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Dear Investors:

With all the turmoil in the markets, we thought it would be helpful to get our perspective out to you quickly to keep you informed as to our performance and current thinking. We will follow this interim communication with our standard quarterly letter.

To date, 2008 has been a difficult year, in fact the worst year in recent memory for hedge funds generally and even for low volatility hedge funds like those in which we invest (although if you compare hedge fund returns to the returns in the stock market, hedge funds have dramatically outperformed that benchmark). Thus we wanted to answer a few questions that we and other investors have asked.

1. Why have most hedge fund strategies lost money this year?

Deleveraging. Hedge funds include a broad range of investments, so generalizing is hard. But when we have months where almost every hedge fund strategy is down, it indicates that there is deleveraging across the asset class.

Deleveraging means managers must sell their long positions to reduce their exposure or raise cash. Because the manager has fewer longs, he/she needs fewer shorts to hedge. So the manager sells longs and buys shorts when deleveraging. This pushes the price of the long position down and the price of the short position up.

If many hedge fund managers have a strategy of buying stocks and bonds with relatively good fundamentals, and shorting stocks and bonds with relatively poor fundamentals, then better quality stocks and bonds could underperform worse quality stocks and bonds during a period of deleveraging. A hedge fund which invests on fundamentals could lose money in such a period, even if the manager was right about the fundamentals.

Deleveraging appears to be coming from:

- Banks and investment banks that needed to raise cash and reduce their balance sheets. They ordered their proprietary trading desks to unwind and reduce positions. This put pressure on hedge fund strategies that were similar to those employed by the prop desks.

- The Lehman Brothers bankruptcy caused a flood of securities to come out for sale from Lehman's own account. This seems to have put pressure on various hedge fund strategies, particularly in bank loans, convertible arbitrage, and merger arbitrage.

- Hedge funds which were positioned too aggressively coming into 2008 needed to delever. These managers had too much leverage, too much equity risk, and/or too much credit risk. (Of course, we attempt to avoid these managers.)

  This led to poor performance, which led to the manager (a) reducing exposure and/or (b) raising cash to meet actual or anticipated redemptions. This put pressure on the low volatility managers in similar strategies. (This is our universe of managers.)

Short covering rallies. All year, tightly hedged managers have struggled in periods of short covering rallies. These periods include:

- In January right after Martin Luther King weekend when the Fed cut rates
- In March after Bear Stearns was acquired by JP Morgan
- In July after the SEC instituted its first stock selling ban in certain financial stocks
- In September following the most recent short selling ban

Why do hedge funds lose money in short covering rallies? In a short covering rally, many stocks that are shorted more than others rise sharply in price. The price rise is triggered by a macro event, not a change in the companies' fundamentals. So:

- if a hedge fund has taken short positions based on companies' fundamentals; and
- stocks that are shorted rise sharply due to a macro event that drives shorts up more than longs; then
- a tightly hedged manager would likely suffer as the shorts rise faster than longs.

This type of event would affect our long/short equity managers especially, who are typically market neutral or close to it and thus have large short positions. Short covering rallies might not hurt more aggressive equity managers who have fewer shorts, but we avoid these kinds of managers.

Short covering rallies have also affected convertible arbitrage managers, who short stock against the convertibles they buy and hedged credit managers, who may short stock against long credit or equity positions. The short equity position in some cases outperformed the corresponding long position(s).

This is one problem managers have in long/short equity and long/short credit. Their positions are moving around based on macro events or market technicals, rather than the actual fundamentals of the underlying companies. If we invest based on fundamentals, and the market moves instead on technicals, it is difficult to make money.

A further note on investing on fundamentals. We have invested with many managers with a strong history of doing excellent fundamental work. If fundamentals are rewarded, we would expect our returns to improve, regardless of market direction.

If managers do good fundamental work, what can happen that would keep the managers from making profits?

- The market goes down and the manager has net long exposure. We typically avoid these managers.

- Market technicals (e.g., short covering rally). This can be mitigated somewhat by managers being involved in idiosyncratic trades, which may be easier for the size managers we tend to invest with. This year, however, it has been difficult to hide from market technicals.

- Having too much leverage and getting taken out of your positions before the fundamentals play out. This is why we try to avoid managers with excessive leverage.

The bailout plan has been enacted into law. For the last few weeks, everyone has been focusing on macro events – will the government bail out this or that institution, will the bailout plan pass, is it the best plan of action? It's no wonder stocks and bonds are moving in ways that surprise our managers. It is my opinion that now that we have a bailout plan, investors will start asking, "What earnings do we expect for this company's stock in the next 12 months. And what is the real risk of default of that company's bank loan. Are these securities overvalued or undervalued?" When investors start focusing on fundamentals, that's when I think our strategies will get a boost.

2. <u>Will hedge funds suffer from these problems next year?</u>

Of course it is impossible to say with any certainty, but we can discuss a bear case and a bull case.

Bear case. Investors pull money from hedge funds. Hedge funds reduce exposure to meet redemptions. Hedge fund strategies suffer from a continued headwind. Investment banks continue to unwind proprietary positions. Regulators create problems with things like short selling bans.

In such a scenario, hedge funds might still be able to generate some profits without markets going up. For example:

- Bankruptcy/restructuring events (e.g., in AIG or Lehman) could create winners for managers in distressed and hedged credit

- Strategic M&A deals closing could create winners for merger arbitrage managers

- Volatility trading could create profits for convertible arbitrage managers

Bull case. Selling by hedge funds and proprietary desks is largely done. There is more focus on fundamentals and prices are less driven by technicals and top down events like the US Treasury's bailout plan.

In such a scenario, we would expect a snapback in performance across our strategies, regardless of the stock market direction. Selling by hedge funds and Wall St. prop desks

have created tremendous opportunities across our strategies. There could also be investment support as hedge funds decide they have more cash than they need to meet redemptions and look for opportunities in a more stable market.

Returns following difficult periods tend to be good. At this point, it may be helpful to review our historic performance following periods of stress for hedge funds. Please see Appendix 1. Of course, past performance may not be indicative of future performance.

3. How have regulatory changes affected the various strategies?

Short selling ban. The short selling ban on "financial" stocks in the US prevents managers from adding new short positions to certain equities, but does not force managers to cover pre-existing short positions. The short ban has generally not caused our managers to cover any restricted shorts, and the managers are mostly maintaining their short positions to the extent their price targets have not been met. When price targets are met, managers may box the trade. Of special note:

- *Convertible Arbitrage*. The short selling ban has had a significant impact on our convertible arbitrage managers. It caused a sell-off of convertible bonds because hedge funds and other investors could not add new hedges to convertibles in the financial sector. This led to losses in convertible positions in financials, which spilled over and caused selling of convertibles in other sectors.

- *Long/Short Equity*. Most of our long/short equity managers focus on a certain sector, with the exception of our quant manager. The short selling ban would thus most directly affect our long/short manager who operates in the financial sector and our long/short quantitative manager who invests across sectors.

  Our financials manager has done a heroic job navigating the short covering rally in financials and continues to be up for the year. Our quant manager, still positive on the year, "flipped a switch" and took out a lot of the exposure relating to the banned equities.

  Indirectly, the short selling bans triggered a global short covering rally. This hurt managers outside of financials when certain short positions rose faster and harder than the long side.

- *Merger Arbitrage*. In any stock-for-stock transaction, merger arbitrage managers would short the acquiring company and buy the target. For the time being, merger arb managers can't use this strategy where the acquiring company is on the short selling list. However, this universe of deals is relatively small.

4. How are investor withdrawals from hedge funds affecting us?

Pine Grove Assets Under Management. This year (Jan 1 – Oct 1, 2008), our firm has raised net +$95 million, including redemption requests made for Dec 31, 2008 but not including any inflows in November and December.

This has been a tumultuous year, and we expect a reshuffling in the hedge fund universe. We expect allocators to reallocate from relatively poor performing hedge funds and funds

of funds to relatively better performing hedge funds and funds of funds. Our investors tell us that we have been on the right side of this relative comparison, and that there are much bigger problems than Pine Grove in their portfolios. That said, in the midst of our worst drawdown in our 14 year history, and speaking personally as a portfolio manager with a significant percentage of his net worth invested in the fund, relative performance is of little comfort, aside from a business perspective.

Hedge Fund Redemptions. Most of our managers have held together better than many of their competitors. We expect our managers' assets to shrink on average, but in most cases, not to a point of concern.

Given Q3 returns in the universe, however, we have to monitor this situation carefully. Some investors will have cash needs and some investors will scale back their hedge fund allocations. As capital comes out of hedge funds, the process puts pressure on hedge fund strategies. In the short run, this could mean more pain, but it continues to create a strong opportunity set for the medium to longer term.

5. Comment on Outlook for Hedge Fund Strategies

For our equity strategies:

- Our long/short managers really just need the market to focus more on fundamentals. As I said earlier, I am optimistic that we can reach this point soon.

- For merger arbitrage, there are compelling spreads in a few deals, but risk remains high. Despite the consolidation expected in the financial services industries, it is not clear this strategy should be increased until deal volume increases and risk subsides.

For our credit strategies:

- Our long/short credit managers again really just need the market to focus more on fundamentals and the relative risk of investing senior secured vs. lower in the capital structure (our managers tend to be long higher in the capital structure and short more junior unsecured credit, which has not been profitable due to deleveraging of senior paper).

- In distressed, the opportunity set is slowly growing. Managers are crawling all over Lehman and AIG. These situations are very complex and our managers will invest months of analysis. We believe this is the tip of the iceberg – more distressed is coming, in lots of different industries, and we expect returns to be strong in the upcoming distressed cycle. Same for our distressed residential mortgage effort.

- In bank loans, prices will have to get to a point where they offer compelling risk adjusted returns on an unleveraged basis. Investors with cheap sources of borrowing drove up the price of bank loans (and other credit instruments, as well). Those investors are history, so loans must now trade to a price that offers good returns without leverage. Some managers say there are many loans that trade at that price now.

- In convertible arbitrage, managers tell us convertibles are as cheap as they've ever been. One manager said, "Earlier in the year I was telling investors we've been bombed back into the 90's. Now I think we've been bombed back into the 80's, when the strategy was just developing."

It is difficult to be optimistic in the face of such historic market adversity. Major financial institutions have failed or required significant government intervention – Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Washington Mutual, Wachovia. Each of the other major investment banks – Merrill Lynch, Morgan Stanley and Goldman Sachs – have surrendered its status as an independent investment bank. It is truly astounding.

Going into the fourth quarter, we've lost money and hedge funds are under pressure. These are difficult times. But our strategy of investing with conservative managers in conservative strategies has allowed us to hold together. With proper respect for the unprecedented events we've seen and which may come to pass, we are cautiously optimistic that our managers are in a position to take advantage of the inevitable opportunities that arise following any severe market dislocation.

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We welcome any comments or questions that you may have.

Sincerely,

Thomas N. Williams, CFA
Portfolio Manager

Appendix 1

Worst HFRI Drawdowns	HFRI FOF: Conservative Index [1] Drawdown [2]	Pine Grove Partners, LP Drawdown
Aug-1998 to Oct-1998	-6.62%	-7.22%
Nov-2007 to Aug-2008	-4.27%	-2.40%
Apr-2000 to May-2000	-1.84%	2.74%
August 2007	-1.79%	-0.11%
Feb-2001 to Mar-2001	-1.39%	2.33%

Worst HFRI Drawdowns	Next 12 Month Return, Annualized	Next 12 Month Return, Annualized
Aug-1998 to Oct-1998	12.43%	11.75%
Nov-2007 to Aug-2008	*n/a*	*n/a*
Apr-2000 to May-2000	4.63%	14.07%
August 2007	-0.99%	1.15%
Feb-2001 to Mar-2001	4.29%	8.39%

Worst HFRI Drawdowns	Next 24 Month Return, Annualized	Next 24 Month Return, Annualized
Aug-1998 to Oct-1998	12.87%	14.84%
Nov-2007 to Aug-2008	*n/a*	*n/a*
Apr-2000 to May-2000	4.19%	10.54%
August 2007	*n/a*	*n/a*
Feb-2001 to Mar-2001	4.33%	8.32%

Worst HFRI Drawdowns	Next 36 Month Return, Annualized	Next 36 Month Return, Annualized
Aug-1998 to Oct-1998	9.40%	13.24%
Nov-2007 to Aug-2008	*n/a*	*n/a*
Apr-2000 to May-2000	4.67%	10.61%
August 2007	*n/a*	*n/a*
Feb-2001 to Mar-2001	5.96%	9.90%

Past performance is no guarantee of future results.

[1] The HFRI FoFConservative Index is an index maintained by Hedge Fund Research, Inc. ("HFRI") that is comprised of funds of hedge funds whose strategies are classified by HFRI as "conservative" because, according to HFRI, they exhibit one or more of the following characteristics: seeks consistent returns by primarily investing in funds that generally engage in more "conservative" strategies such as Equity Market Neutral, Fixed Income Arbitrage, and Convertible Arbitrage and exhibits a lower historical annual standard deviation than the HFRI Funds of Funds Composite Index. A fund in the HFRI Funds of Funds Conservative Index shows generally consistent performance regardless of market conditions. See http://www.hedgefundresearch.com/index.php?fuse=indices-str#8406

The HFRI FOF Conservative Index data is provided for comparative purposes only in order to show general trends in the markets for the referenced periods. The index does not necessarily reflect the actual investment strategy of any Pine Grove fund and its use herein is not intended to imply that the portfolio of any Pine Grove fund is benchmarked or similar to the index either in composition or level of risk. The index is unmanaged, not investable, has no expenses and reflects reinvestment of dividends and distributions. A variety of factors may cause the index to be an inaccurate benchmark for the Pine Grove funds and there is no guarantee that any of the Pine Grove funds will meet or exceed the index.

[2] Drawdown: The largest losing period (the total drop point of maximum decline from peak to trough) during the investment period shown above.