which, over the long term, have good prospects to grow readily ascertainable Net Asset Values ("NAVs"); and also in FF, it becomes important to understand the motivations and practices of activists.

As such, FF tends to be quite different than activities revolving around trading, or academic finance as embedded in Modern Capital Theory ("MCT"). Also, as an FF disciple, I reject a number of commonly held beliefs including the concept of "too big to fail"; the definition of corporate failure; the belief that credit-worthy entities, corporate or governmental, ever repay indebtedness in the aggregate; or the belief that a capital infusion into a private enterprise by a governmental agency is, *ipso facto* a "bailout" rather than an "investment".

It seems to me that almost all other approaches to investing and academic finance ranging from *Principles of Corporate Finance* by Brealey and Myers to *Security Analysis Principles and Technique* by Graham, Dodd and Cottle ("G & D") to tracts on trading techniques focus on forecasting and explaining short-run market prices, especially on prices at which securities are traded in markets populated by Outside Passive Minority Investors ("OPMIs"). In sharp contrast, FF focuses strictly on explaining and understanding commercial enterprises and the securities they issue. To me, short run market prices in OPMI markets are "random walks" except for the special cases of "sudden death securities", such as options, warrants, certain convertibles and risk arbitrage situations where there will be relatively determinant workouts in relatively determinant periods of time. As a consequence of the 2008 economic meltdown an FF approach to investing became more relevant, and MCT and G & D approaches seem to have become less relevant.

A contrast in approaches between academic finance and FF is contained in the introduction to Brealy and Myers *Principles of Corporate Finance* (McGraw Hill 1991) a leading finance text, where the authors state "there are no ironclad prerequisites for reading this book except Algebra and the English language. An elementary knowledge of accounting, statistics and macroeconomics is helpful, however." To understand FF, however, the market participant ought to strive to become knowledgeable in several fields – knowledgeable enough to be an informed client. FF areas where knowledge is a prerequisite include the following:

- Securities Law and Regulations
- Financial Accounting
- Corporate Law with some emphasis on Delaware Law
- Income Tax

Other disciplines that might come into play depending on the particular situation being analyzed are Bankruptcy Law, Insurance Law and Regulation, Banking Law and Regulation, Environmental Law, etc.

To others, the default position embodies the MCT view that markets are efficient, to wit, the price is right. In FF, in contrast, most prices are quite wrong most of the time.

In FF, control issues and changes in control are a major consideration. Control issues are pretty much ignored by MCT and G & D. Control common stocks and passively owned common stocks are the same in form but control common stocks are, in fact, a vastly different commodity than non-control common stock, certainly priced very differently in their respective markets. Control issues are also highly important in restructuring troubled issuers. It appears as if subsequent to the 2008-2009 economic meltdown, an increased percentage of changes of control have occurred through recapitalization, asset sales and capital infusions involving troubled publically-owned companies, rather than has occurred through acquiring common stocks or using the proxy machinery to effect changes of control of healthy companies.

The conventional thinking seems to be that one has to take huge risks to obtain huge rewards. I demur. Rather, the royal road to riches is not to take investment risks, but, rather, to lay off the investment risks on someone else. Great fortunes have been built by those who successfully laid off investment risk on others. These success stories include the following people:

- Corporate Executives
- Hedge Fund Operators
- Plaintiffs' Attorneys
- Bankruptcy Attorneys and Investment Bankers
- Securities Brokers
- Venture Capitalists

The best – but far from the only – way for OPMIs to lay off investment risk is to acquire securities that are high quality and have good prospects for growing NAV over the long term. The elements that go into investing in such common stocks encompass the following:

1) The issuer has to enjoy a super strong financial position.
2) The common stock has to be available at, at least, a 20% discount from readily ascertainable NAV.
3) The company has to provide comprehensive disclosures, including complete audits, and also be listed or traded in markets in jurisdictions that provide strong investor protections. (The U.S., Canada and Hong Kong being examples).
4) After thorough analysis the prospects appear good that, over the next three to seven years, the company will be able to increase NAV by not less than 10% compounded annually after adding back dividends.

These are certain shortcomings to this approach. A strong financial position, especially in the 2012 low interest rate environment, means the OPMI is dealing with managements willing to sacrifice Return on Equity ("ROE") and Return on Assets ("ROA") in exchange for the insurance against adversity provided by a strong financial position; and the opportunism for companies that arise out of a strong financial position. Also, the OPMI market seems efficient enough so that a large discount from NAV almost always indicates an absence of catalysts that could result in immediate market appreciation.

There are many, many value investors who are quite competent competitors. As far as I can tell, however, none seem to put as much emphasis on strong financial positions as we at Third Avenue do.

Another factor that others seem to ignore is the importance for companies to have access to capital markets, both credit markets and equity markets. Capital markets are notoriously capricious, sometimes not available at all (see the 2008 credit meltdown) and sometimes willing to give companies what might be characterized as "almost free money" (see the 1999 IPO boom).

The goal of most corporations and most (but not all) OPMIs ought to be wealth creation and it is important to note that there are four general ways to create wealth, not just the two seemingly cited by MCT and G & D. MCT and G & D believe in a primacy of the income account, i.e., creating wealth by flows – whether cash flows or earnings flows (earnings is defined a creating wealth while consuming cash). The four general ways of creating wealth- either corporate or individual – are as follows:

1) Cash flow from operations
2) Earnings from operations
3) Resource conversion, i.e., massive asset redeployments, mergers and acquisitions, liability restructurings, changes of control, spin-offs, and liquidations.
4) Having attractive access to capital markets.

It seems as if conventional securities analysis puts overemphasis on four factors which makes their approach much less useful in helping to understand FF in particular and business in general. The four areas of overemphasis are as follows:

1) Primacy of the income account (to the exclusion of balance sheet and financial position considerations).
2) Short-termism
3) Emphasis on top-down analysis and a consequent denigration of bottom up analysis.
4) Equilibrium Pricing – i.e., the price at any moment of time represents an efficient market, and that price will change as the market digests new information

G & D seem guilty on the first three accounts. MCT seems guilty on all four.

For us, much common wisdom is just plain wrong:

Too big to fail is meaningless. The standard has to be "Too Important Not To Be Reorganized Efficiently and Expeditiously". The reorganization and/or capital infusions after 2008 into GM, Chrysler, CIT, Citigroup and AIG are good examples of efficient and expeditious reorganizations of very important companies.

Corporate failure is defined as a restructuring or liquidation where junior security holders are wiped out or almost wiped out. Chapter 11 does not define failure. Staying in business does not define success. After 2008, AIG and Citicorp both failed using our definitions of failure, though neither ever filed for Chapter 11 Relief.

In the aggregate, debt is almost never repaid by entities which remain creditworthy. Rather, it is refinanced and expanded insofar as the entity – whether corporate or governmental – expands its borrowing capacity, i.e., becomes more creditworthy.The difference between a bailout and an investment is that a bailout constitutes a capital infusion without any hope of a return, no matter how return is measured. If there are prospects of a return, as well as a return of principal, the capital infusion is an investment. The Troubled Asset Relief Program ("TARP") instigated in 2008 to rescue U.S. banks was an investment by the government, not a bailout.

Three elements go into the determination of credit-worthiness for functional purposes.

a) Amount of Debt
b) Terms of Debt
c) How Productive are the Use of Proceeds from Incurring the Debt.

Of the above, perhaps c) is the most important.

Also there are three tests of solvency, and most entities do not have to pass all three to be deemed solvent.

1) Does the fair value of the assets exceed the claims against those assets (a balance sheet test)?
2) Does the entity have the wherewithal to meet its obligations as they come due (an income account test)?

3) Does the entity have access to the capital markets to meet cash shortfalls (a liquidity test)?

In *Security Analysis,* on page 47, G & D opine on the difference between investment and speculation. "An investment operation is one which upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative." At Third Avenue, we agree wholeheartedly with G & D. The Third Avenue approach described in this letter is designed to be an investment operation, not a speculation.

There are three general measures of investment risk:

1) Quality of the Issuer
2) Terms of the Issue
3) Price of the Issue

Diversification is only a surrogate, and usually a damn poor surrogate for knowledge, control and price consciousness.

The most talented value investors seem to graduate into distress investing and control investing. Such graduates include Warren Buffett, Sam Zell, Carl Icahn, Bill Ackman and David Einhorn.

The appraisals of managements ought to examine them not only as operators, but also as investors and financiers.

In FF there is no Substantive Consolidation but plenty of Structural Subordination. In particular the company is a stand-alone – it is not the management, it is not the stockholders. Every constituency in an economic entity in its relationships with other constituencies combine communities of interest and conflicts of interests.

Essentially stock options are a stockholder problem, not a company problem.

It is axiomatic that if an economic entity cannot be made creditworthy, sooner or later the entity has to be reorganized or liquidated. It seems as if no one is really doing anything on the sovereign front to make Portugal, Ireland, Italy, Greece and Spain creditworthy. For starters, at the minimum there is a need for efficiency rather that austerity.

For most portfolios of performing loans time corrects the error of having bought at too high a price.

In examining NAV, it is important to examine the dynamics of NAV, rather than just the statics of NAV. For almost all corporations, NAV will grow year by year almost continuously. Quality of NAV tends to be much more important than the quantity of NAV. Certain assets contained in book value reflect overhead unlikely to ever be recovered through earnings or cash flow. Those are the types of NAV common stocks Third Avenue tries to avoid as an OPMI. There are valuable lessons to be learned from G & D's analysis of Net-Nets.

"For Third Avenue, a principal goal is to buy growth; but, don't pay for it."

Payments to shareholders, either in the form of dividends or stock-buy backs, has to be a residual use of cash most of the time, compared with using cash to expand corporate assets or reduce corporate liabilities. However, from a corporate point of view, it sometime makes sense to pay large and increasing dividends, because that can give the corporations better access to capital markets than would otherwise be the case. Also, managements might consider large dividends simply because it is desired by so much of the company's OPMI constituency.

For the most part, the Third Avenue approach is basically a buy-and-hold approach. Sales take place when the security becomes grossly overpriced, the analyst has made a mistake, corporate conditions change, or for portfolio considerations.

For Third Avenue, a principal goal is to buy growth; but, don't pay for it.

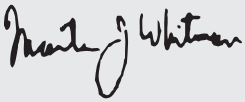
A security has value to a holder only insofar as it promises a cash bailout, control or both.

A fair price is that which would be arrived at between willing buyers and willing sellers each with knowledge of the relevant facts and neither under any compulsion to act. Most going private and Leveraged Buy Out transactions are characterized by coerced seller – willing buyer. However, OPMIs become willing sellers when offered premiums over market prices.

I will write you again when Third Avenue results for the quarter to end 31 January 2013 are published.

Best wishes for a Happy Holiday season.

Sincerely yours,



Martin J. Whitman
Founder, Third Avenue Management, LLC

Ian Lapey
Co-Portfolio Manager of Third Avenue Value Fund

Michael Lehmann
Co-Portfolio Manager of Third Avenue Value Fund

Dear Fellow Shareholders:

The primary change to the Third Avenue Value Fund (the "Fund") during the quarter was a reduction in the Hong Kong exposure to 27% from 32.1%. The rationale for these sales is discussed below. Additionally, Fund Management added to existing positions in the Energy, Financial Services and Technology industries that were discussed in last quarter's letter. The bulk of this letter discusses current composition of the Fund. Fund Management also trimmed several large positions (Brookfield Common, Forest City Common, Posco Common, Toyota Common and Investor AB Common) primarily to make the portfolio more diversified, a strategy we have discussed in prior shareholder letters. As of fiscal year end (October 31, 2012), the top ten positions in the Fund accounted for 50% of the portfolio, down from 57.1% at the beginning of the quarter. The Fund no longer has any individual positions that exceed 8% of total assets. Finally, the Fund exited a few small non-core positions. The Fund's cash position totaled 13% at fiscal year end.

REDUCTION IN HONG KONG EXPOSURE

During the quarter, the Fund's exposure to Hong Kong was reduced to 27%, from 32%. The decision to more aggressively reduce the position sizes was driven by the strong stock performance of these issuers and the resultant narrowing of discounts to net asset value ("NAV"). For the quarter, Henderson Common, Cheung Kong Common and Wheelock Common were the largest three contributors to performance with appreciation of 20%, 13% and 12%, respectively. These same three issuers were also the largest three contributors to year-to-date performance with appreciation of 43%, 28% and 81%, respectively.

Each of our Hong Kong companies reported strong first half 2012 financial results. Specifically, for the Fund's significant holdings, leasing income grew by 14% to 33%, property development margins ranged from 18% to 63% and NAVs per share increased by 6% to 26% on an annualized basis, including dividends. The common stocks remain attractively valued, at discounts to NAV averaging about 30%. However, these discounts are more in line with historical levels, as opposed to the historically wide levels of last year and early this year. Henceforth, more modest position sizes seem appropriate. The Fund's positions in Hutchison Whampoa Common, Hang Lung Properties Common and Wharf Common were eliminated, owing to my preference for being invested alongside management at the holding company level (i.e., Cheung Kong Common, Hang Lung Group Common and Wheelock Common, respectively), given generally wider discounts and stronger financial positions.

PORTFOLIO OVERVIEW

Owing to the significant repositioning of the Fund this quarter, we thought it would be helpful to provide an overview of the portfolio. As of October 31, the Fund had 29 positions.

HONG KONG REAL ESTATE AND INVESTMENT COMPANIES (26%)

The Fund owns the common stocks of Wheelock & Co., Henderson Land Development Co., Cheung Kong Holdings, Hang Lung Group and Lai Sun Garment International. Each of these companies is engaged in real estate development in Hong Kong and China. Additionally, the companies have significant investments in other businesses including ports, gas distribution, telecommunications, retail and energy. As mentioned above, the recent business performance has been strong. The companies all have very strong financial positions with net debt to capital ratios ranging from 3% to 16%. Importantly, these financial positions enabled the companies to navigate the Great Recession and financial crises of 2008-2009 without issuing dilutive equity. Despite strong stock performance in 2012, the average discount to reported NAV as of October 31, 2012 was 30%.

FINANCIALS (21%)

In 2012, I have increased the Fund's exposure to global financial institutions owing to the attractive pricing opportunities created by depressed overall markets. However, cheap valuations are not enough; each company in whose common stock the Fund is invested has a very strong financial position that should enable it to withstand another crisis, like the one we experienced in 2008-2009, without being forced to issue dilutive equity. A brief review by sub-sector is below:

"However, cheap valuations are not enough; each company in whose common stock the Fund is invested has a very strong financial position that should enable it to withstand another crisis, like the one we experienced in 2008-2009, without being forced to issue dilutive equity."

- **Asset management.** The Fund's two common stock investments in this area are the Bank of New York Mellon and Brookfield Asset Management. Both have been long-term holdings having weathered the 2008-2009 financial crises without issuing significantly dilutive equity and maintained strong financial positions. Both companies have demonstrated terrific persistence in retaining assets under management / custody, a Third Avenue requirement for investments in this industry.

- **Banks.** The common stocks of U.S. regional banks KeyCorp and Comerica Inc. account for 5.4% of the Fund's assets, following increases in both positions this quarter. Both companies have strong financial positions (10% to 11% Tier 1 common ratios, conservative loan and investment portfolios and low cost deposit funding), management teams that seem to be navigating the slow loan growth environment prudently and common stocks trading at 11% to 12% discounts to tangible book value. Both companies have been repurchasing their shares, a strategy that should be value enhancing, given their discounted valuations. The Fund also has a small position in the common stock of Chong Hing Bank, a very well-financed Hong Kong bank with an impressive long-term track record trading at a 13% discount to book value.

- **Securities brokerage.** The Fund continued to increase its position in the common stock of Daiwa Securities Group, which has been discussed in the last two shareholder letters. Daiwa recently announced its third consecutive profitable quarter driven by aggressive cost

reductions and fees from leading the Japan Airlines IPO. The company is very conservatively managed, with a capital adequacy ratio of 28% – about twice that of its global peers. Although Daiwa's common stock price has appreciated modestly in 2012, the valuation remains very attractive at a 20% discount to tangible book value and about a 30% discount to our estimate of net asset value, which includes the company's valuable asset management business.

- **Property & Casualty Insurers.** In 2012, the Fund initiated small positions in the common stocks of White Mountains Insurance Group and Alleghany Corp. at modest discounts to tangible book value. Owing to the low interest rate environment and what appears to be an increased incidence and severity of weather related disasters, I would like to see bigger discounts before increasing the Fund's positions materially. So far, the stock price reaction to Hurricane Sandy has been minimal, although claims are likely to be significant.

TECHNOLOGY (7%)

As discussed last quarter, the Fund has been building a basket (1% to 3% individual positions) of common stocks of technology companies with extremely strong financial positions and depressed valuations, often owing to cyclical or product timing issues. So far, the Fund's technology investments have been in the following three sub-sectors:

- **Telecommunications equipment.** It has been an eventful last few months for our telecommunications equipment investments. Sycamore paid a $10 per share dividend and then announced the sale of its main business, another $2 per share dividend and that it would pursue the sale of its other assets and ultimately the liquidation of the business. While this outcome is somewhat disappointing, at a minimum, Sycamore Common should end up being a slightly profitable investment for the Fund. After Tellabs reported disappointing third quarter revenue and guidance, Third Avenue filed a Form 13D with the Securities and Exchange Commission to reserve the right to meet with management, the Board and other shareholders in an attempt to enhance shareholder value. Tellabs Common is a very promising investment with the common stock selling at only a slight premium to the company's $940 million in cash and investments, and expected growth in demand for telecommunications equipment from carriers, such as AT&T, over the next few years because of the explosion in broadband demand from smartphones.
- **Software.** Last quarter, the common stocks of Symantec Corp., a leading provider of security, backup / recovery and storage management software, and Nintendo, a producer of video game hardware and software, were added to the portfolio. Both stocks have appreciated since our purchase. Symantec announced a management change with Steve Bennett, who had been a board member and was previously the CEO of Intuit, taking over as CEO. While it is early, the initial reviews and demand indications of Nintendo's new hardware platform, the WiiU, seem to be favorable. Therefore, Nintendo Common is no longer trading at the near liquidation value at which the shares were purchased in the Fund.
- **Semiconductor capital equipment.** We have continued to add to our position in Applied Common, the leading provider of semiconductor capital equipment in the world. While current demand is weak, the shares are very attractively valued at about eight times normalized earnings, and the company's balance sheet is very strong with net cash of more than $1.2 billion.

U.S. REAL ESTATE (7%)

The Fund has common stock positions in two U.S. real estate operating companies: Forest City Enterprises and Tejon Ranch. Our preference is to own real estate operating companies ("REOCs"), as opposed to real estate investment trusts ("REITs"). REOCs can reinvest their earnings to grow NAV, which is consistent with the Fund's goal of generating

attractive long-term capital appreciation. Also, unlike REITs, REOCs should not be dependent on access to the capital markets since they do not have to pay out most of their earnings as dividends. Forest City Common and Tejon Ranch Common sell at discounts to our estimates of net asset value and appear to have attractive NAV growth potential. The Fund also owns shares of Cavco, a leading company in the manufactured housing industry.

STEEL (6%)

The Fund's exposure to the global steel industry is in the common stock of Posco, a Korean steel producer that also has investments in raw materials, energy and trading. Posco has been performing relatively well in an industry that is currently plagued by weakening demand and excess capacity. In its recently reported third quarter, Posco announced an impressive 9.2% operating margin and solid cash flow that enhanced its already strong financial position. Posco Common is very attractively valued at about nine times earnings and a 31% discount to book value.

AUTOMOTIVE (5%)

The Fund has been a long-term shareholder of Toyota Industries, a diversified manufacturing company (automobiles, air conditioning compressors, forklifts, diesel engines, automobile electronics) with a large securities portfolio, including 6.8% of the common stock of Toyota Motor. Fund Management has been quite pleased with the business performance of Toyota Industries in 2012. The company recently reported 6% revenue growth and 27% operating income growth for the six months ended September 30, 2012. Additionally Toyota Motor, whose common stock accounts for roughly 50% of our estimate of the net asset value of Toyota Industries, is having a terrific year as evidenced by its 36% revenue growth and more than six times increase in earnings over the same period. Nevertheless, Toyota Industries Common remains very inexpensive at only seven times look through earnings and a 45% discount to our estimate of net asset value.

EUROPEAN HOLDING COMPANIES (4%)

The Fund's only significant direct exposure to Europe is the common stock of Investor AB, which accounted for 4.5% of net assets, as of 31 October 2012. Investor AB is a Sweden-based holding company invested mostly in European "blue-chip" common stocks, such as Atlas Copco, Astra Zeneca, Eriscsson, SEB and ABB. Additionally, the company has private equity fund investments and interests in unlisted securities. As of 31 October 2012, Investor AB Common traded at a 35% discount to the company's September 30, 2012 reported NAV. It should be noted that the company's largest unlisted investment, Molnlycke Healthcare, a manufacturer of single use surgical and wound care products, whose business has been performing quite well, is valued in Investor's NAV at a discount to its peers and likely IPO or sale price. The Fund also has a small investment in RHJI International, a Belgian holding company that trades at about a 50% discount to book value. The company recently announced the acquisition of BHF-BANK, a leading private bank in Germany, through its Kleinwort Benson subsidiary.

ENERGY (5%)

As noted in recent letters, the Fund has been accumulating a position in the common stock of Devon Energy, which now accounts for 4% of net assets. The company recently reported mixed third quarter results that were negatively impacted by the significantly lower natural gas and natural gas liquids prices compared to a year ago. Nevertheless, oil production increased 14% compared to a year ago, and the company's financial position remained very strong, due in part to the closing of an attractive joint venture agreement with Sumitomo. Devon Common is very attractively valued at about $9 per barrel of proved reserves and a 25% discount to our estimate of net asset value. The Fund also has a position in Encana Corp., a Canadian exploration and production company.

UTILITIES (3%)

The Fund's utilities exposure is in the common stock of Covanta Holding Corp, a leading owner and operator of energy from waste projects. The company has been utilizing its strong cash flow to return cash to shareholders through dividends (3% yield) and share repurchases (16.5% of its shares repurchased since the onset of its share repurchase program in 2010). Despite minor interruptions from Hurricane Sandy, the company continues to perform well and currently trades at an attractive 2012 free cash flow yield of 11%.

THE FISCAL CLIFF AND TAVFX

With the election now behind us, the focus of many investors has shifted to the looming Fiscal Cliff. If no new laws are passed, spending cuts of $136 billion and tax increases of $532 billion will kick in on 1 January, 2013. In total, these account for about 4% of GDP, threatening to push the U.S. economy into a recession. The front page of a recent issue of *Barron's* warned readers to "Get ready for the recession of 2013".

Our approach to managing the Fund in this environment is to continue to focus on the bottom up, that is, to evaluate the impact of a significant slowdown in the U.S. on the businesses and financial positions of the companies whose common stocks are owned by the Fund. The focus will continue to be protecting against investment risk, as opposed to market risk. Therefore, Fund Management will not try to make a market call by significantly increasing the Fund's cash position in anticipation of a market decline.

As described above, all of the issuers whose common stocks are owned in the Fund have very strong financial positions. These companies should be able to not only withstand a period of deteriorating macroeconomic conditions, but also take advantage of opportunities by making acquisitions and / or continuing to invest in new products while weaker competitors have to pull back. Often the best deals occur during the worst of times, such as Brookfield Asset Management's acquisitions of General Growth Properties and Babcock and Brown during the financial crises that subsequently drove the company's strong NAV growth and stock performance.

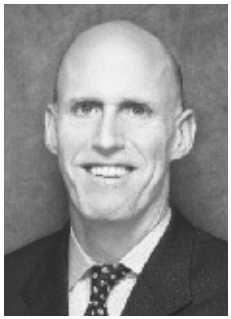
The Fund's cash position of 13% also provides flexibility to add to existing holdings at lower prices and initiate new positions. The Fund has a large pipeline of potential investments that meet our criteria (strong financial positions, competent management teams and understandable businesses with attractive long-term growth potential), but are not cheap enough at the moment.

The Fund's current valuation, at only 80% of book value (versus 2.1 times and 1.7 times for the S&P 500 and Morgan Stanley World Indices, respectively), seems to already incorporate the type of significant slowdown that *Barron's* and others are forecasting. This multiple to book value is only modestly higher than the Fund's valuation at the market trough in March of 2009. While a significant slowdown in the U.S. and global economies would impact negatively the earnings for most of the Fund's holdings, I would still expect book value for most holdings to grow in 2013. Therefore, I believe the Fund's performance should still be healthy, even in a gloomy economic scenario.

Thank you for your continued interest in the Fund. I hope you and your families have a healthy and happy holiday season. I will write to you again when we publish our quarterly report for the period ended 31 January, 2013.

Ian Lapey
Co-Portfolio Manager,
Third Avenue Value Fund

Michael Lehmann
Co-Portfolio Manager,
Third Avenue Value Fund



Curtis R. Jensen
Chief Investment Officer &
Portfolio Manager of
Third Avenue Small-Cap Value Fund

Dear Fellow Shareholders:

At 31 October 2012, Small-Cap Value held positions in 64 common stocks, the top 10 positions of which accounted for approximately 25% of the Fund's net assets.

QUARTERLY ACTIVITY

In contrast to earlier periods this year, the Fund's activity during the quarter was relatively restrained; a broad-based and rapid recovery in share prices during August and September challenged our value-conscious approach, but provided opportunity to realize some gains. Fund Management added two new, modestly sized, holdings to the portfolio and added selectively to existing holdings, while trimming those positions where our conviction levels receded, either because of valuation or other fundamental considerations. What is not reflected in this quarter's portfolio activity, however, but every bit as important, is the substantial progress made related to the expansion of our idea pipeline. The Fund's expanded team continues to deepen and broaden that pipeline – the Fund's lifeblood – and gets credit for the ideas added this quarter and discussed in more detail below.

Started in a New York City apartment building basement in the early 1960s, Weight Watchers today is the leading provider of weight management products and services through its global network of owned and franchised operations and via its online presence, WeightWatchers.com. Operational setbacks combined with a downbeat enrollment outlook in recent periods conspired to produce a mixed set of results at the company. Along with a generally tempered outlook for consumer spending, these developments produced enough pessimism around the shares to provide the Fund an entrée at an attractive entry point. Our research suggests the company's operational challenges have likely subsided and that the public market value of Weight Watchers Common ignores a very good business with bright longer-term prospects.

Weight Watchers' approach to helping people lose weight – a process based on group-based support, behavior modification and easy-to-understand dietary guidelines – has been tested for nearly 50 years against a torrent of diet fads, exercise regimes and pharmaceuticals, and continues to attract weight-conscious adults and to garner the highest marks from the scientific and clinical communities. Over the decades and with the benefit of years of scientific research, management has developed a well regarded brand whose strength seems to rest on a highly differentiated approach, not only in terms of technology and programs, but also in how it treats its customers. For example the company's Points Plus Program, introduced last year, represents a major innovation for the company. In simplistic terms, the company is in the business of selling peer support, a platform and approach that, we believe, would be difficult for any competitor to replicate. In this respect, we think the company has built a sustainable competitive advantage. Additionally, Weight Watchers has several plausible avenues by which it can grow (and defend) its business, specifically:

i) Internationally: Obesity has reached epidemic proportions globally while the company's international operations (mostly in the U.K., Australia and Europe) account for only 30% of revenues;

ii) Male demographic: The company has undertaken initiatives focused on building awareness and relevance among the male demographic, which is relatively under-penetrated among the company's customer base;

iii) Online tools / Mobile applications: The Weight-Watchers.com segment, where the cost of revenues is largely fixed, contributes higher margins than the in-person meetings side of the business and can draw a different demographic by offering high convenience at a lower price point. The company reported approximately 1.5 million online subscribers, as of the end of 2011. The online business has experienced rapid growth and, through a customized approach, ought to enhance management's ability to draw more men as customers. The company's mobile applications allow for barcode scanning that members can use to obtain nutritional information, for example, when they grocery shop.

iv) Corporate partnerships: Leveraging off its long-time partnership with the Cleveland Clinic, the company has started to form partnerships with corporations such as American Express which can offer Weight Watchers programs and meetings for employees onsite.

v) Meeting efficiency: More attendees per meeting can translate into ancillary revenues from the sale of healthy snacks, cookbooks and the like.

In time, it is conceivable that Weight Watchers' solutions would benefit from an evolving healthcare landscape that becomes increasingly focused on preventive care and cost containment.

Investments are rarely perfect, however, and Weight Watchers Common is no exception. The "fly in the ointment" in this case relates to the company's controlling shareholder, a Luxembourg-based private equity firm that controls 50% of Weight Watchers stock and periodically requires a "liquidity event" that involves leveraging the company's balance sheet. Such an event took place earlier this year and has saddled the company with considerably more debt than we would otherwise like. Our analysis suggests, however, that the debt is manageable and should be weighed against the company's highly cash-generative, fee-based business model that requires little capital investment. Shares of Weight Watchers were acquired at a free cash flow yield[1] approximating 10%, or roughly 11 times estimated 2012 GAAP earnings.

Allscripts provides software and information technology services for electronic health records, administration and finance to healthcare providers including physicians, hospitals, nursing homes and hospices.

The company is benefiting as healthcare providers move to adopt information technology solutions as a means of lowering costs and improving patient care, a trend accelerated by U.S. government stimulus spending under the American Recovery and Reinvestment Act of 2009. The relevant sections for Allscripts provide a "carrot and stick" incentive system under which payments are made to providers that adopt electronic health records and future Medicare reimbursement rates are reduced for providers that do not.

Allscripts is the product of several mergers among software companies, the larger and more recent of which include transactions in 2008 and 2010. These brought together new solutions for established customer bases and credibility to bridge the linked but distinct physician and hospital end markets.

The wings of this once higher flier have been clipped by slow and bumpy integration of its major acquisitions, stumbles with new software releases, delays and changes in the government incentive program, and a dispute at the board level that spilled into public view. Unsurprisingly, new software sales have been pressured and expenses have increased as management works to rectify its mistakes.

We think the value of Allscripts' existing customer base is being overlooked amidst the noise and resulting poor recent financial results. The company counts approximately 50,000 physician practices, 1,500 hospitals and 10,000 post-acute care organizations as customers using one or more of its offerings. These customers can generate significant recurring revenue

[1] Free Cash Flow is defined as Cash from Operations less Capital Expenditures. Free cash flow may be a proxy for "owner earnings" or what an owner of the business could take out of the company.

and cash flow from maintenance contracts and ongoing services. These revenues can be very "sticky", as software and systems can be extremely costly and disruptive to rip out and replace. Longer term, we think the company can be turned around and the business may regain a growth profile, neither of which outcomes is reflected at recent prices.

We view Allscripts Common as a pre-merger arbitrage of sorts, believing Allscripts' cash flows, customers and expertise would be of significant value to a private equity or a larger strategic buyer. We have sized the position accordingly. As a private company or subsidiary of a larger organization, investments to return the business to growth might be accelerated away from the distractions of public company reporting – distractions for management, customers, and potential customers. This may be bearing out. Subsequent to quarter end, management has confirmed they have hired advisors and are evaluating strategic options.

"In the meantime, job number one continues to be to protect capital and then produce competitive returns without taking outsized investment risks."

In the absence of a deal or amidst the noise of a turnaround playing out in the public arena, we may have opportunity to expand the Fund's ownership at more attractive prices.

THE THREE Ps – PERFORMANCE, PEOPLE, PORTFOLIO

Given that the October quarter marks the end of the Fund's fiscal year and that we find ourselves more than 80% of the way through the calendar year, it seems to be a reasonable point to address the year's performance. When we think about performance, however, it is far more than the change in the Fund's net asset value. Rather, in our view, performance should be included along with people and portfolio – what we call the "Three Ps" – when considering the question of "How did we do this year?"

The Fund's relative performance was also stung by an underweighting of REITs, which comprised 16% and 9% of the Russell 2000 Value and Russell 2000, respectively and which returned 18% and 21%, respectively. The search for yield among investors during the past couple of years has driven average REIT valuations to unattractive levels and well beyond anything we would consider interesting in light of our team's long-term investment horizon. REIT common stocks today – and for quite some time – seem to us like a game of musical chairs whose music has intoxicated investors.

Because we, our colleagues, friends and family are personally invested in this strategy, *absolute* performance gets far more weight from us than does relative performance. In this regard the true test of performance usually comes when market tailwinds fade and turn into headwinds. In the meantime, job number one continues to be to protect capital and then produce competitive returns without taking outsized investment risks.

One of the best parts of our report card concerns the significant progress we made in adding to our human capital. Tim Bui and Evan Strain joined Charlie Page and me this summer to focus specifically on small-cap companies. Tim is a veteran value investor whose tools nicely complement our existing tool kit. Tim comes to us without any ego; he is not only humble and rational, but a lot of fun too. We promoted Evan from his position as the research assistant where he did just about everything for the entire 28-member Third Avenue research team. Evan is the fourth analyst at Third Avenue who started as the investment team's research assistant. While Evan is young, he has evidenced the right temperament to be a successful investor and his work ethic is unmatched. In this case I am utterly convinced that adding two plus two makes five!

The Small-Cap Fund's portfolio remains highly differentiated from any small company index, an outgrowth of our fundamentals-based and proprietary research process. Consider the table below, which compares the Fund's top ten holdings as of October 31 to the Russell 2000 Value Index.

Top 10 Holdings As of October 31, 2012	Fund	Russell 2000 Value Index
Alleghany Corp.	3.2%	—
Liberty Media Corp.	2.9%	—
Oshkosh Corp.	2.9%	—
Teleflex, Inc.	2.6%	—
Madison Square Garden, Inc.	2.5%	—
JZ Capital Partners Ltd.	2.3%	—
SEACOR Holdings, Inc.	2.3%	—
Kennametal, Inc.	2.3%	—
Compass Minerals International, Inc.	2.1%	—
Semgroup	2.0%	—
Total	24.7%	0.00%

You will note that there is no overlap and that less than half the Fund by market value is represented in the index. By virtue of the kinds of companies we generally seek out – well-financed, undervalued and strong or improving businesses – the Fund inevitably benefits from Resource Conversion[3], several examples of which occurred this year. As such, it is our belief that the Fund's results, over longer stretches, should not look like those of the broader indices, a characteristic that ought to attract those looking for a better source of diversification within their equity choices.

I look forward to writing you again in the New Year when we publish our First Quarter Report dated 31 January 2013. May you and your families enjoy a healthy and prosperous New Year. Thank you for your continued support.

Sincerely,

Curtis R. Jensen
Chief Investment Officer and Portfolio Manager
Third Avenue Small-Cap Value Fund

[3] Resource Conversion, broadly defined, may include activities that help to realize value inherent in a company's assets and liabilities and may include mergers and acquisitions, bulk share repurchases, the acquisition and disposition of assets or refinancing of liabilities.

Third Avenue Real Estate Value Fund
(Unaudited)

Michael H. Winer
Co-Portfolio Manager of
Third Avenue Real Estate Value Fund

Ryan Dobratz
Co-Portfolio Manager of
Third Avenue Real Estate Value Fund

Jason Wolf
Co-Portfolio Manager of
Third Avenue Real Estate Value Fund

Dear Fellow Shareholders:

During the quarter ended 31 October 2012, the Third Avenue Real Estate Value Fund (the "Fund") added one new equity security, and one new debt security and eliminated two equity securities and one debt security.

DISCUSSION OF QUARTERLY ACTIVITY

Investment activity during the quarter could best be described as "defensive posturing." As noted in the prior two quarters, since the beginning of 2012, the Fund has been selling appreciated securities. In some instances prices reached our sell targets and we eliminated positions. In other cases, we reduced position sizes to reflect appropriate weighting based on expected return profiles. Net selling activity has once again resulted in above-normal cash balances (22% at fiscal year-end), which we believe is prudent in the current market environment for global real estate securities.

During the quarter we reduced our holdings in Taylor Wimpey Common, and Wheelock Common. While our outlook on these companies remains positive, our portfolio construction process requires value weighting adjustments in an effort to maximize overall prospective returns. The commitment to a disciplined selling process will result in higher-than-historical average turnover for the year, but will likely remain much lower than the average mutual fund.

CapitaLand Common and Hongkong Land Common were both sold during the quarter after appreciating to levels that reached our sell targets. Both stocks were added to the portfolio during the 2008/09 financial crisis at deeply discounted prices. Both companies own very high quality assets and have well-regarded management teams. They will remain on our inventory list and we hope to have the opportunity to own them again – a likely prospect, as both companies' shares exhibit extreme volatility when economic conditions appear troublesome and neither company appears to be a takeover candidate.

The widespread appreciation in share prices of global real estate securities over the past twelve months has limited our ability to fully deploy proceeds generated from our sales activity. Typically, in this type of investment climate, we fine tune our analysis of securities on our inventory list and prepare to take decisive action on companies experiencing

near-term distress due to business conditions or a strategic change of direction.

Both of the Fund's new positions this quarter were a result of this form of near-term crisis. Wereldhave NV, an Amsterdam-based real estate investment trust, owns a diversified property portfolio in Europe and the U.S. The company's earnings outlook deteriorated earlier this year as a result of the Eurozone crisis coupled with overly optimistic assumptions about its U.S. portfolio. The stock price declined more than 25%, the CEO was replaced, the dividend was cut by 30% and the company is reviewing its corporate cost structure. Fund Management recently met with the new CEO and we have become more optimistic about the company's new strategic direction. Wereldhave is focused on streamlining its business, including the sale of its U.S. portfolio and other non-core assets and using the proceeds to firm up its capital position and increase the quality of its core portfolio. Wereldhave Common is trading at a substantial discount to published NAV and at an implied yield greater than 8%. We believe that the restructuring plan set out by the new management team is the right move to create an attractive return profile for Wereldhave Common (with limited downside) over the next few years, despite the company's exposure to trouble spots within Europe.

"Our outlook for global real estate securities remains optimistic, given the unprecedented global interest rate environment. Historically low interests rates act as structural support for real estate valuations and allow well-capitalized companies the ability to attract long-term, low cost financing."

As noted in last quarter's shareholder letter, the Fund initiated a position in JC Penney Senior Notes. The Fund added to its position during the recent quarter. A familiar name, JC Penney operates approximately 1,100 retail department stores (primarily mall-based in the U.S.) that generate nearly $15 billion of sales annually. In addition to its core retail operations, JC Penney owns approximately 45% of its stores, controls the remaining 55% of its stores through below-market leases, and it owns stakes in several regional malls and U.S. REIT's. Earlier this year, JC Penney's new CEO introduced some dramatic changes to its business, including moving away from promotional pricing and integrating a "store within a store" concept. The initial results of these changes were disruptive and led to same-store sales declines of nearly 20% in the second and third quarters. Due to these underwhelming results, the market prices for most of JC Penney's securities fell significantly, allowing the Fund to establish a position in the company's long-dated notes (2036 Maturity) at a price of approximately 71% of the face value. Fund Management believes that, based on its financial resources and management group in place, there are reasonable prospects that JC Penney will stabilize its retail business and ultimately increase the profitability from current levels. The Fund is earning approximately a 9% current yield on the JC Penney Senior Notes. If the turnaround is successful, JC Penney Senior Notes should benefit (trade closer to par value) if the company is once again perceived as an investment-grade credit. If the turnaround efforts fail, it is possible JC Penney would be forced to reorganize or liquidate. We believe that in this "reasonable worst-case scenario", given the substantial value of JC Penney's real estate and other assets, JC Penney Senior Notes would not be impaired below the Fund's cost basis. This is not the first time the Fund has invested in securities of a real estate-rich retailer. The Fund's previous investments in KMart common stock, Pathmark debt, Winn-Dixie debt and Frank's Nursery & Crafts debt are examples where Fund Management took advantage of its broad mandate to invest in securities of real estate and real estate-related companies.

Our outlook for global real estate securities remains optimistic, given the unprecedented global interest rate environment. Historically low interests rates act as structural support for real estate valuations and allow well-capitalized companies the ability to attract long-term, low cost financing. Notwithstanding low interest rates, we believe a

very selective approach to investing in real estate securities is warranted as evidenced by the fair-to-over valuations observed in many markets. For example, global REITs appear to be priced well ahead of their fundamentals and trade at historically high multiples of cash flow. Of course, this has been the case for some time and could extend for a couple years, given central banks forward interest rate guidance. Said another way, the continued drive for yield may support real estate securities until it doesn't – and no one knows when that will be. Despite the almost universal acceptance of yield investing regardless of price at the moment, we are unwilling to waver from our value orientation that emphasizes price discipline.

The current investment climate requires us to wait patiently for a substantial price correction or to selectively pursue special situations. Our inventory list of potential investments is robust as we await better pricing. The obvious risk to the portfolio with this approach is that appropriate pricing never materializes. We are willing to accept that risk given the fragile state of the global economy. Guided by history, we have learned that investment sentiment reversals occur often, quickly and unexpectedly. Fund Management's prudent action is preparation.

We believe that our competitive advantage, particularly in the current environment, is illustrated by (1) our investment mandate that allows us to make substantial out-of-benchmark investments, (2) our willingness and ability to hold excess cash when value opportunities are diminished, and (3) our long-term investment horizon which allows us to pursue investments that may take more than a year to provide investment success. All three points are central to our style, but the last one is of particular importance in the markets today, where widespread underperformance against a benchmark often forces fund managers to press their winning investments and all but ignore the down-and-out securities that may provide selective investment opportunities. Our cash balance provides an element of downside support and adequate dry powder to opportunistically invest when time is of the essence. And finally, our ability to cast a wider net offers us the ability to look across geographies, market capitalizations, capital structures (debt and equity), and real estate-related securities (*e.g.*, JC Penney Senior Notes) to invest capital in the best opportunities at the moment.

We take our job as stewards of your hard-earned capital (and our own) very seriously and believe that by focusing our efforts on owning discounted securities of well-financed companies that are capably managed and with prospects for NAV growth, we can successfully navigate through these uncertain market conditions.

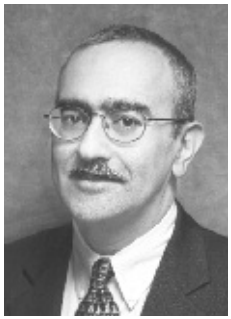
We wish you a prosperous end to 2012 and look forward to writing and speaking to you in 2013.

Sincerely,

Michael Winer
Co-Portfolio Manager

Jason Wolf
Co-Portfolio Manager

Ryan Dobratz
Co-Portfolio Manager
Third Avenue Real Estate Value Fund



Amit B. Wadhwaney
Portfolio Manager of
Third Avenue International Value Fund

In the most recent quarter, Third Avenue International Value Fund (the "Fund") established one new position, and eliminated two positions.

REVIEW OF QUARTERLY ACTIVITY

During the quarter, we initiated a small position in the common stock of De'Longhi S.p.A. ("De'Longhi") in the Fund. Based in Italy, De'Longhi designs, manufactures and distributes small household appliances, mainly under the De'Longhi and Kenwood brand names. De'Longhi is active in a variety of product areas. The company ranks among the leading producers of coffee makers, with a global leadership position in premium priced, capsule-based and fully automatic espresso machines. Small, countertop kitchen appliances (e.g., advanced food processors, mixers, etc.) make up another product segment, sold primarily under the Kenwood brand name. In this product area, De'Longhi also focuses on high-end price points. Other product segments include portable heaters and air conditioners (a legacy business in which De'Longhi made its name) and ironing systems. The strength of the company's franchise and market position is noteworthy in various product areas – for example, by some estimates, De'Longhi has manufactured nearly one in every three espresso machines sold in Germany.[1]

De'Longhi's management team has overseen an impressive transformation over the past several years. In the early 2000s, De'Longhi, like many Western manufacturers, suffered from intense pressure on its profit margins, owing primarily to low-cost competition from China and elsewhere in Asia. But its management team, led by Fabio De'Longhi (appointed CEO in 2005), has confronted this challenge through a greater focus on higher margin, branded kitchen appliances (*e.g.*, espresso makers and food processors), in addition to an aggressive relocation of much of its production base to China and Eastern Europe. The results have been impressive – gross profit margins have increased from less than 23% in 2005 to nearly 38% in 2011, and operating profit margins increased from 6% to nearly 11% during that same period, while earnings per share have grown at an average annual rate of 17% over the past five fiscal years. These results are particularly commendable in light of strong macroeconomic headwinds facing the global economy in general, and Southern Europe in particular, during this timeframe.

De'Longhi's acquisition track record is also impressive. Specifically, the 2001 acquisition of Kenwood has proven to be nothing short of a home run, as De'Longhi has grown that business from €170 million to €475 million in annual sales, primarily through more focused investments in product development, distribution and advertising. We see similar potential in a new opportunity: De'Longhi's agreement with Procter & Gamble (completed in August 2012) to acquire the perpetual license for the Braun brand in select product areas, including small kitchen appliances and ironing systems.

Potential growth opportunities for De'Longhi are numerous, including: continued growth in the at-home, premium coffee market; the Braun licensing agreement; emerging markets (already 23% of De'Longhi's revenue and growing at double-digit annual rates); growing sales of high-end food preparation devices, driven by increasing demand for organic and fresh foods at home; and North America, a market

1 Source: *Spiegel Online,* "An Economic Miracle in the Venetian Hinterlands," by Alexander Jung. 8 August 2012. http://www.spiegel.de/international/europe/booming-economy-in-northern-italy-could-be-a-model-for-the-country-a-848759-druck.html

where De'Longhi has traditionally had only modest exposure (only about 7% of revenue) in lower margin product areas, but one that the company is increasingly targeting with renewed focus, particularly at higher price points.

Shares of De'Longhi were purchased in the Fund at a price that we believe represents a modest multiple of operating profit, given the company's brand value, considerable growth prospects, management track record and strong balance sheet, and at a meaningful discount to estimated private market value. We view the current position as a small, "starter" position that has potential to increase in size as pricing permits.

On the sell side, during the quarter we eliminated our position in Resolution Ltd. ("Resolution") common stock. Resolution is a vehicle that was created to acquire and consolidate U.K. life insurance companies, with the aim of creating value from operating, financial and tax synergies, delivered by a management team with a solid track record of doing so. After we initiated a position, our investment thesis appeared to be playing out, with Resolution acquiring life insurance businesses such as Friends Provident and the U.K. life insurance subsidiary of AXA at steep discounts to run-off or liquidation value, with the opportunity to realize considerable synergies.

However, a number of recent developments have caused us to reassess our investment thesis. First, we believe that there is a potentially increased regulatory risk with regard to increased regulatory capital requirements, which would in turn reduce the amount of excess capital that would be available for return to shareholders. Also, a number of other life insurance businesses have become available for sale, creating a market environment that is less conducive to the type of highly profitable exit that Resolution's management team might otherwise seek, and pushing the date of ultimate value realization out further into the future. Finally, Resolution's management team has begun to eye financial services consolidation opportunities within entities that are separate and distinct from Resolution; thus as Resolution shareholders, we believe that we had become beneficiaries of less and less of management's time and attention. This combination of factors contributed to our decision to eliminate our position in Resolution and redeploy the capital into other opportunities that we believe are more compelling at this point in time.

FINDING OPPORTUNITY AND SERENITY IN A TUMULTUOUS WORLD

At our core we are fundamental, bottom-up value investors who will go wherever each individual opportunity takes us, regardless of where it resides, so long as it meets our investment criteria (more on that later). Our approach to managing the Fund focuses our efforts on identifying and investing in securities that are significantly undervalued in relation to their intrinsic worth as businesses, even under what we believe are very conservative assessments of value, while also limiting the risk of permanent impairments of capital by investing in businesses with sound financial positions, quality business models and solid management teams. Top-down, macroeconomic predictions or forecasts do not dictate the contents of the Fund's portfolio. Where any individual opportunity exists, in itself, is not important to us, as long as there is nothing specific about that geography that we believe exposes us to levels of risk that are imprudent.

With that said, although our investment approach is resolutely opportunistic and bottom up, we nevertheless operate with a considerable awareness of, and attention to, top-down factors that might influence a company's fortunes, particularly for the worse, with a view to assessing the business's ability to survive and, ideally, to thrive during periods of adversity. And while we have taken advantage of various sources of investment opportunities over the course of the Fund's history, in the volatile world in which we live today, macroeconomic upheavals have been an increasingly important and fruitful source of bottom-up opportunities in recent years.

Part of the reason why times of economic anxiety have provided us with some of our greatest opportunities is due to the long-term focus of our investment approach. Macroeconomic uncertainty and volatility often eventually

prove to be friends of long-term investors who stay true to their discipline, although this is an endeavor that is not for the faint of heart. Our investment time horizon (generally three-to-five years, though varying on a case-by-case basis) is longer than those of many of our peers. We believe that our long-term focus provides a key advantage: it allows us to look past the "noise" of near-term depressants to earnings, while instead focusing on longer-term business values which, in our years of experience, have tended to be ultimately recognized, either in more appropriate stock market valuations, or sometimes via takeovers or other forms of "resource conversion." Macroeconomic difficulties sometimes drive real deterioration in business conditions, resulting in depressed short-term earnings. At other times, they result in increased investor anxiety and, subsequently, indiscriminate selling of stocks even if underlying business performance remains reasonably stable. Either way, these conditions can result in companies being valued in the stock market at significant discounts to their longer-term business values, providing opportunity for longer-term investors like us, as those with shorter time horizons flee for the exits regardless of underlying value.

"We believe that our long-term focus provides a key advantage: it allows us to look past the 'noise' of near-term depressants to earnings, while instead focusing on longer-term business values which, in our years of experience, have tended to be ultimately recognized, either in more appropriate stock market valuations, or sometimes via takeovers or other forms of 'resource conversion.'"

Given the tumultuous economic times in which we live today, we thought it might be timely to discuss how economy-wide downturns and/or capital market dysfunction have recently offered us unique bottom-up opportunities that, from a historical perspective, have been available only sporadically and fleetingly. Specifically, how do we assess and think about potential investment opportunities brought about by economic and/or capital market turmoil or crisis? Furthermore, how do we gain enough comfort to invest in those same areas that other investors have fled because of such difficult environments?

Over the past five years, investors have been bombarded by seemingly one economic or capital market crisis after the next. Starting in 2007, when the bubbly residential real estate market in the United States began to wobble, the world has been subject to a succession of upheavals, most notably the Global Financial Crisis in 2008-2009. Having barely emerged (if at all) from that crisis, the world plunged headlong into the seemingly unending Eurozone crisis, which to this very day is awaiting a definitive resolution or closure of some sort. What this seemingly unending sequence of crises has done is exacerbate investor discomfort, given the absence of a neat start and end to these periods of tumult. Furthermore, the broad geographic spread of these crises did little to commend diversification as a means of sidestepping these crises, as places to hide proved few and far between.

Notwithstanding this backdrop, one investor's discomfort may present another's opportunity. We hope you find the brief examples below illustrative of how we have approached investing in the currently unsettled market conditions in various parts of the world, with some degree of serenity. Such serenity, albeit unlikely in times of tumult like those which exist today, derives primarily from the characteristics of those businesses in which we invest. Since we have written about each of these four holdings in greater detail in recent shareholder letters, in the interest of brevity we will merely highlight a few vital features that all of these investments share:

- A sound financial footing, as manifested by a strong financial and business position.
- Attractive business models, with demonstrated excellence over their operating history.
- A valuation that lies well below its conservatively measured worth as a business.

Drawing comfort from the deeply discounted valuation and the survivability of each business allows us to own these attractive businesses for longer periods of time and across periods of uncertainty, whenever and wherever they occur. Looking back over the past several years, we will explore three questions, all related to the relationship between crisis and opportunity. First, where have we observed crises? Second, where have we found opportunities amid such crises? And, finally, how do we gain enough comfort to seize upon such opportunities, despite observing the same crises that have driven many other investors to flee?

GERMANY

We begin attempting to answer these questions in Germany. To our eyes, the onset of the 2007-2008 financial crisis merely exposed what had been many long standing, structural problems facing large swaths of Europe: a poor competitive position stemming in great part from labor immobility; a related inability to generate growth at the macroeconomic level; and ballooning national debts running unchecked by European authorities and policymakers. Efforts to address these issues have, to date, merely constituted a process akin to trying to get the patients into rehab. The real heavy lifting remains ahead. While there has not been a crisis, per se, in Germany, the German economy remains quite export dependent, and several of its larger trading partners are among those very patients in need of rehabilitation. This is, admittedly, not a recipe for a strong macroeconomic tailwind. Yet amid such dark clouds, we believe we were able to find an attractive investment opportunity in Daimler AG ("Daimler") common stock – a position that was initiated in the Fund in September 2011 – despite, and partially because of, a macroeconomic backdrop that would make even those with the most iron clad stomachs squeamish. But what do we find attractive about an investment in Daimler, even against the backdrop of Europe potentially teetering on the brink of implosion?

Business Quality: For better or worse, the public perception of Daimler is that of a European manufacturer of expensive luxury automobiles. The reflex reaction for many may therefore be that Europe will continue to be wracked with austerity, that austerity and luxury goods don't mix, and that therefore Daimler's near-term growth prospects are not promising. The reality, however, is not that straightforward. Daimler, the manufacturer of Mercedes-Benz cars, is indeed one of three German manufacturers that dominate the global luxury auto industry (along with BMW and Volkswagen). But Daimler also happens to be the world's largest manufacturer of heavy trucks, and it is also the operator of a financial services business that holds €80 billion of assets, including its own deposit-taking bank with more than €11 billion of deposits.

Furthermore, while indeed a "European" company, Daimler's business is decreasingly driven by Europe, with the recent push being provided by growing volumes, revenue and profit out of China (11% of revenue) and even more recently and more significantly, the U.S. (23% of revenue). Additionally, it is underappreciated that the luxury auto market is a fundamentally less competitive business on a global basis than mass market auto, with materially higher levels of profitability. In sum, this is a quality business, with admirable features including meaningful geographic diversification, the oligopolistic nature of the industry globally, and reasonably high levels of profitability.

Balance Sheet Strength: Lost on those who are more focused on earnings growth than on the safety of their capital is that Daimler's industrial business has amassed an €8.2 billion net cash position, which equates to over 20% of its current market capitalization. We have observed the building of this cash pile since 2009, when we first looked at Daimler but were not satisfied with its safety under stressed scenarios at that time. Today, all things considered,

the company's very strong balance sheet should provide the wherewithal to get through difficult times.

Compelling Valuation: For these elements of safety and business quality, we would normally expect to pay premium valuations. But in this case, Daimler common stock is currently valued at about seven times earnings, below book value, and at a dividend yield of roughly 6%. Again, we could only attribute this valuation to market participants' focus on the gloomy economic environment enveloping Europe, and consequently on poor near-term earnings growth, with a relative lack of emphasis on asset values and financial wherewithal. Looking at it another way, if we theoretically stripped out Daimler's net cash and the book value of its finance business, the company's industrial business is currently valued at around 2.5 times EBITDA[2]. Such a price offers an attractive margin of safety, and assuming a normal long-term operating environment for the company, seems to reflect an overly draconian assessment of a well-capitalized business, which boasts one of the world's iconic brands.

JAPAN

Moving east, our next port of call is Japan. The well-documented challenges that the Japanese economy faces, both locally and in its export markets, have historically presented the Fund with numerous opportunities. Last year, these difficulties were exacerbated by a strong yen and slowing economic conditions affecting some of its trading partners (notably China and Europe), in addition to the impact of major natural disasters such as Japan's earthquake, tsunami, and nuclear crisis, along with floods in Thailand, each of which disrupted the supply chains that serve the operations of a number of manufacturing companies. These less than encouraging developments that affected some of the historically better performing sectors led a number of long time investors to give up, sell their holdings and leave the Japanese market. One such security was Daiwa Securities ("Daiwa"), whose common stock we purchased in January 2012. You might ask, how do we gain comfort investing in a financial services company in Japan, which is (and has been for some time) the poster child of everything going wrong in an economy?

Business Quality: Daiwa's Japanese franchise is formidable. While Daiwa has a relatively modest presence in North America, the company is a giant in Japan, where it is the second largest brokerage (with 18% market share), a leading asset manager (with almost $170 billion in assets under management), and one of the leading investment banks in the country.

Balance Sheet Strength: Daiwa's balance sheet is rock solid. The company is backed up by $10 billion of equity on its balance sheet, and its extraordinary capital adequacy ratio of 27% (versus a required minimum of 8%) is twice as strong as leading European and North American peers. A majority of Daiwa's assets are liquid, marketable securities, most of them being Japanese government and corporate bonds that have deep markets, while its exposure to illiquid securities such as mortgages or structured products is insignificant, as the company avoided forays into toxic products in the run up to the financial crisis. Furthermore, Daiwa's leverage ratios are well below those of global investment banks, and its assets and liabilities do not suffer from the duration mismatch that is typical of commercial banks. Daiwa is well positioned to weather macroeconomic challenges and even, perhaps, fill the void left by troubled competitors.

Compelling Valuation: As in the case of Daimler, the unusually attractive price at which Daiwa shares are available also belies the strength of the company's franchise and financial position. Daiwa is currently valued at a nearly 20% discount to tangible book value (which approximates liquidation value), and at around a 33% discount to our estimate of Net Asset Value ("NAV"), which values the brokerage and investment banking businesses at nothing more than liquidation value, and applies a conservative estimate of the private market value of Daiwa's consistently profitable asset management business.

[2] Earnings before interest, taxes, depreciation and amortization (EBITDA): one frequently used measure of operating cash flow.

BRAZIL

Moving from low/no growth Japan to the other end of the spectrum, Brazil has long been perceived to be the country which held the promise for much growth in the future, and Brazilian securities have long been valued accordingly. Brazil largely sidestepped the Global Financial Crisis of 2008-2009 with the help of aggressively stimulative fiscal and monetary policies. At the same time, the country benefitted from the iron ore that it supplied to the aggressive infrastructure building program that China, one of Brazil's major trading partners, embarked upon in order to blunt the impact of the global slowdown that was then underway. This confluence of factors enabled Brazil to navigate the financial crisis without much incident.

However, if we fast forward to the present, the picture is much cloudier, as a number of factors have provided headwinds for the Brazilian economy over the past year or so. First, inflationary concerns began to surface in Brazil, causing a reversal of what had been its easy money policy. Additionally, the throttling back of fixed asset investment has dampened China's appetite for Brazilian iron ore, and the shedding of assets by troubled European banks is resulting in a rapid tightening of the interbank market, making it more and more expensive for smaller Brazilian banks to fund themselves. The predictable outcome of these factors has been a falling rate of economic growth and corporate earnings estimates in Brazil, causing a downward re-pricing of a number of securities.

As near-term growth oriented investors began to exit Brazil amid an interruption in its economy's growth, we were presented with the opportunity to invest in a company which provides us with exposure to one of the premier private equity groups in the nation: GP Investments Ltd. ("GP"). The Fund's investment in GP was initiated in March 2012. But how do we find enough comfort to invest in an area that so many other investors have been exiting?

Business Quality: GP has been operating in the Brazilian private equity space since 1993, and its management team is high quality and very experienced, having invested roughly $4 billion in over 50 deals, across 15 different industries. Management has an enviable track record, an extensive base of accumulated knowledge, and a well-developed professional network covering the Brazilian business community. There is also considerable insider ownership, with GP's partners directly owning a 28% economic stake in GP. Further, GP Investments is an investor itself in the private equity funds that it manages and also owns the general partner; this results in the generation of management and performance fees that offset operating costs. In short, management has skin in the game at multiple levels, which we like.

Balance Sheet Strength: GP has a strong, relatively liquid balance sheet. The value of GP's cash, marketable securities and publicly listed investments is well in excess of total liabilities. Also, the permanent capital that GP raised on very attractive terms (pre-crisis) provides flexibility to invest whenever it sees opportunities, regardless of the broader market's risk appetite at the time; this is important because the best opportunities are likely to be available when the broader market is the most risk averse and least likely to provide capital. This balance sheet should serve GP well in cushioning the business during periods of short-term turmoil and also position the company to invest considerable amounts of capital in depressed environments.

Compelling Valuation: Despite the above strengths, GP's valuation is, in our opinion, very modest, providing a meaningful margin of safety. GP is currently valued at a nearly 40% discount to NAV, which itself is now based on much more subdued values of the underlying assets than had been the case in the past. This valuation also assigns virtually no value to the management company of one of the largest private equity firms in Latin America.

INDIA

Late 2010 and 2011 provided a wake-up call for foreign investors seeking to invest in the promising growth potential of India. Investors had been willing to gloss over tenuous macro underpinnings for some time, focusing solely on growth and expectations of growth which sustained elevated

securities valuations until recently, when reality began to bite. Here too, like in Brazil, the promise attracted many, but when faced with the reality of a slow moving bureaucracy and capricious rule making and law enforcement, investors were scared away from both portfolio and foreign direct investment, presenting us with an unusual investment opportunity in the form of Piramal Enterprises Limited ("Piramal"). Piramal, an Indian-listed holding company with investments in pharmaceuticals, healthcare information technology and financial services, shares a number of the same attractive attributes discussed earlier.

Business Quality: Chairman Ajay Piramal remarkably transformed this business from a near bankrupt textile mill with a land holding into India's largest generic pharmaceutical firm, which was assembled over many years by putting together subsidiaries of foreign drug companies as they left India. This business was sold to U.S.-based Abbott Laboratories in 2010 at an incredible price of $3.8 billion (equating to 30 times EBITDA). Mr. Piramal's thoughtful and skillful investment approach has allowed the company to compound book value per share at an impressive compound annual growth rate of 20% over the past 24 years. Following the sale, the company repurchased 20% of its shares outstanding, and has begun to invest its remaining cash hoard gradually and deliberately into the development of four business areas, in each of which Mr. Piramal can arguably lay claim to some expertise: niche pharmaceutical businesses (including outsourced manufacturing and over-the-counter drugs), a new drug discovery business, healthcare information systems, and non-bank financial services (primarily real estate).

Balance Sheet Strength: Piramal has an extremely strong financial position, with roughly $2 billion in liquidity, and cash and short-term investments which exceed total liabilities. The liquid nature of the balance sheet is noteworthy, with cash, short-term investments, and the remaining receivable from Abbott Labs accounting for an estimated two-thirds of Piramal's current gross asset value. This highly liquid asset base provides Piramal with the availability of on-balance sheet financing to take advantage of opportunities as they present themselves, even large ones.

Compelling Valuation: Piramal is currently valued in the stock market at a discount of roughly 25% to our conservative estimate of NAV. A key point here is that the ample discount to NAV at which Piramal shares currently trade is relative to their underlying balance sheet-based net asset value (again, which is made up primarily of highly liquid assets), and is not based upon any blue sky projections of future earnings. Such a valuation, we believe, provides for a considerable margin of safety along with significant upside potential. Additionally, as noted earlier, the company stands well-positioned financially to take advantage of any opportunities as they arise. These are the seeds of future growth, which Mr. Piramal has a solid track record of delivering over nearly a quarter-century, but for which we pay nothing at the current price. Given the areas that Piramal is investing in, we believe that there is the prospect of attractive growth in NAV and earnings over time. We like that. We have nothing against growth – we just can't bear to pay for it!

WHERE NEXT?

Let us now look forward. We should disabuse anyone noting the title of this section from assuming that we know precisely where the next set of investment opportunities will present themselves, let alone have a forecast for the timing or location of the next crisis or crises. But we hope the previous discussion provided at least somewhat of a blueprint of how we will approach investing amid future crises, and, more generally, of how we find serenity while investing in an increasingly tumultuous world – typically, by investing in well-financed, high quality businesses at attractive valuations that provide ample margins of safety and exciting upside potential.

Given the recent history of recurring upheavals across a wide swath of economies, and the as yet unsatisfactory resolution of the root causes of some of these crises (for example, in Europe), combined with the increased linkages between countries via trade or capital flows, it is reasonable to assume

that such occurrences might continue to provide us with new investment opportunities in the future, as they have in recent years.

We continue to be watchful for such opportunities, and remain confident that our investment approach – which benefits from the collective breadth of accumulated knowledge acquired over years of investing, spanning a number of large crises – combined with a disciplined approach toward valuation and risk avoidance, will allow us to identify investments which we believe will prove to be rewarding to our fellow investors.

Geographical Distribution of Investments

At the end of October 2012, the geographical distribution of securities held by the Fund was as follows:

Country	% of Total
Japan	9.54
United States	9.40
Singapore	8.57
United Kingdom	8.49
Germany	7.82
France	7.20
Canada	6.04
Poland	5.65
Hong Kong	5.31
Bermuda	3.33
Austria	3.00
South Korea	2.99
Switzerland	2.62
Norway	2.34
Taiwan	2.28
Greece	2.22
New Zealand	1.72
Brazil	1.71
Chile	1.57
India	1.31
Italy	0.35
Equities-total	93.46
Cash & Other-Total	6.54
Total	100.00%

Note that the preceding table should be viewed as an *ex-post* listing of where our investments reside, period. As we have noted in prior letters, there is no attempt to allocate the portfolio assets among countries (or sectors) based upon an overarching macroeconomic view or index-related considerations.

We look forward to writing to you again when we publish our Quarterly Report for the period ended January 31, 2013. Best wishes for a happy and prosperous New Year.

Sincerely,

Amit Wadhwaney
Portfolio Manager,
Third Avenue International Value Fund