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Fourth Quarter 2016 Investor Letter

Review and Outlook

> *What people remember about the past is likely to warp their judgment of the future. "We often decide that an outcome is extremely likely or impossible because we are unable to imagine any chain of events that could cause it to occur. The defect is our imagination."*
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> Michael Lewis. *The Undoing Project: A Friendship That Changed Our Minds*, citing a paper by Daniel Kahneman and Amos Tversky

2016 Review

When Third Point was founded nearly 22 years ago, we defined ourselves as an event-driven fund investing in special situations such as spin-offs, demutualizations, bankruptcies, and risk arbitrage transactions. While we still make these types of investments, the critical events driving market, sector, and individual security performance and valuations are increasingly political and economic in nature. Last year, several events had a profound impact on markets and correctly interpreting them was vital for investors.

Early in 2016, a number of funds crowded into a trade based on the consensus view that Chinese policy makers, facing a trilemma, would be forced to choose only two options among ensuring a stable Renminbi, stressing economic growth, or restructuring vast amounts of impaired private debt. Following the popular conclusion that of these three options, China would allow the devaluation of the currency, many hedge funds shorted the RMB and further pressed this view by positioning their portfolios long defensive names and short materials companies. It turned out that the Chinese government had another trick up its sleeve, avoiding a trilemma choice by engaging in stealthy policies to gradually implement devaluation while continuing expansionary fiscal policy and kicking debt issues down the road. The result of this "unimaginable" maneuver was violent and swift in markets. While we too had many variations of the short RMB trade on, we avoided most of the ensuing mayhem by covering shorts and dramatically increasing our credit and energy bets. As a result, we more than recovered initial losses and had a solid start to the year.

Brexit was the next "unanticipated" event, despite polling which showed it to be a coin flip. Most investors were caught flat footed, panicked in the aftermath of the vote, and took risk off. Some of those who were actually positioned properly for Brexit misinterpreted the likely consequences of the vote and saw huge two day gains on their shorts evaporate just as quickly when markets rallied back. While we did not anticipate the vote, we responded by using the sell-off as an opportunity to increase our exposure and turned in a good post-Brexit performance.

Finally, the U.S. Presidential election was the most significant event of the year and the most important paradigm shift since the financial crisis. We did not anticipate Trump's win although his election served to crystalize trends that had been taking place for some time but had been largely ignored. Starting the morning after the election, we took immediate steps to reorganize the portfolio around investments that we believe will benefit from Trump's stated policy objectives.

Despite being properly positioned for two of the three significant macro turns last year, our overall performance was a disappointing +6.1%. While corporate and sovereign credit outperformed meaningfully, our equity portfolio underperformed primarily due to losses in Allergan and Amgen, weak performance of our technology investments, and lackluster performance in structured credit. We discuss our performance and lessons learned in further detail below.

Outlook

Trump's election has accelerated the end of QE. The baton is now passing from the Fed to the Treasury, which will provide fiscal stimulus via comprehensive tax reform and infrastructure spending. We expect a significant reduction of corporate and individual taxes, the elimination of the interest rate deduction, and the removal of the deductibility of state and local income taxes from federal returns. To stimulate investment, we see an immediate deduction for capital spending and a dramatic pullback in government bureaucracy, red tape, and regulation. Most controversial and complex is the proposal to help pay for these measures with a Border Adjusted Tax ("BAT"). According to its proponents, the BAT would encourage greater investment in the United States and harmonize our tax policies with the Value Added Tax levied by many of our trading partners. Finally, a significant infrastructure plan would also stimulate the economy, create jobs, and increase the labor participation rate, which dropped drastically in the Obama era. The infrastructure plan would be paid for in part by an ~8% tax on repatriated funds held offshore by United States corporations.

In the immediate term, we believe we will see an acceleration of economic growth at home. Electing a President who is seen as pro-business (ignoring his protectionist views on global trade) has awakened animal spirits, already demonstrated by the record spikes in both business and consumer confidence since the election. This economic growth will come at the same time as inflation is starting to inflect upwards and the domestic economy is close to full employment, notwithstanding the low labor force participation rate.

While markets are at highs, accelerating economic growth both in the U.S. and globally means that earnings should also rise for the first time in three years. The combination of higher nominal growth and lower tax rates could cause earnings to rise in the high single digits this year. Some observers highlight the parallels to the 1980s, but drawing too much from that comparison is dangerous because the starting levels are very different. Then, both interest rates and unemployment were high; now, both are low and likely moving higher. Debt as a function of GDP was 30%. It is now 80%. The median age in the U.S. was 30 then, and is now 38. While this does not mean things cannot improve, particularly in 2017-18, creating a virtuous cycle by following a 1980s blueprint is highly unlikely.

The regime shift to fiscal spending will create a very different investing backdrop. Cross-asset class correlations should fall and, even within equities, there will be much greater dispersion of results. This environment is undoubtedly better for active investing – just as active investing was considered to be on its deathbed. Higher rates will create opportunities, reversing the one-way trade in yields that dampened the past few years.

Winners and losers will be impacted by policies created by the Trump administration's actions and the world's reactions to them. While the markets have moved since the election, we do not believe that investors have digested how different things will be. Markets will continue to do well if we see the promised lower taxes, massive deregulation, and higher growth and wages. For the new President, it will be tough to #MAGA if the stock market is faring poorly. This is not a simple task. Some aspects of tax reform, namely BAT, have the potential to create some volatility in earnings for large importers of goods into the U.S. In anticipation of the BAT becoming reality, we have added investments in securities that have interest rate sensitivity, domestic supply chains, and are net exporters, as well as domestic businesses that benefit from a much lower tax rate.

We expect to do well this year by applying our approach to investing opportunistically in this brave new market. The move from deflation to inflation is good for our style of investing. A reflationary environment creates favorable conditions for value and event-driven investing, risk arbitrage, and activism and so our exposure has increased in equities relative to corporate and structured credit. We expect that credit will be a mini-cycle story like the one we saw last year, where opportunities popped up quickly and only those with the ability to be nimble and move capital quickly generated profits. While our portfolio is primarily focused on the U.S., an accelerating U.S. economy (which results in global growth accelerating as well) creates the right backdrop for non-U.S. markets to perform and so we will likely have more non-U.S. exposure as 2017 progresses. Our bullishness is not without some caution, however. We recognize that trade wars and/or escalating inflation could result in a policy mistake that could then result in a sharp sell-off. Our hedges are structured to guard against negative impact from those events.

Quarterly Results

Set forth below are our results through December 31, 2016:

	Third Point Offshore Fund Ltd.	S&P 500
2016 Fourth Quarter Performance*	-1.1%	3.8%
2016 Year-to-Date Performance*	6.1%	12.0%
Annualized Return Since Inception**	15.7%	7.5%

*Through December 31, 2016. ** Return from inception, December 1996 for TP Offshore Fund Ltd. and S&P 500.

Portfolio Performance and Positioning

Our net return to investors in the flagship fund was 6.1% last year. We generated positive returns in corporate credit via the long energy trade, Argentine sovereign credit investments, risk arbitrage, and our constructive positions in Baxter, Dow, and Sotheby's. Hedges detracted moderately while structured credit was roughly flat. Our biggest losers were sizeable equity investments in the healthcare sector – particularly Allergan – and shorts.

So, what did we learn that can help us improve? Primarily that our portfolio has suffered over the past few years from being too heavily skewed towards specific sectors. Our differentiated individual ideas proved not to be so when entire sectors traded off. We have reoriented the portfolio to have more balance across a number of areas. For the first time in a long time, there is a similar amount of VAR emanating from healthcare, technology, industrials, and financials.

We were reminded last year that in a volatile market, there is a chance to buy everything at the price you prefer if you practice patience. Avoiding consensus is also essential. We are looking for securities that are beaten up – where our projections are not necessarily rosy but simply less dire than other investors' – and not stories that are simple. Hunting where others are not should be easier now that so many assets have flowed away from event and activist funds. We have added data science to our toolkit for identifying interesting, uncorrelated opportunities. We start 2017 with the strongest team in the history of the firm and high expectations for our own performance this year.

Financials Equities

On November 8th, our financials portfolio was 4.4% of the fund. One day later, it was 6.0%; one week later, 10.5%; one month later, 11.8%. These figures actually understate the magnitude of the shift, however, as we reallocated half our initial holdings from high-multiple, FCF businesses in Payments, Ratings, and P&C (which traditionally outperform during periods of deflation), to more traditional reflationary exposures in Banks, Brokers, and, geographically, in Japan. This was a calculated top-down shift and was expressed in stocks where we had a fundamental view. Our conviction has only increased since we first initiated these investments; we have added exposure to each of the names in 2017.

Some believe the rally in financials has been driven by expectations of tax cuts, or the potential repeal of the Volcker Rule, or reduced compliance costs, or more relaxed capital regulations. Any and all of these things would bring material, additional upside to bank stocks. But our focus is different. The pendulum in monetary policy has begun to shift away from the past decade of extraordinary easing just as the pendulum in fiscal policy has begun to shift away from austerity and its limiting factors. The U.S. elections served as a marker for these policy shifts which, in our view, are bullish for rate-sensitive financials.

In terms of fundamentals, rising rates in the U.S. have the obvious benefit of boosting net interest margins. But this is particularly true today because banks are sitting on more excess cash and liquidity than at any time in history. Indeed, with over $4 trillion of liquidity parked at the Fed, many banks do not need additional deposit inflows to fund loan growth for years to come – they already have the cash on hand to lend. This amplifies the benefits of rising rates as banks raise lending rates without a corresponding hike in deposit rates. Rising rates also unlock activity across fixed income trading, which was crowded out by excessive easing, with negative-yielding bonds reaching $12 trillion on the cusp of the U.S. election. Furthermore, as relative policies between countries diverge, currency trading and hedging accelerates. Both businesses – net interest income from loans and trading activity in Fixed Income, Currencies and Commodities ("FICC") – have very high incremental pre-tax margins (>70%). Expanding interest income from higher rates or more velocity in trading does not require additional technology or more personnel – if anything, banks have been over-staffed and have over-spent for years during a period of subdued activity. This highlights a final key point: most will underestimate the significant operating leverage inherent in financials. In Q4, we continued to see improving cost/income ratios with compensation/revenues falling to record lows in some cases – a sign that shareholders may be put before employees in this cycle. Across our holdings, we see 200 – 450bps of ROE expansion in the next 2 years, and again, *this is before tax cuts or deregulation is considered*. Our bank stocks trade <10x earnings with high-teens EPS growth ahead and at a small premium to tangible book value for returns that will expand into the mid-teens. We continue to like what we own and are increasingly focused on expanding our global coverage to capture how these trends unfold outside the U.S.

Credit Update

Structured Credit

Since inception of the strategy for Third Point in 2009, structured credit has generated significant returns. Gains in the strategy have been driven primarily by opportunistic trading in the U.S. residential mortgage-backed security ("RMBS") market. Over the past eight years, we have seen a massive decentralization in securitized products. When we began investing in ABS, nearly a dozen large financial institutions were able to distribute product flow, and trade in structured residential mortgage products was robust. Today, increased regulation has forced over half of these institutions to exit the market, limiting the opportunity set. Last year, we cut our exposure in U.S. RMBS and other areas of the structured credit market. Our exposure was once almost a quarter of the overall Third Point portfolio and is now less than 10%.

As our focus has shifted away from RMBS, we have been finding opportunities in new or different parts of the structured products universe. Roughly half of our current exposure is in Re-Performing Loan ("RPL") securitizations where we took a medium-term view that the borrowers would continue to make mortgage payments and become clean-pay borrowers. The other key component of the portfolio is in the marketplace lending sector. As the origination and securitization of assets have become more difficult for larger financial institutions, smaller technology-driven platforms have filled the void. We have been working with several of the leading marketplace lenders to access or help create attractive securitizations with an optimal duration profile. We are excited about the opportunities in this quickly evolving market and in other, newer areas of ABS.

Corporate/Sovereign Credit

After gapping late in 2015 and early in 2016, high yield spreads are back to historical averages. The spread compression drove a 13.4% return in high yield for 2016 with depressed energy and materials segments doubling the performance of the overall high-yield market. Fortunately, we were concentrated almost entirely in these sectors and were able to profit from that dislocation, driving strong returns in credit last year.

Credit – like equities – is starting from a relatively high point in valuation this year and we expect the rising rate backdrop to provide a headwind. We have reduced our corporate credit exposure and hedged our interest rate risk across the board in the credit book. The distressed class of 2016 did not produce a stellar crop of post-reorg equities and we expect some freshly minted energy equities to turn out to be value traps. Retail is the only credit sector with relatively widespread distress but we have not yet seen a solution to address the increasing secular challenges in the brick and mortar retail world and so the distress is probably warranted.

In the sovereign space, we have reduced our exposure to Argentina but it continues to be a significant position in our portfolio. Argentina remains a major outlier when we look across the globe at sovereign yields relative to leverage, and most importantly, economic trajectory and governance. We believe that Greece is once again approaching a pinch point between populist promises and political-economic realities. As has been the case in the past, we expect a volatile reconciliation, but a reconciliation nonetheless, and are positioned to capitalize on the confusion surrounding that political process.

Third Point has historically generated its strongest returns at the end of credit cycles as we use our cross capital structure approach to profit from credit, then post-reorg equities, and finally, fully-emerged equities. While we flourish in major dislocations, we have been able to bring the same mindset to more minor dislocations, capitalizing in environments when emotions run high. While America may or may not be made great again, there is no question that the rules are literally being rewritten and there is likewise no question that this process will be carried out in a flamboyant fashion. We do not plan to trade the tweets but we expect an increasing number of real and, even better, fake dislocations to create some extremely rewarding investing opportunities.

Sincerely,

Third Point LLC
