



**Third Avenue Value Fund**

**Third Avenue Small-Cap Value Fund**

**Third Avenue Real Estate Value Fund**

**Third Avenue International Value Fund**

**Third Avenue Focused Credit Fund**

**SEMI-ANNUAL REPORT  
AND PORTFOLIO MANAGER COMMENTARY**

April 30, 2010

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Third Avenue Funds are offered by prospectus only. Prospectuses contain more complete information on advisory fees, distribution charges, and other expenses and should be read carefully before investing or sending money. Please read the prospectus and carefully consider investment objectives, risks, charges and expenses before you send money. Past performance is no guarantee of future results. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than original cost.

If you should have any questions, please call 1-800-443-1021, or visit our web site at: [www.thirdave.com](http://www.thirdave.com), for the most recent month-end performance data or a copy of the Funds' prospectus. Current performance results may be lower or higher than performance numbers quoted in certain letters to shareholders.

M.J. Whitman LLC, Distributor. Date of first use of portfolio manager commentary — May 18, 2010.

*This booklet consists of two separate documents.*

**THIRD AVENUE FUNDS  
PORTFOLIO MANAGER COMMENTARY**

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**THIRD AVENUE FUNDS  
SEMI-ANNUAL REPORT**

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**Third Avenue Value Fund**

**Third Avenue Small-Cap Value Fund**

**Third Avenue Real Estate Value Fund**

**Third Avenue International Value Fund**

**Third Avenue Focused Credit Fund**

**SECOND QUARTER PORTFOLIO MANAGER COMMENTARY**

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April 30, 2010



## Letter from the Chairman



**MARTIN J. WHITMAN**  
CHAIRMAN OF THE BOARD

Dear Fellow Shareholders:

It is difficult to function as a value investor unless the value analyst has a firm grasp of economic reality. It is equally difficult to promulgate intelligent financial regulations unless the sponsors of the regulation have a firm grasp of economic reality. Neither the general public, nor legislators and Obama administration officials, seem to have much of a grasp of economic reality, at least when it comes to dealing with troubled financial institutions.

I recently finished reading the book, *Freefall* by Joseph E. Stiglitz, an eminent economist. It certainly seems obvious from reading Stiglitz's prose that economists, whether left wing or right wing, have little conception in certain important areas of what is really involved in rehabilitating troubled companies, or what are the uses and limitations of financial accounting.

In this letter, I discuss eight areas of financial misunderstanding:

- 1) Rehabilitation of troubled entities can be accomplished via three approaches, either alone or in concert: recapitalizations; monetization or liquification of certain assets, (i.e., liquidations); and capital infusions.
- 2) "Too Big to Fail" is a phony concept.

- 3) In the aggregate, debt is never repaid. It is refinanced and expanded by those borrowing entities which remain credit-worthy.
- 4) The private sector and government are in partnership whether they like it or not. The private sector is part of the problem and part of the solution. Government is part of the problem and part of the solution.
- 5) Wall Street professionals and corporate executives are all in the business of creating moral hazards. Eliminate moral hazards and you eliminate entrepreneurship, creativity, and much of superior management performance.
- 6) Taxpayer bailouts are a phony concept, stretching beyond creditability the concept of substantive consolidation. If the government provided financing at a loss to private sector entities, then it is the government providing bail-out funds, not taxpayers, which can be deemed to be the equivalent of common stockholders of the U.S. government.
- 7) A revolution in corporate reorganizations and liquidations may have occurred in 2009 when General Motors, Chrysler, and CIT reorganized speedily and relatively cheaply through controlled Chapter 11 reorganizations. No longer do large, important companies necessarily have to be reorganized in uncontrolled Chapter 11s where administrative expenses can run into the hundreds of millions to billions of dollars. Also, most uncertainties about what a reorganization might entail can be resolved before a filing takes place rather than at some indeterminate time in the future.
- 8) Strict regulation is essential if most financial institutions are to function well.

### **How to Rehabilitate Entities**

There are three ways of rescuing troubled companies so that these companies have odds in their favor that they can be made feasible going forward.

- 1) Reorganize – i.e., recapitalize
- 2) Liquidate – that is, convert assets to other uses and/or other ownership and/or other control
- 3) Make capital infusions into the business entity. Sometimes capital infusions are made by the private sector. Sometimes governments have to make the capital infusions because no funds are available from the private sector. This occurs at the all too frequent times when private markets freeze-up because these markets, for these purposes, are notoriously capricious and grossly inefficient. All sorts of businesses, especially most financial institutions, need continuous access to capital markets. Capital infusions are their lifeblood. Sometimes the infusions have to be supplied by governments.

To economists, capital infusions by governments are known pejoratively as bail-outs. It ain't necessarily so. It certainly isn't so if the government earns a reasonable profit from the capital infusion and/or otherwise obtains productive concessions from the entities which receive the capital infusion.

In many recent cases – Lehman Brothers, AIG, Citigroup, Fannie Mae, Freddie Mac – it would have been extremely difficult, if not impossible, to either reorganize or partially liquidate each company in order to rehabilitate it. This was the case whether the rehabilitation would have taken place through voluntary exchanges or by seeking court protection, usually under Chapter 11. First, voluntary exchanges frequently don't work since in the USA no creditor can be compelled to give up a right to a money payment unless the individual creditor so consents, or a Court of competent jurisdiction, a Chapter 11 Court, imposes an “automatic stay” on payments. Seeking Chapter 11 Relief, (or its rough equivalent from a State Insurance Department), might not contribute to an effective rehabilitation since many assets of troubled

issuers, e.g., derivatives, don't deliver to the troubled issuer the benefits of the “automatic stay”. Thus, as if almost by default, the preferred method for rehabilitating troubled financial institutions in 2008-2009 was capital infusion by the government and government agencies.

The basic problem with the various government stimulus packages certainly has nothing to do with the “taxpayer bailouts” or whether or not the returns to the government agencies from providing the financing result in an accounting profit. Rather, the problems revolve around *quid pro quos*. There was an apparent failure of the government to negotiate terms for the capital infusions which might have compelled various financial institutions in return for the government's capital infusions, to undertake actions which would have been beneficial to the economy even though they entailed realizing losses for the financial institutions. For example, one *quid pro quo* could have been the required restructuring of large amounts of underwater residential mortgages held as assets by the financial institution receiving the capital infusion. Another *quid pro quo* might have revolved around counterparty risk inherent in derivatives, e.g., Goldman Sachs, under the threat of AIG insurance subsidiaries entering state supervised conservatorship, might have been coerced into compromising its claims as a policyholder of credit default swaps. Admittedly such “strong-arm” tactics probably were politically unfeasible. However, I'll bet that if it were private, profit-seeking entities negotiating the terms for capital infusions into troubled companies, lots of “strong-arm” compulsion would have existed. *Quid pro quos* would have occurred.

### **“Too Big To Fail” Is a Phony Concept**

Bank Holding Companies and Commercial Banks are two different financial institutions. Bank Holding Companies own the common stocks of commercial banks, frequently

the common stocks of other eligible businesses and perhaps other assets. Bank Holding Companies are financed conventionally – perhaps with several layers of debt, mostly publicly-held preferred stocks and publicly-owned common stock.

Commercial Banks are primarily financed by deposits plus, to a much smaller extent, loans from U.S. government agencies.

Failure of a financial institution occurs when the holding company's common stockholders are wiped out, or almost completely wiped out, whether that holding company is a bank holding company, an insurance holding company, a broker-dealer holding company or another type of holding company. Thus, in 2008 and 2009 many giant financial institutions did, in fact, fail. Such failures included AIG, Citigroup, Lehman Brothers, Fannie Mae, Freddie Mac, Bear Stearns, GMAC and Countrywide Financial. With the possible exception of Lehman Brothers, all of the above-named failed companies are still in business.

Those inexperienced in rehabilitating companies don't really mean "Too Big To Fail"; they mean "Too Big to Be Reorganized or Liquidated in an Uncontrolled, Contested Proceeding Whether Out-of-Court or in Chapter 11." The solution to preventing Lehman- type debacles seems not to be to restrict the size of financial institutions, but rather to set in place mechanisms whereby financial institutions – large and small – can be reorganized, if troubled, via pre- packaged, pre-negotiated Plans of Reorganizations ("POR") where relevant government regulators have a strong influence on what the POR will be. The reorganization of General Motors, Chrysler and CIT, all accomplished after less than sixty days in court, may have set a very good precedent for where major U.S. reorganizations ought to go.

In other countries, the existence of giant financial institutions doesn't seem to cause a problem, Canadian finance seems to function extremely well, dominated by five super-large commercial bank holding companies.

Most financial institutions (though not Registered Investment Advisers such as Third Avenue Management) need relatively continuous access to capital markets to refinance short- term indebtedness of all sorts. As such,

even well-managed companies can be in trouble when markets "freeze up" as they did in 2008. Mechanisms ought to be in place to provide capital, and/or expeditiously reorganize these companies which are reasonably well managed but lack access to capital markets. Badly managed companies ought to be permitted to be sick – that is go out of

business either through liquidation or the reorganization process. This is the case regardless of the size of the enterprise. The thing that ought to be avoided, in the U.S. at any rate, is uncontrolled reorganizations and liquidations; these are inordinately expensive and inordinately unpredictable. Very little will be accomplished, I fear, without intelligent courts, and intelligent, powerful regulators.

### **In the Aggregate Debt Is Never Repaid**

While individual credit obligations have maturity dates, dynamic entities in most instances, and in the aggregate, never repay debt. Economies as a whole, including this country, almost never repay aggregate debt. Rather, such debt is refinanced and expanded. This can comfortably be done as long as the borrowing entities maintain, or achieve, credit worthiness. Maintaining or achieving credit worthiness is not just a function of how much has been borrowed, and on what terms, but at least equally important, what were the "Use of Proceeds" – productive or wasteful?

**“Economies as a whole, including this country, almost never repay aggregate debt. Rather, such debt is refinanced and expanded.”**

Insofar as the use of proceeds creates wealth both long term and short term, the borrowing entity will remain credit-worthy. Insofar as little or no wealth is created through the use of proceeds, most borrowing entities are doomed to default on their money obligations, sooner or later. Creating wealth is akin to the concept of the Multiplier, originated in the 1930's by the noted economist, John Maynard Keynes.

Borrowing entities fall into three broad sectors: private enterprise, governments and consumers. Over the years, both the private sector and the government have been involved in certain activities which have had hugely high multipliers. For example, the nation benefitted mightily (despite the pain suffered by many market participants) from the dotcom bubble. The availability of equity money on extremely attractive terms for venture capital start-ups in the 1990s through IPOs, was probably essential for the U.S. to develop as a great and growing power in various high- tech industries. The Homestead Act of 1862 entailed government borrowing and the use of proceeds contributed significantly to the country being able to settle the West and realize its "Manifest Destiny." Two results of the GI Bill of Rights passed during World War II where financing was provided by the federal government, were that this country ended up with, by far, the best university system in the world, and probably the best educated and most productive population in the world, at top levels anyway. I can't think of any uses of proceeds in the consumer sector that ever could have the gigantic multipliers realized from the dotcom bubble, the Homestead Act or the GI Bill of Rights.

Of course, many use of proceeds by the private sectors (see the housing bubble and many leveraged buy-outs) and the government (see the Iraq War) are largely, or completely unproductive. Yet, it is my prejudice that the country is better off insofar as increases in borrowing are undertaken by the corporate sector rather than governments or consumers. Because they are governed by a profit motive, expenditures by corporations seem to have better prospects

for achieving high multipliers than would be expenditures by government or consumers. This by no means connotes that government should not borrow and spend. The economy just would not function if this were the case.

### **The Government and Private Sector are in Partnership Whether They Like It or Not**

The real environment that exists is that the government is part of the problem and part of the solution. The private sector is also part of the problem and the solution. If you don't believe that the private sector is part of the problem, look at the ultra poor performance of various parts of the private sector in the last thirty years ranging from the 2008-2009 fiasco in residential housing and going through the myriad of failed companies in automobile manufacturing, textiles, shoes, TV set manufacturing, steel, motion picture exhibition, real estate and retailing, among others.

It is important for the government to provide meaningful incentives to the private sector and, in general, the government should earn reasonable returns for providing such incentives. There are myriad relationships between the private sector and the government. There are three areas, though, where the private sector reacts instantly, massively and efficiently to government policies. It is as if government policies, in reality, direct the "invisible hands" which Adam Smith wrote about in 1776. These three areas are tax policy, credit granting and credit enhancement.

In terms of tax policy, much more important than the tax rate are tax provisions which give the private sector incentives to undertake activities that might be highly productive. For example, there seems to be a crying need for the private sector (rather than the government) to be making equity investments in financially troubled companies. Corporations such as AIG, General Motors, Chrysler and Citigroup, all have hidden assets, in the form of billions of dollars of unused tax loss carryforwards. It would be highly productive if Section 382 of the Internal Revenue Code were repealed or amended to eliminate the

change of ownership rules in order to ensure that these tax loss carryforwards would be available to offset future income taxes that would otherwise be payable by such companies. Under Section 382, the issuance of a significant amount of new stock by a troubled company could result in a change of ownership which could dramatically reduce the ability of the issuing company to use its tax loss carryforwards. The change of ownership rules deter financially troubled companies from issuing significant equity which could provide much needed capital for use in expanding their existing businesses or in acquiring new and potentially highly profitable businesses. Under present law, it is pretty much impossible for a troubled company to issue significant amounts of new shares of its common stock without sacrificing the ability to use its net operating loss carryforwards. Tax loss carryforwards become a tremendously valuable asset for troubled companies insofar as: a) future losses are stemmed or eliminated; and b) new sources of income can be sheltered from taxation. The repeal of the ownership change rules would encourage the Country's leading entrepreneurs, investors and investment bankers to make massive equity infusions into troubled companies. Furthermore, equity capital would improve the issuer's balance sheet, but fear of triggering an ownership change drives companies to borrow, which overextends them. The virtual ban on the trafficking in tax losses is a relatively new phenomenon. The current version of Section 382 was promulgated as part of the Income Tax Reform Act of 1986. In my opinion, it is likely that increases in productivity from the repeal of Section 382 would far outweigh the losses of tax revenue for the government.

Credit enhancements have been extremely important to the growth of this country. They have played a special role in financing expenditures by municipalities which could obtain an AAA credit rating by buying credit insurance from monoline insurers such as MBIA, Ambac and FSA. Those days are gone forever. The only AAAs left standing after 2008-2009 are the U.S. government and its agencies.

It is important that there be a credit enhancement industry to insure borrowings by municipalities and others where bonds are rated AAA. This could be accomplished in a private sector-government partnership. The private sector would be the primary underwriters of such guarantees and be responsible for structuring deals, doing due diligence and providing administrative services. The private sector would be in the first loss position. A government guaranteed (and owned) insurance company would be in a second loss position and would provide reinsurance so that the policies would obtain a AAA rating. The government insurance company should be run with the expectation that it would earn reasonable profits.

### **Wall Street Professionals and Corporate Executives are all In the Business of Creating Moral Hazards**

The environment for moral hazard exists where an activist can create a situation vis-à-vis a passivist, so that the activist can believe "Heads I Win; Tails I Don't Lose or I Don't Lose Too Much". That's what corporate executives do vis-à-vis their stockholders. That's what Wall Street professionals do as Underwriters, Salesman, Investment Bankers, Hedge Fund General Partners, Leverage Buyout General Partners and Mutual Fund Managers.

Economists seem to believe that much of the problem in commercial banking revolves around moral hazard – banks financed largely with government insured deposits could take special risks in lending because if the loans turned bad, the government would bail out the depositors. Virtually all these commercial banks were, and are, wholly-owned subsidiaries of holding companies. Insofar as the banks took excessive risk, holding company security holders were compromised, or in many cases virtually wiped-out (see Citigroup Common). Prior to 2008-2009, bank management caused the banks to take risks for which they were not close to adequately compensated. The blame for these management shortcomings seems not to be on moral

hazard, but rather incompetence and a follow the herd mentality.

Ian Lapey and I, as co-managers of the Third Avenue Value Fund, are probably a lot more stupid than other fund managers because while we own interests in the management company, we both have very meaningful amounts of our net worth invested in Third Avenue Value common. These shares were purchased for cash at net asset value on the date of purchase, exactly the same way all other Third Avenue Value shareholders created their positions. In many other funds, fund managers seem to primarily own interests in the management companies, rather than the funds themselves. If the fund prospers, the management company will prosper even more; if the fund falters, the management company owners will lose less than the fund shareholders.

I'm troubled by all these moral hazard attacks. First, I've never met a bank executive who did not care very much about the interests of the holders of holding company common stock. Second, and more important, if moral hazard were eliminated, I fear the economy would be much less innovative and productive than it is.

### **Taxpayer Bailouts are a Phony Concept**

In Chapter 11 proceedings, there are questions of substantive consolidation, e.g., should a parent company and its subsidiaries be treated as one entity for reorganization or liquidation purposes, or should they be treated as separate entities. The government is the government; it is not the taxpayers unless one stretches the concept of substantive consolidation beyond reason. If the government provides financing to the private sector on a basis where there are positive returns to the government or the country, there has been no bail-out. If the government provides financing to private sector entities at a loss to the government or the country, then it is the government providing bail-out funds, not taxpayers who can be deemed to be the equivalent of common stockholders. In the first instance, the funds for

the "bail-out" are provided to the government by lenders to the government, e.g., the Chinese much more than average taxpayers.

The concept of taxpayer bail-out seems to be a pejorative uttered by sincere people who do not understand that capital infusions can be an extremely useful tool, but only one tool, useful in the rehabilitation of financially troubled entities.

### **A Revolution in Corporate Reorganizations and Liquidations May Have Occurred in 2009 with the Chapter 11 Reorganizations of General Motors, Chrysler and CIT Corporation**

I am the co-author of, *Distress Investing – Principles and Technique*. I finished writing my parts of the book in December 2008. At that time, I never dreamed that if a major corporation like General Motors filed for Chapter 11 Relief that anything could be done in the short term. Rather, I thought it had to be an uncontrolled proceeding full of uncertainties, an unpredictable outcome, lengthy and very, very expensive with administrative costs probably running to several billion dollars. In my book I pointed out how important it was to have controlled reorganizations or liquidations: pre-packs, pre-arranged or whatever. At the time, I wrote that controlled reorganizations appeared do-able only for small companies. Perhaps General Motors, Chrysler and CIT have set a new precedent which will give rise to new legislation which will permit, and even encourage, all sorts of troubled issuers to reorganize expeditiously in a controlled manner while still preserving creditor rights. If so, such developments would be highly constructive for the U.S. economy.

### **Strict Regulation of Financial Institutions is Absolutely Necessary**

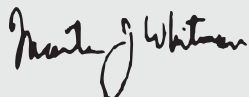
Coming from the mutual fund industry I am, of course, prejudiced. The enormous success of the industry over the last twenty-five years seems directly attributable to ultra strict regulation under the Investment Company

Act of 1940 as amended (the “Act”). Because of the strictness of the Act, investors woke up to the fact that the industry could be trusted; fund investors would get a fair shake. There is no question that the existence of the Act has stifled initiative, is very expensive, is sometimes unfair and places burdens on a fund manager, such as myself, that I’d rather not have. Granting this, I have no question that the existence of the Act has been beneficial to the Industry, to Third Avenue Management and Third Avenue Value Fund.

In seeking strict regulation for other financial institutions, legislation might well look at the Act as a template for regulation, adapting the principles of the Act to the regulations of other financial institutions all of whom are vastly different from mutual funds and need vastly different regulations. Comprehensive regulation should cover the various areas covered by the Act: asset composition; how financed; how operations are conducted; executive compensation; corporate governance; disclosure requirements; and income tax issues.

The opinions voiced above are my own and not necessarily those of Third Avenue Management, Third Avenue Value Fund or any of our employees. Some of my colleagues at Third Avenue Management agree with most of what I’ve stated, some don’t.

Sincerely yours,

A handwritten signature in cursive script that reads "Martin J. Whitman".

Martin J. Whitman  
Chairman of the Board

## Third Avenue Value Fund



**IAN LAPEY**  
**Co-Portfolio Manager of**  
**THIRD AVENUE VALUE FUND**

Dear Fellow Shareholder:

At April 30, 2010, the unaudited net asset value attributed to the 116,882,332 shares outstanding of the Third Avenue Value Fund Institutional Class Shares (“TAVF”, “Third Avenue”, or the “Fund”) was \$47.15 per share. This compares with an unaudited net asset value of \$43.41 per share at January 31, 2010; and an unaudited net asset value of \$36.01 per share at April 30, 2009, adjusted for a subsequent distribution to shareholders. At May 14, 2010, the unaudited net asset value was \$44.52 per share.

### QUARTERLY ACTIVITY

Number of Warrants	Position Added
20,919,747 warrants	Henderson Land Development Co. Ltd Warrants Exp 6/23/11
Number of Shares or Principal Amount	Positions Decreased
623,000 shares	Chong Hing Bank Ltd. Common Stock (“Chong Hing Common”)
651,426 shares	Cimarex Energy Co. Common Stock (“Cimarex Common”)

Number of Shares or Principal Amount	Positions Decreased (continued)
9,793,000 shares	Henderson Land Development Co. Ltd Common Stock (“Henderson Common”)
\$62,167,000	MBIA Insurance Corp. 14% Surplus Notes (“MBIA Surplus Notes”)
1,175,700 shares	Toyota Industries Corp. Common Stock (“Toyota Industries Common”)
1,842,000 shares	Wharf Holdings Ltd. Common Stock (“Wharf Common”)
Positions Eliminated	
8,955,191 shares	Ambac Financial Group, Inc. Common Stock (“Ambac Common”)
3,004,556 shares	AVX Corp. Common Stock (“AVX Common”)
6,045,667 shares	CGA Group Ltd. Series C Preferred (“CGA Preferred”)
\$26,604,000	Forest City Enterprises Senior Unsecured Debentures (“Forest City Seniors”)
5,266,460 shares	MBIA Inc. Common Stock (“MBIA Common”)
311,119 shares	Omega Flex Inc. Common Stock (“Omega Flex Common”)
\$21,215,000	Standard Pacific Corp. Debentures (“Standard Pacific Debentures”)

Portfolio activity during the quarter was focused on meeting redemptions and maintaining a prudent cash position (approximately 5%) as the number of outstanding shares in the Fund declined by 6%. The vast

\* Portfolio holdings are subject to change without notice. The following is a list of Third Avenue Value Fund’s 10 largest issuers, and the percentage of the total net assets each represented, as of April 30, 2010: Henderson Land Development Co., Ltd., 12.09%; Cheung Kong Holdings, 12.02%; Toyota Industries Corp., 9.20%; Posco (ADR), 7.11%; Wheelock & Co., Ltd., 4.91%; Brookfield Asset Management, Inc., 4.59%; Wharf Holdings, Ltd., 4.57%; Nabors Industries, Ltd., 4.33%; Forest City Enterprises, Inc., 3.86%; and Investor AB, 3.54%.

majority of the sales during the quarter were for portfolio management rather than investment considerations.

The only exceptions were the sales of our remaining holdings of MBIA Common and Ambac Common. In both cases, as discussed in previous letters, there is a threat of permanent impairment to the companies' common stocks. As noted in last quarter's letter, the Fund's investments in the common stocks of bond insurers were the largest detractors to performance over the last decade.

Fund Management took advantage of the rise in the market price in MBIA's Surplus Notes during the quarter and in early May to sell a portion of its position at a modest premium to our average cost after factoring in interest received and accrued interest. The Fund continues to hold \$270 million (face) of MBIA Surplus Notes, and Fund Management has been pleased with several recent developments, including the following:

- Denials of MBIA's motions to dismiss fraudulent transfer suits brought by groups of hedge funds and banks in Federal and New York State Supreme Court, respectively.
- A denial of Countrywide's motion to dismiss a complaint in New York State Supreme Court by MBIA Corp. alleging fraud involving ineligible second lien mortgages insured by MBIA Corp., including a denial of Countrywide's motion to dismiss the complaint as against Bank of America (a much deeper pocket).
- Significant improvement in April 2010 delinquency data for MBIA's insured closed end second portfolio, the largest source of losses and paid claims to date.

As noted in last quarter's letter, the massive recalls by Toyota Motor caused us to put our investment in Toyota Industries under review and trim the position. Based on

recent events, including Toyota Motor's U.S. sales growth of 35% and 24% in March and April, respectively, compared to a year ago, and a return to profitability for Toyota Industries in its fiscal fourth quarter (year ended March 31, 2010), we do not believe that there has been a permanent impairment to our investment in Toyota Industries Common and believe that the company's future prospects remain attractive.

#### **HONG KONG REAL ESTATE AND INVESTMENT COMPANIES – ROBUST BUSINESS RESULTS AND FINANCIAL POSITIONS; ATTRACTIVE VALUATIONS**

As of April 30, 2010, approximately 40.5% of the portfolio was invested in the common stocks of companies based in Hong Kong. These common stocks meet our basic criteria well: 1) the businesses enjoy super-strong financial positions; 2) the common stocks are available at meaningful discounts from Net Asset Value (NAV); and 3) we believe the prospects are strong that NAVs over the next five to seven years will grow at rates of at least 10% per annum compounded. Additionally, each company is run by a management team with an impressive long-term track record whose interests are aligned with ours through meaningful insider ownership. These companies are primarily involved in real estate development in Hong Kong and China but also have investments in numerous other industries, including gas distribution, ports, telecommunications, retail, energy and financial services. Although the Fund's concentration in these Hong Kong common stocks has resulted in increased volatility in its day-to-day NAV, we believe that these investments continue to be the best applications of our "safe and cheap\*" investing philosophy and that the increased volatility is more than justified by their very attractive long-term return potential.

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\* "Safe" means the companies, in our judgment, have strong finances, competent management, and an understandable business. "Cheap" means that, in our judgment, we can buy the securities for significantly less than what a private buyer might pay for control of the business.

**Third Avenue Value Fund  
Hong Kong Real Estate and Investment Companies**

	Common Stock Price	Common Stock Per Share		Discount Adjusted NAV (2)	Net Debt-to- Capital	Insider Ownership
		NAV (1)	Adjusted NAV (2)			
Cheung Kong Holdings	\$97.05	\$105.17	\$106.03	8%	8.6%	42%
Hang Lung Group	\$38.50	\$ 35.58	\$ 40.38	5%	3.8%	37%
Henderson Land Development	\$49.85	\$ 62.01	\$ 66.08	25%	16.1%	54%
Wharf Holdings (3)	\$42.65	\$ 41.83	\$ 47.73	11%	15.7%	30%
Wheelock (4)	\$24.55	\$ 34.30	\$ 38.65	36%	4.3%	59%

Note: Prices as of April 30, 2010. All figures in Hong Kong dollars.

(1) Reported Net Asset Value as of 12/31/09.

(2) Excludes Deferred Tax Liability.

(3) Insider ownership represents indirect ownership through Wheelock.

(4) Excludes Wharf's net debt (non-recourse to Wheelock) and Wheelock Properties' net cash.

Source: Company reports.

I recently visited Hong Kong and Shanghai with Jason Wolf, our Senior Real Estate Analyst and Portfolio Manager. We toured properties and met with the management teams of all of our significant holdings, following the release of their 2009 financial results. Additionally, we met with competitors, local property analysts and real estate brokers. Generally, the meetings reinforced our view that property fundamentals remain healthy in Hong Kong, and our companies appear to be very well positioned to capitalize on this strength over the next several years.

In Shanghai, there is considerable competition and excess supply, particularly in office buildings, but the assets of our companies appear to be well located and likely to benefit over the long term from their high

**“Each Hong Kong-based company in which we have a significant investment reported very strong financial results in 2009, despite a global credit crunch and recessions in many countries, including Hong Kong. Each company remained profitable and generated attractive net asset value growth, while retaining an extremely strong financial position.”**

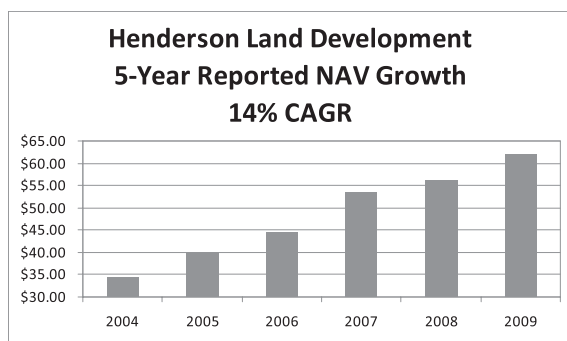
quality development standards. The measures being taken by the Chinese government to cool the property market, which include raising down payments (to 30% from 20% on first homes and to 50% from 40% on second homes), setting a minimum mortgage rate for banks (1.1 times the central bank's benchmark interest rate) and raising bank reserve requirements, appear to be sensible and constructive on a long-term basis. These measures appear to be primarily focused on residential speculation in tier 1 cities. Our companies have generally avoided the speculative areas and are more focused on secondary cities which tend to be more owner occupied.

As the discussion below indicates, each Hong Kong-based company in which we have a significant investment

reported very strong financial results in 2009, despite a global credit crunch and recessions in many countries, including Hong Kong. Each company remained profitable and generated attractive net asset value growth, while retaining an extremely strong financial position. We are looking forward to the financial results for these companies under more normal global economic conditions. The following are highlights of our recent meetings and the 2009 financial results for our significant holdings, which, in the aggregate, represent 37.7% of the Fund's net assets.

#### HENDERSON LAND

Henderson Land Development Co, whose common stock represents 11.9% of the net assets of the Fund, reported earnings for the 18 months ended December 31, 2009 of HK\$ 6.67 per share (the company changed its fiscal year end to December 31 from June 30). Reported net asset value per share and adjusted net asset value per share (excludes deferred tax liability on investment properties in Hong Kong since there is no capital gains tax) each increased 10% to HK\$62.01 and HK\$66.08 per share, respectively. Over the last five years, Henderson's reported net asset value has increased at a 14% cumulative annual growth rate (CAGR) including dividends.



The company's net rental income (including associates and jointly controlled entities) increased by approximately

11% after adjusting for the 18-month reporting period. Henderson's major investment properties in Hong Kong (excluding properties completed after January 1, 2008) were 97% leased as of year-end. Henderson's balance sheet remained strong with a net debt-to-capital ratio of only 16.1% (by comparison, real estate companies often have net debt-to-capital ratios of around 50%). Given this strong financial position, we were surprised when the company announced a Bonus Warrant Issue in which one warrant to purchase stock for HK\$58 per share (exercisable for one year) would be issued for every five shares held. Based on our discussions with management, we believe that the Bonus Warrant Issue was driven by the company's desire to take advantage of attractive real estate development opportunities in both Hong Kong and mainland China while keeping a very strong financial position and allowing all shareholders to participate in the company's growth without being diluted. Additionally, we believe that the Bonus Warrant Issue indicates that management believes that the corporate value is in excess of the current common stock price (the exercise price is at a 16% premium to the price of Henderson Common as of April 30, 2010).

Henderson appears to have attractive growth prospects based on its low cost land and expertise in redevelopment projects. In Hong Kong, the company is converting its huge agricultural land bank (40 million square feet) for residential projects and purchasing old buildings for redevelopment (11 buildings purchased to date totaling 1.2 million square feet, with 19 additional buildings to be purchased in 2010 covering 3 million square feet). The company has a two-pronged strategy for its mainland China real estate development business, consisting of building commercial investment properties for rental on low cost land (primarily purchased in the 1990s by Henderson China, which was privatized in 2005) in primary cities and developing its huge land base (146 million square feet purchased between 2006 and 2009) for residential use in secondary cities. We viewed the

Henderson Metropolitan, a 730,000 square foot Grade A office building and shopping mall development, which is expected to be completed this June, and were impressed with the quality construction and prime location on Nanjing Road East in Shanghai.

While Henderson is largely a real estate development company, its 39.9% ownership stake in Hong Kong and China Gas (“HKCG”), a publicly-listed associate, accounted for 46% of its market cap as of April 30, 2010. HKCG is the largest distributor of piped gas in Hong Kong, with a growing presence in mainland China through its 45.6% stake in Towngas China. Owing to the stability of HKCG’s Hong Kong business, the company has been a steady source of dividends for Henderson during the recession and credit crises (approximately HK\$900 million per year). On March 17, 2010, Towngas China and HKGC entered into an agreement whereby Towngas China would purchase six piped gas projects in China for HK\$1.7 billion, which will be satisfied by the issue of new shares to HCGC, resulting in an increase in HKCG’s ownership to 56.4%. Based on our discussion with Henderson’s management, Towngas China appears to be very well positioned to add gas customers in the mainland over the next several years.

Along with its 2009 Annual Report, the company provided valuations of its property interests and publicly-listed associates as of February 28, 2010. The property valuations were done by DTZ Debenham Tie Leung Limited, an independent professional property adviser headquartered in London. Based on these valuations, Henderson’s net asset value and adjusted net asset value totaled HK\$85 and HK\$89 per share, respectively, compared to its common stock price of HK\$49.85 as of April 30, 2010. This huge discount appears to have also been compelling to Chairman Lee Shau-kee, who acquired 5.32 million shares between May 3 and May 5, 2010 for HK\$253 million (US\$32.5 million). These purchases raised Chairman Lee’s ownership stake to 54.12%.

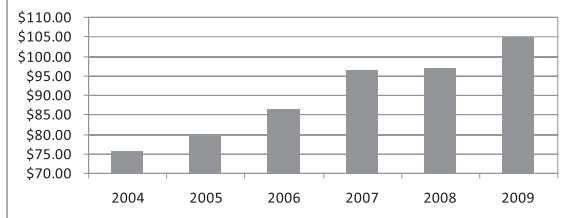
## CHEUNG KONG

Cheung Kong Holdings, whose common stock represents 12% of the Fund’s net assets, reported 2009 earnings of HK\$8.59 per share, a 53% increase compared to 2008. The earnings growth was driven by a HK\$3.9 billion increase in the fair value of its investment properties, primarily owing to the completion of 1881 Heritage, a high-end shopping mall that we viewed in Hong Kong adjacent to Wharf’s Harbour City. The property is already fully leased. Additionally, the company reported a 28% increase in profit from property sales, reflecting strength in both the Hong Kong and China residential property markets, and a 20% increase in property rental income, including jointly controlled entities.

Cheung Kong’s 50% owned subsidiary, Hutchison Whampoa, reported a 12% increase in earnings as declines in cyclical businesses, such as ports and energy, were more than offset by reduced losses in its 3G telecom operations and lower interest expense. The outlook for many of Hutchison Whampoa’s cyclical businesses seems to be improving, and the company should benefit from cost reduction efforts undertaken during the recession. For example, Hutchison Whampoa’s retail business generated a 120 basis point improvement in EBIT margin to 4.9%, despite a 2% decline in sales. The company is believed to be the largest health and beauty retailer in the world, with 13 different brands and 8,700 stores. Management is cautiously expanding the retail business in markets with high growth potential, such as mainland China. Cheung Kong’s stake in Hutchison Whampoa accounted for approximately 51% of its market cap as of April 30, 2010.

Cheung Kong’s NAV increased by 8% to HK\$105.17 per share, compared to its price as of April 30, 2010 of HK\$97.05 per share. Over the last five years, Cheung Kong’s reported NAV has increased at a 9% CAGR, the lowest growth rate among our major Hong Kong holdings, owing primarily to the losses incurred by Hutchison Whampoa’s 3G telecom operations.

**Cheung Kong Holdings**  
**5-Year Reported NAV Growth**  
**9% CAGR**



Cheung Kong generated strong cash flow during the year, resulting in a HK\$9.7 billion reduction in total borrowings and a net debt-to-capital ratio of only 8.6%, down from 13.2% a year ago. Cash flow should also be healthy in 2010, as the company's large residential land banks in both Hong Kong (an estimated 5-6 year supply) and China (approximately 200 million square feet) position it well to benefit from the current strength in both markets. Cheung Kong should be able to take advantage of timely investment opportunities both in the property sector and other areas with HK\$50 billion in available funds. Based on our recent meeting with management, we would expect any significant new investments to be by Cheung Kong as opposed to Hutchison Whampoa.

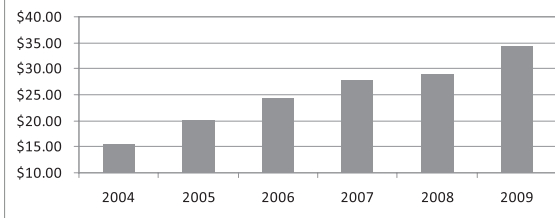
Chairman Li Ka Shing appears to agree with our bullish assessment of the company's long-term prospects and the attractiveness of its common stock. Since September 2009, he has purchased 41.1 million shares at an average price of HK\$99.66 per share (versus the price of HK\$97.05 per share as of April 30, 2010) for approximately US\$529 million. These purchases increased Chairman Li's ownership position to 42.0% from 40.3%.

**WHELOCK AND WHARF**

Wheelock and Company, whose common stock represents a 4.9% position in the Fund, reported that 2009 earnings increased 181% to HK \$4.74 per share. The results were

driven by robust earnings from 50% owned subsidiary Wharf Holdings (see below). Wheelock's NAV increased by approximately 19% to HK\$34.30 per share, compared to a stock price of HK\$24.55 as of April 30, 2010. Wheelock's reported NAV has increased by an average of 18% per year over the last five years, including dividends.

**Wheelock**  
**5-Year Reported NAV Growth**  
**18% CAGR**



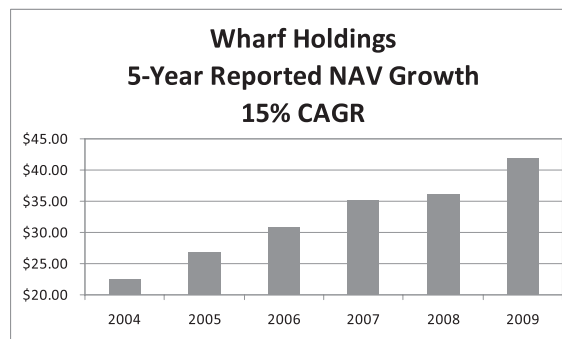
On April 19, 2010, Wheelock announced a proposed privatization plan for Wheelock Properties (a holding in the Third Avenue Real Estate Value Fund), a 74% owned subsidiary focused on real estate development in Hong Kong and Singapore (through its 75% stake in Wheelock Singapore). Wheelock is offering HK\$13 per share in cash, which represents a 144% premium over the last trading price before the transaction was announced, but a 3.4% discount to reported NAV as of year end. During our recent meeting with management in Hong Kong, management indicated that it was looking to make acquisitions. It appears that, at least initially, the most attractive opportunity existed within its own company.

Wharf Holdings, whose common stock represents 4.6% of the Fund's net assets, reported a 179% increase in 2009 earnings to HK\$6.35 per share. Even excluding the large increase in the fair value of its investment properties (HK\$12.2 billion), earnings increased by 86%. Property leasing income increased by 13% owing to robust performance by the company's core Hong Kong

properties, Harbour City and Times Square, both of which had 100% retail occupancy and office occupancy in the mid 90% range. These two properties accounted for 8% of Hong Kong's total retail sales in 2009. Based on our tour of Harbour City, and reportedly robust results during the first quarter of 2010, new retail property supply (Cheung Kong's 1881 Heritage shopping mall) is not having a significant negative impact.

Wharf's China investment properties generated rental income growth of 26%, driven by a full year's contribution from the Dalian Times Square, which opened in late 2008. The company also monetized its Beijing Capital Times Square investment, resulting in a HK \$1.4 billion after tax gain. Wharf also generated much improved results from its property development business in China, as operating profit increased to HK\$1.0 billion from HK\$0.1 billion in 2009. The outlook for this business is healthy, given the company's large land position of more than 100 million square feet. In 2010, the company expects to more than double the 4.7 million square feet sold in 2009 and improve upon its 33% operating margin.

Despite the company's aggressive development in China, Wharf's financial position improved in 2009, with net debt declining by 10% excluding non-recourse debt of subsidiaries. Wharf's NAV increased by 16% to HK\$41.83 per share. Over the last five years, Wharf's reported NAV has increased at a 15% CAGR, including dividends.



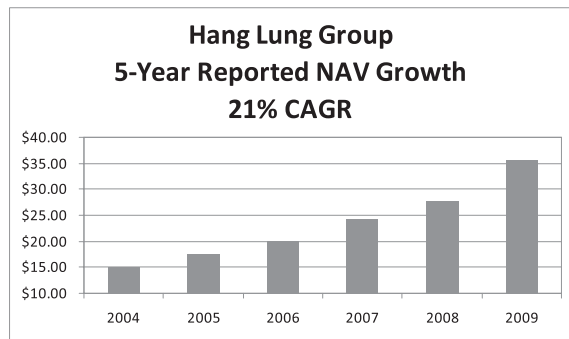
#### HANG LUNG

As we reported last quarter, Hang Lung Properties Ltd. ("Properties"), whose common stock represents 2.0% of the Fund's net assets, reported very strong financial results for the first half of its fiscal 2010 (June 30 year-end). Earnings per share increased to HK\$4.14 from HK\$0.29 a year ago, owing primarily to large increases in the fair value of investment properties in both Hong Kong and mainland China and highly profitable sales of residential units from its HarbourSide project in Hong Kong. Management indicated that fiscal 2010 earnings will exceed the record set in 2008, even without the sale of additional apartment units in Hong Kong.

In Shanghai, we toured the company's Plaza 66 shopping mall, the premier property of its kind in the mainland. This mall, along with its Grand Gateway property, which is also fully leased, drove rental income growth of 15%. Shanghai now accounts for 43% of the company's total rental revenues.

These strong results drove a 28% increase in the reported NAV of the parent company, Hang Lung Group Ltd ("Group"), whose common stock represents a 2.1% position in the Fund, to HK\$35.58 per share. Group's NAV has increased at a 21% CAGR over the last five years. This represents the highest net asset value growth rate among our major Hong Kong holdings, despite the use of

virtually no leverage, and is a tribute to Chairman Ronnie Chan's long-term vision and execution.



Hang Lung is well positioned to continue its rapid net asset value growth going forward, owing to its strong financial position and attractive land sites in the rapidly growing secondary cities in the mainland. These land sites were purchased opportunistically in recent years (no land was purchased when prices were high from 2007 through May 2009). Properties has a net cash position of HK\$2.2 billion, while Group's net debt-to-capital ratio is only 3.8%. In the next several years, Properties plans to open the following projects:

- 2010 – Palace 66, Shenyang; 1.2 million square foot (msf) shopping mall.
- 2011 – Parc 66, Jinan; 1.8 msf shopping mall.
- 2012 – Forum 66, Shenyang; 9.1 msf shopping mall, office, hotel, serviced apartments (in phases).
- 2013 – Centre 66, Wuxi; 4.1 msf, multi-complex (in phases).
- 2013 – Riverside 66, Tianjin; 1.7 msf shopping mall.
- 2014 – Olympia 66, Dalian; 2.4 msf shopping mall.

The opening of these projects is projected to increase Properties' rental turnover to more than HK\$8 billion from HK\$4.2 billion in 2009. The early results appear to

be promising, with Palace 66 in Shenyang scheduled to open the last week in June and already more than 90% pre-leased.

I shall write to you again after the July 31, 2010 quarter end.

Ian Lapey  
Co-Portfolio Manager  
Third Avenue Value Fund

## Third Avenue Small-Cap Value Fund



**CURTIS R. JENSEN**  
**CHIEF INVESTMENT OFFICER &**  
**PORTFOLIO MANAGER OF THIRD AVENUE**  
**SMALL-CAP VALUE FUND**

Dear Fellow Shareholders:

At April 30, 2010, the end of the Fund's fiscal second quarter, the unaudited net asset value attributable to the 64,781,275 common shares outstanding of the Third Avenue Small-Cap Value Fund Institutional Class Shares ("Small-Cap Value" or the "Fund") was \$19.41 per share, compared with the Fund's unaudited net asset value of \$17.62 per share at January 31, 2010, adjusted for a subsequent distribution, and an unaudited net asset value at April 30, 2009 of \$13.97 per share, adjusted for a subsequent distribution to shareholders. At May 14, 2010, the unaudited net asset value was \$18.54 per share.

### QUARTERLY ACTIVITY

During the quarter, Small-Cap Value established one new position, added to five of its existing positions and reduced its holdings in 16 companies. At April 30, 2010, Small-Cap Value held positions in 48 common stocks, the top 10 positions of which accounted for approximately 34% of the Fund's net assets.

### Number of Shares

136,624 shares

680 shares

50,000 shares

100,000 shares

75,000 shares

5,306 shares

### Number of Shares or Face Amount

36,000 shares

72,654 shares

489,440 shares

86,191 shares

7,500 shares

161,987 shares

8,555 shares

### New Position Acquired

Liberty Media Corp. –  
 Starz Common Stock  
 ("Starz Common")

### Increases in Existing Positions

Ackermans & van Haaren N.V.  
 Common Stock ("AvH Common")

HCC Insurance Holdings, Inc.  
 Common Stock ("HCC Common")

Investment Technology Group, Inc.  
 Common Stock ("ITG Common")

Viterra, Inc. Common Stock  
 ("Viterra Common")

Westlake Chemical Corp.  
 Common Stock ("Westlake Common")

### Positions Reduced

Alamo Group, Inc. Common Stock  
 ("Alamo Common")

Bristow Group, Inc. Common Stock  
 ("Bristow Common")

Brookfield Asset Management, Inc.  
 Common Stock ("Brookfield Common")

Cimarex Energy Co., Common  
 Stock ("Cimarex Common")

E-L Financial Group, Ltd.  
 Common Stock  
 ("E-L Financial Common")

Electro Scientific Industries Inc.  
 Common Stock ("ESI Common")

K-Swiss, Inc. Common Stock  
 ("K-Swiss Common")

\* Portfolio holdings are subject to change without notice. The following is a list of Third Avenue Small-Cap Value Fund's 10 largest issuers, and the percentage of the total net assets each represented, as of April 30, 2010: Lanxess AG, 3.99%; Sapporo Holdings, Ltd., 3.78%; Alexander & Baldwin, Inc., 3.73%; Parco Co., Ltd., 3.72%; Viterra, Inc., 3.67%; Synopsys, Inc., 3.13%; National Western Life Insurance Co., 3.10%; Tidewater, Inc., 3.09; Brookfield Asset Management, Inc., 2.90%; and Ackermans & van Haaren NV, 2.67%.

**Number of Shares  
or Face Amount****Positions Reduced**

135,271 shares	Lanxess AG Common Stock ("Lanxess Common")
\$28,760,000	MBIA Insurance Corp. Surplus Notes ("MBIA Notes")
17,152 shares	National Western Life Insurance Co. Common Stock ("NWLI Common")
29,588 shares	Park Electrochemical Corp. Common Stock ("Park Common")
25,000 shares	Pharmaceutical Product Development, Inc. Common Stock ("PPDI Common")
14,319 shares	Pioneer Drilling, Inc. Common Stock ("Pioneer Common")
575,149 shares	Tellabs, Inc. Common Stock ("Tellabs Common")
126,800 shares	Timberwest Forest Corp – Stapled Units ("Timberwest Units")
60,476 shares	Vail Resorts, Inc. Common Stock ("Vail Common")

**QUARTERLY ACTIVITY**

Fund Management's posture during the fiscal quarter ended April 30th can best be described as cautious, wary of the rapid and relentless appreciation generally characterizing small-capitalization stocks during recent periods<sup>1</sup>. We added a single new name to the portfolio (Liberty Media – Starz Common), initiated defensive put options on the Euro and trimmed several holdings, taking advantage of the significant market appreciation that pushed some of those issues into the range of fair value. Liberty Media Starz was created as a tracking stock in the wake of Liberty Media's split off of various of its media assets late in 2009. Starz provides premium movie services, distributing movie channels, including its Starz and Encore brands (with 17 million and 31 million subscribers, respectively), through cable operators,

telephone companies and satellite (DBS) services providers. In addition to its on-demand services, Starz has in recent years also been developing original content and in 2008 licensed its broadband service, "Starz Play," to Netflix. As a "wholesaler", Starz occupies an incumbent and seemingly difficult-to-replace middleman role between its affiliate customers such as Verizon, Comcast and DISH Network on the one hand, and content producers such as Disney and Sony with which it has longer-term contractual arrangements. Starz's new CEO, Chris Albrecht, spent more than 20 years building an enviable track record at HBO, and Starz continues to add to its management team post split-off. As of the end of March, Starz reported attributable cash and equivalents of nearly \$1 billion (representing approximately 37% of its market cap) with virtually no debt, affording the company ample financial flexibility to pursue multiple growth opportunities, including via:

- i) growth in subscribers/digital cable customers and effective price increases associated with new functionality (e.g., high definition) and CPI-based escalations within their contracts;
- ii) the creation of cost effective original content and programming; and
- iii) share repurchases at economically attractive levels.

Tracking stocks like Starz are generally established to reflect the economic performance of a particular business or group within a company. Such "trackers" often sell at a discount to intrinsic value, however, because shareholder voting rights and economics ultimately remain tied to the parent company. Boards of companies with tracking stocks can, for example, transfer assets and liabilities attributed to the company without shareholder approval. In this case that economic/governance risk appears to be mitigated by the favorable track record of Liberty's shareholder-oriented executive team, including that of Chairman John Malone.

<sup>1</sup> As of April 30, 2010, the Fund's 6.7% return was well behind small-cap benchmarks like the Russell 2000, which had a return of 14.5%.

In its current form, Starz appears to have reasonable growth prospects and enjoys many of the right ingredients with which it can develop its per share business value at attractive rates. However, it seems unlikely that the company will stay “as is” during the next three to four years given Malone & Co.’s track record of “resource conversion,” suggesting additional paths towards value creation. For example, were Starz spun off into its own legally separate company, it is quite likely that the current discount between the market price and the underlying business value would narrow considerably. The Fund’s cost basis, which equates to approximately five times EBITDA and ten times free cash flow, seems like a good starting point for this cash generative business with an accomplished leadership team.

The Fund currently owns shares of three European-based companies, two of which are headquartered in Germany and one in Belgium. In each case the companies do business globally, and are exposed to foreign exchange movements to varying degrees within their respective businesses. While the recent weakening of the euro against the U.S. dollar<sup>2</sup> can actually benefit these companies – where, for example, products or services are sold in dollar terms and those sales subsequently get translated at strengthening exchange rates back into euros – a weakening euro can, symmetrically, have a deleterious effect on U.S.-based investors with euro-denominated investments like the Fund. (Conversely, U.S. companies doing business in Europe with euro-based revenues will be hurt by the same movement in exchange rates.) Given the rapidly deteriorating fiscal conditions of select European Union members, a growing fear of sovereign debt defaults (e.g., Greece), and the adverse effects on the euro, Fund Management elected to buy a one-year and a two-year, out of the money put options on the euro as a relatively cheap insurance policy against a potentially draconian outcome for the European currency. (The Fund has approximately

30% of its assets in securities of companies domiciled outside of the United States, including in Canada, Japan and Europe. At present the Fund has currency hedges, in the form of put options, on the yen and the euro.)

The other activity of note during the quarter involved the disposition of a substantial portion of the Fund’s investment in MBIA Surplus Notes whose 40%+ increase in value during the period enabled the Fund to realize a modest profit (after including both paid and accrued interest.) The Fund’s investment in the MBIA Notes has been effectively resized to better reflect the potentially improving, but still difficult to handicap, outcomes that today are comprised of both a litigation as well as a credit element. (More comments on this investment can be found in the accompanying shareholder letter from sister fund, Third Avenue Value Fund.)

#### **CREDIT CRISIS REDUX AND THE THIRD AVENUE MAXIM**

As global investors discovered in recent weeks, not all the credit ghosts have been exorcised from the system. The European sovereign credit bomb, the fuse to which was lit by questions about Greek liquidity and solvency, reminds me of that period in 2008 leading up to the structured finance/leveraged finance credit crisis with, in this case, headlines predicting the imminent demise of the Euro zone, government officials fighting the public relations war (as opposed to solving the problems) and politicians pointing fingers at speculators (i.e., so-called “bond vigilantes”) and rating agencies (again). Predictably (see Mexico c. 1994, Korea c. 1997 and Russia c. 1998, among others), once the “rescue package” was organized and announced, equity markets heaved a collective sigh of relief and rallied furiously.

It would be easy to get swept away by such headlines and ignore the fact that capitalism, on a very long-term basis, and especially as practiced in the United States, has been

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<sup>2</sup> The euro/USD exchange rate peaked most recently on November 25, 2009, at 1.51. As of May 5th, the exchange rate has moved to 1.26, implying a nearly 17% drop in the value of the euro during that period. The Fund bought its put options in early March when the exchange rate was around 1.37.

remarkably resilient, surviving war, depression, inflation/stagflation, terrorism, social unrest and political upheaval. In fact, according to a study by Credit Suisse, “the very long-run trend of real equity returns is apparently around 6% to 6½% per year” reflecting a long-term equity premium of roughly 5% over treasury bills.<sup>3</sup> Unfortunately, the swings on either side of this long-term trend can not be ignored. A certain amount of volatility, like the kind the markets have experienced this year, is part and parcel of equity investing. At times like these it is critical to have an investing framework on which the investor can rely. Such is the case with Third Avenue’s “Safe and Cheap\*” philosophy, a philosophy grounded in risk aversion and price consciousness that has served investors well for decades, and one that is designed to preserve and grow capital over the long haul.

As we wrote to you about our investment philosophy almost two years ago, at the onset of the credit crisis, at Third Avenue, when considering a new investment, we are naturally defensive, skeptical and paranoid. Our due diligence process is extensive. We try to poke holes in our colleagues’ ideas. We talk to business people, not to Wall Street cheerleaders. We eschew the use of leverage in our own portfolios, as well as in the companies whose securities we are invested. We ask ourselves, “how can this business get hurt, and what can go wrong? What is our potential downside?” Given the recent market turbulence, it is worth reminding you, our partners and shareholders, about the central tenets of investing at Third Avenue:

**“When considering a new investment, we are naturally defensive, skeptical and paranoid. Our due diligence process is extensive. We try to poke holes in our colleagues’ ideas. We talk to business people, not to Wall Street cheerleaders.”**

- We do not borrow money in order to invest, or to boost our returns. In the presence of lots of leverage, even a small downward twitch in the associated asset value can wipe out the investor’s equity in a heartbeat;
- Part of our focus is on capital preservation. We invest in attractively-priced securities underpinned by conservatively financed and well-managed businesses;

- We expend little money or energy trying to avoid market risk (i.e., short-term market price fluctuations in our holdings), but we do spend an inordinate amount of time and energy trying to minimize investment risk (a loss of capital created by a permanent impairment of the business);

- We strive to share new developments in the Fund by writing these shareholder letters every quarter. We highlight new investments, dispositions and discuss both positive outcomes, as

well as mistakes, so that you know what you own and why;

- Our mutual funds provide shareholders with daily liquidity at readily ascertainable net asset values which, in the case of the Fund, rely upon publicly quoted stock prices;
- We are personally invested alongside of our shareholders, an investment made on the same terms as those available to you. In my case, that investment significantly increased at the beginning of this year (along with my personal investments in all of our sister funds).

<sup>3</sup> Credit Suisse Global Investment Returns Yearbook 2009.

\* “Safe” means the companies, in our judgment, have strong finances, competent management, and an understandable business. “Cheap” means that in our judgment, we can buy the securities for significantly less than what a private buyer might pay for control of the business.

Today's volatility, if it persists, will likely continue to set up some excellent long-term investment opportunities and we have already initiated new positions in the current quarter.

Supported by an outstanding team of colleagues, I look to the future with confidence. I look forward to writing you again when we publish our Third Quarter report dated July 31, 2010. Thank you for your continued loyalty and support.

Sincerely,

A handwritten signature in black ink that reads "Curtis R. Jensen". The signature is written in a cursive, flowing style.

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

## Third Avenue Real Estate Value Fund



**MICHAEL H. WINER**  
**PORTFOLIO MANAGER OF THIRD AVENUE**  
**REAL ESTATE VALUE FUND**

Dear Fellow Shareholders:

At April 30, 2010, the end of the second fiscal quarter of 2010, the unaudited net asset value attributable to the 73,402,729 shares outstanding of the Third Avenue Real Estate Value Fund Institutional Class Shares (the "Fund") was \$21.83 per share. This compares with an unaudited net asset value of \$19.44 per share at January 31, 2010, and an unaudited net asset value of \$14.66 per share at April 30, 2009, adjusted for subsequent distributions to shareholders. At May 14, 2010, the unaudited net asset value was \$20.96 per share.

### QUARTERLY ACTIVITY

The following summarizes the Fund's investment activity during the quarter:

**Principal Amount  
or Number of Shares**

1,043,576 shares

**New Positions Acquired**

Berkeley Group Holdings PLC  
Common Stock  
("Berkeley Common")

**Principal Amount,  
Number of Shares,  
Warrants or Contracts**

2,782,600 warrants

4,300 contracts written

6,250 contracts purchased

\$10,000,000

108,000 shares

10,884 shares

2,710,323 shares

21,000 shares

1,800,000 shares

51,729 shares

**New Positions Acquired (continued)**

Henderson Land Development Co. Ltd.  
Warrants ("Henderson Warrants")

Vornado Realty Trust September 2010  
\$90 Calls ("Vornado Calls")

Vornado Realty Trust June 2010  
\$75 Puts ("Vornado Puts")

**Increases in Existing Positions**

Alliance Bernstein Legacy Securities  
(C1) Fund L.P. Limited Partnership  
Interest ("Alliance Bernstein LP  
Interest")

Hysan Development Company Ltd.  
Common Stock ("Hysan Common")

NTT Urban Development Corp.  
Common Stock ("NTT Urban Common")

Songbird Estates PIC Common Stock  
("Songbird Common")

Sun Hung Kai Properties Ltd.  
Common Stock  
("Sun Hung Kai Common")

**Decreases in Existing Positions**

Forest City Enterprises, Inc. Class A  
Common Stock  
("Forest City Common")

Thomas Properties Group, Inc.  
Common Stock  
("Thomas Common")

\* Portfolio holdings are subject to change without notice. The following is a list of Third Avenue Real Estate Value Fund's 10 largest issuers, and the percentage of the total net assets each represented, as of April 30, 2010: Forest City Enterprises, Inc., 7.91%; Brookfield Asset Management, 5.75%; Henderson Land Development Co., Ltd., 5.48%; Vornado Realty Trust, 4.44%; Newhall Holding Co. LLC, 3.48%; Wheelock & Co., Ltd., 3.44%; Mitsubishi Estate Co., Ltd., 2.86%; Mitsui Fudosan Co., Ltd., 2.78%; Sun Hung Kai Properties, Ltd., 2.63%; and St. Joe Co., 2.51%.

<b>Principal Amount or Number of Shares</b>	<b>Decreases in Existing Positions</b>
685,000 shares	Wheelock & Company Ltd. Common Stock ("Wheelock Common")
	<b>Positions Eliminated</b>
\$16,500,000	Brandywine Operating Partnership 3.875% Convertible Senior Notes payable October 2011 ("Brandywine Senior Notes")
383,500 shares	Forest City Enterprises 7.375% Preferred Stock ("Forest City Preferred")
\$13,000,000	General Growth Properties Term Loan Tranche A due February 2010 ("General Growth Term Loan")
112,000 shares	RAIT Financial Trust 7.75% Series A Preferred Stock ("RAIT Series A Preferred")
82,400 shares	RAIT Financial Trust 8.375% Series B Preferred Stock ("RAIT Series B Preferred")

#### **DISCUSSION OF SIGNIFICANT QUARTERLY ACTIVITY**

During the quarter, the Fund established one new common stock position, eliminated two debt positions, resized several holdings for portfolio management reasons and utilized put and call options to create a "collar" for a core position.

The Fund established a new position in Berkeley Common. Berkeley is a U.K.-based real estate operating company focused on urban regeneration projects in London. Berkeley is headed by Chairman Tony Pidgley, who has a long track record of creating value for shareholders by opportunistically acquiring brownfield sites that are well-suited for redevelopment. Berkeley's business is focused on the central London market, where it owns and controls sites that can accommodate more than

30,000 residential units. With the well-documented shortage of housing in London and lack of new building activity, Berkeley's existing inventory and entitlements for future development should prove highly valuable over the long term. In the short term, any weakness in the U.K. property markets will create an opportunity for Berkeley to utilize its \$500 million net cash position to pick up additional sites at attractive prices.

The Fund eliminated General Growth Term Loan and Brandywine Senior Notes at prices in excess of par value. These securities were initially part of a basket of real estate debt securities that the Fund purchased in late 2008 and early 2009 with yields to maturity of 20% or better. With the dramatic re-pricing of real estate debt securities over the past year, the returns on these two positions far exceeded Fund Management's expectations – generating IRRs of 404% and 59%, respectively.

One of the Fund's long-time holdings, Vornado Realty Trust, is a U.S. REIT that owns a high-quality collection of properties in New York City and Washington, D.C. Vornado is run by Steve Roth and Mike Fasticelli, two managers that have a knack for making timely and profitable real estate investments. The Fund increased its position in Vornado Common in April 2009 by purchasing shares in the company's equity offering at a discount to net asset value (NAV). Since that time, Vornado's stock price has almost doubled and Vornado, like almost all U.S. REITs, is currently trading at a substantial premium to NAV. To protect the Fund in the event Vornado's stock price falls back in line with more traditional valuation metrics, the Fund sold "out of the money" covered call options on approximately one-half of its position, and used the proceeds to buy "out of the money" put options on approximately 70% of its position. If Vornado's stock price were to decline closer to NAV, the puts would become more valuable and offset the decline in Vornado's stock price. Meanwhile, the Fund remains a shareholder in this blue-chip real estate company.

Other portfolio activity during the quarter included funding an additional \$14 million towards the Fund's \$40 million commitment to Alliance Bernstein LP Interest and adding to the Fund's existing positions in Songbird Common, Hysan Common and Sun Hung Kai Common. The Fund also received a distribution of Henderson Warrants which will entitle the Fund to purchase additional shares of Henderson Common at any time prior to June 23, 2011 for HK\$58 per share. The Henderson Warrants are expected to begin trading on the Hong Kong exchange in June 2010. The Fund also resized its positions in Forest City Common, Thomas Common and Wheelock Common for portfolio management reasons. At quarter-end, the Fund had approximately 39% of its capital invested in North America (33% equity, 6% debt); 22% in Asia ex-Japan; 12% in the United Kingdom; 8% in Japan; and 19% in cash and equivalents.

#### **PORTFOLIO UPDATE**

The U.S. REIT Index has risen 165% since its market low on March 6, 2009, and 71.4% and 17.9% for the one year and four months ended April 30, 2010, respectively. The spectacular rally in U.S. REIT stocks seems unwarranted given that fundamentals for commercial real estate remain uncertain and U.S. REITs trade at more than 20 times free cash flow and a 25% premium to NAV. Fund Management believes that these uncertainties are not necessarily reflected in securities prices. Therefore, the Fund has continued to maintain a defensive position by concentrating its investments in common stocks of well-financed real estate companies trading at discounts to NAV and holding substantial cash reserves. In general (from a macro view), certain real estate markets seem expensive – in particular, the U.S., the U.K. and Europe. However, this does not mean that there is a lack of investment opportunities for the Fund. Rather, it warrants a cautious approach and strict adherence to fundamental, bottom-up analysis to identify bargains in global real estate securities as well as meaningful developments occurring at the “micro-level”. Below is a discussion of some of the

Fund's key holdings and factors impacting investments in each geographic area.

#### **North America**

Approximately one-third of the Fund's assets are invested in the common stocks of North American real estate companies. Core holdings include: U.S.-based Forest City Enterprises; Vornado; four land development companies; and its sole Canadian-based holding, Brookfield Asset Management.

Brookfield is an extremely well-managed asset management company with significant investments in real estate, power and infrastructure. Brookfield Common currently trades at a 15% discount to its stated NAV, which continues to grow as underlying cash flows increase and excess capital is allocated to value-enhancing investments alongside its partners. The company's most recent investments include (1) its participation in the reorganization of General Growth Properties (the largest U.S. real estate-related bankruptcy in history); and (2) completing the \$1.8 billion recapitalization of Babcock & Brown's infrastructure business (which resulted in Brookfield becoming one of the dominant investors in global infrastructure assets).

Forest City Common is the largest position in the Fund and represents one of the most compelling valuations for a U.S.-based real estate company. In 2009, due to the rapid decline in U.S. economic activity, Forest City was forced to raise equity at dilutive prices (the Fund participated in the equity raise) and right size its development pipeline. However, Forest City's long-term strategy of owning a diversified portfolio of high-quality, income-producing properties and financing its business almost exclusively with non-recourse mortgage debt has allowed it to emerge from the downturn with its portfolio and key development projects intact. Given the lack of construction activity in the U.S. (40 year lows), Forest City's well-located projects in key urban locations – such as New York City and

Washington, D.C. – should ultimately prove quite profitable.

While commercial real estate values have declined 40% from their peak in 2007, land values have declined even further. Public homebuilders with large land inventories were forced to sell off holdings at distressed prices to maintain liquidity. Other landowners with debt were wiped out in bankruptcy or through foreclosure. Land developers with little or no debt were able to withstand the downturn and are now positioned to take advantage of

what appears to be a resurgence in demand for residential lots. National homebuilders have resumed buying lots, and by some estimates, residential lot prices have increased by 30-40% in certain California and Florida markets as a result. Through its investments in Newhall Common, St. Joe Common, Tejon Ranch Common and Consolidated Tomoka Common, the Fund has a substantial stake in some of the most prime developable land parcels in Southern California and Florida-

both of which will continue to be high-growth markets in the future. Fund Management is especially optimistic about the activity surrounding St. Joe's land holdings in Northwest Florida. After a multi-year process, the Northwest Florida Beaches International Airport will open in Panama City in May 2010. This will be the first international airport to open in the U.S. in more than 10 years and will initially be served by Southwest and Delta. With connections to other major markets in the U.S., the airport should significantly boost commercial and leisure travel to the area. St. Joe wisely donated 4,000 acres for the new airport – as it owns nearly all of the land for miles surrounding the airport and 300,000 acres within a 40-mile drive.

#### **Asia ex-Japan**

Approximately 22% of the Fund's assets are invested in the common stocks of real estate operating companies based in Hong Kong (seven companies) and Singapore (one company). As noted in last quarter's Letter to Shareholders, the assets are heavily concentrated in Hong Kong, but with meaningful exposure to mainland China. Each company has a super strong financial position – Fund Management believes they are among the most well-capitalized real estate companies on a global basis. In some

cases, the companies are net cash (e.g., Hang Lung Properties). Recent corporate announcements by Henderson Land and Wheelock & Co. (two of the Fund's largest holdings in the region) could be catalysts that will help eliminate the material discrepancy between their current stock prices and underlying NAVs.

Henderson Land (Hong Kong listed) has substantial holdings in Hong Kong income-producing properties (office and retail), major real estate development

projects in Hong Kong and mainland China, and a 40% stake in separately-listed Hong Kong & China Gas, one of Asia's market-dominant and cash-generative gas producers. Henderson recently provided its shareholders with a supplement to its Annual Report that outlined the results of a property appraisal conducted by a globally-recognized and independent property valuation company. The appraisal was commissioned to improve transparency and assist shareholders in understanding the substantial hidden value in the company's portfolio. The appraisal highlighted a HK\$49 billion unrealized gain (after tax) on the company's real estate development projects and publicly-listed associates. Factoring this unrealized gain into the company's financial statements results in an adjusted book

**“Recent corporate announcements by Henderson Land and Wheelock & Co. (two of the Fund's largest holdings in the region) could be catalysts that will help eliminate the material discrepancy between their current stock prices and underlying NAVs.”**

value of approximately HK\$85 per share, compared to the current trading price of HK\$50 per share.

Wheelock & Co. (Hong Kong listed) owns a 43% stake in Wharf Holdings and a 74% stake in Wheelock Properties (each separately listed in Hong Kong). Wheelock's investment in Wharf accounts for a substantial portion of its overall value. Wharf owns Harbour Center and the Times Square properties in Hong Kong. These market dominant, mixed-use assets continue to report robust retail sales figures due to the influx of shoppers visiting from the mainland. During the quarter, Wheelock announced a take-over offer to the minority shareholders of Wheelock Properties. By acquiring 100% ownership of Wheelock Properties, the company would simplify its corporate structure, which may eliminate some of the "complexity discount" for its common stock. The Fund will also benefit from this transaction since Wheelock Properties Common was approximately a 1% position in the Fund (increasing to a 2.5% position at quarter-end after trading resumed). The offer price represents a 144% premium to the previous closing price and more than double the Fund's cost basis.

Given the Fund's material exposure to the Hong Kong and China property markets (through Hong Kong-based companies), we continue to closely monitor not only our portfolio companies but the region in general. Jason Wolf, senior analyst on the real estate team, and Ian Lapey, co-portfolio manager of Third Avenue Value Fund, recently traveled to Hong Kong and Shanghai where they met with company managements and visited properties. Based on their recent feedback, we remain very comfortable with these holdings.

### **United Kingdom**

Approximately 12% of the Fund is invested in the common stocks of U.K. companies that primarily own properties in London – a market that has its share of fundamental problems, but has recently been fueled by international capital investments in commercial and residential real estate. The bulk of that capital has been

invested in high-quality, central London commercial assets, driving up prices to reflect 5% yields (cap rates) for Class "A" assets. One of the Fund's holdings, Derwent London, a REIT that specializes in owning and redeveloping offices properties in the West End submarket, has exploited this recent influx of foreign capital by selling fully stabilized assets and reinvesting profits into its redevelopment pipeline. Derwent's management team has a long track record of creating value for shareholders by profitably repositioning assets.

As prices for high-quality properties are increasing, transaction volumes are also on the rise. By some estimates, residential and commercial transactions have increased by more than 80% over last year and are approaching 2007 levels. The increased transaction volume will undoubtedly benefit the Fund's investment in Savills, a property services firm with a dominant commercial and residential brokerage business in London. Savills entered the downturn in a net cash position (unlike the other global property service firms) and was able to retain its "rainmakers" in addition to adding some key producers to its team, while competitors were cutting staff to reduce costs. It is likely that, as transaction volumes rebound, Savills will gain market share in London and drive profits beyond previous levels. Savills' Common currently trades at an eight times multiple of peak earnings (adjusting for the Company's net cash position).

There has been a noticeable lack of building activity in the London office market and the last remaining large blocks of space (200,000 square feet or more) have been snapped up by tenants in recent months. As a result, new development activity is now being considered. But only a handful of companies have the resources and know-how to undertake a meaningful new project – one being Songbird Estates, a 2% holding in the Fund. Songbird owns a 70% controlling interest in Canary Wharf Group, which owns and manages 8 million square feet of prime office and retail space and has a development pipeline that could accommodate an additional 6 million square feet. Canary

Wharf is extremely well financed, with \$1.7 billion of cash reserves.

## **Japan**

Japanese real estate securities trade at the largest discounts to NAV relative to other developed regions. Notwithstanding the large discounts to NAV, the Fund only has 8% of its assets invested in the common stocks of Japanese real estate companies. Fund Management considers both quantitative and qualitative factors in the portfolio construction process. Strong balance sheets and discounted stock prices are clearly given substantial weight. However, corporate governance issues (e.g., general disregard for outside, passive minority shareholders) and a virtually non-existent M&A market are causes for an apprehensive approach to investing in Japan.

One development that may serve as a catalyst to close the gap between stock prices and NAV for Japanese property companies is the requirement that, commencing with the fiscal year ended March 31, 2010, companies must disclose in their financial results the fair market value of income producing property portfolios. Japanese generally accepted accounting principles (GAAP) requires assets to be carried at historical cost less accumulated depreciation (similar to U.S. GAAP), which often results in the stated “book value” being a fraction of true market value. This is particularly true for Japanese property companies that have low-cost, legacy land positions in central Tokyo. The new disclosure rules only require companies to report fair market value figures in the footnotes to the financial statements – unlike international financial reporting standards (IFRS) used by U.K. and Hong Kong companies, which require companies to report fair market value as “book value” and record changes in fair market value in the income statement. Daibiru Corp. (a 2% holding in the Fund) recently reported its year-end results and disclosed an unrealized gain on its leased property portfolio of Y97 billion, resulting in an adjusted book value of approximately Y1,400 per share. At quarter-end, Daibiru Common traded at Y902, a 36% discount to

adjusted book value. At December 31, 2009, Daibiru Common traded at Y666, a 52% discount to adjusted book value.

## **Cash Reserves**

At quarter-end, the Fund had approximately 19% of its assets in cash and equivalents. As highlighted in the most recent Letter to Shareholders, there is an opportunity cost associated with this cash balance since short-term cash yields are nearly zero. Nonetheless, Fund Management is unwilling to speculate and risk a permanent loss of capital by buying expensive securities in order to be fully invested. The Fund’s cash position will prove beneficial if there is an adverse movement in the markets. First, the Fund would have substantial “dry powder” to take advantage of opportunities to buy cheap securities when others may be forced sellers (e.g., the Fund invested heavily in performing debt securities in late 2008 and early 2009). Second, although the Fund has had positive inflows since last summer, the Fund would have adequate liquidity to meet any redemption requests without having to liquidate securities in a declining market.

Fund Management is confident that the Fund is properly positioned to take advantage of long-term economic growth in Asia, while being conservatively exposed to markets where securities prices have outpaced economic fundamentals or where growth prospects seem marginal. The portfolio is comprised of common stocks of extremely well-financed companies that Fund Management believes are the “best in class” global real estate companies and should continue to outperform their competitors over the long term.

I look forward to writing to you again when we publish our third quarter report for the period ended July 31, 2010.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael H. Winer". The signature is fluid and cursive, with a large initial "M" and "W".

Michael H. Winer  
Portfolio Manager

## Third Avenue International Value Fund



**AMIT B. WADHWANEY**  
**PORTFOLIO MANAGER OF THIRD**  
**AVENUE INTERNATIONAL VALUE FUND**

Dear Fellow Shareholders:

At April 30, 2010, the unaudited net asset value attributable to the 95,116,045 shares outstanding of the Third Avenue International Value Fund Institutional Class Shares (the "Fund") was \$15.58 per share, compared with the Fund's unaudited net asset value at January 31, 2010 of \$14.93 per share, and an unaudited net asset value of \$11.68 per share at April 30, 2009, adjusted for a subsequent distribution to shareholders. At May 14, 2010, the unaudited net asset value was \$14.74 per share.

### QUARTERLY ACTIVITY:

In the most recent quarter of operations, the Fund added to positions in the common stocks of 12 companies, eliminated two positions and reduced its holdings in the common stock of one company.

Number of Shares	Increases in Existing Positions
52,666 shares	Allianz SE Common Stock ("Allianz Common")
148,698 shares	Alma Media Corp. Common Stock ("Alma Common")

Number of Shares	Increases in Existing Positions (continued)
157,100 shares	Antarchile S.A. Common Stock ("Antarchile Common")
182,908 shares	Cenovus Energy, Inc. Common Stock ("Cenovus Common")
235,630 shares	EnCana Corporation Common Stock ("EnCana Common")
14,118 shares	GlaxoSmithKline PLC Common Stock ("GSK Common")
142,443 shares	L. E. Lundbergforetagen AB Common Stock ("Lundbergs Common")
264,000 shares	Mitsui Fudosan Co., Ltd. Common Stock ("Mitsui Fudosan Common")
21,381 shares	Münchener Rückversicherungs-Gesellschaft AG Common Stock ("Munich Re Common")
13,226,275 shares	Resolution Limited Common Stock ("Resolution Common")
6,424,441 shares	Rubicon Limited Common Stock ("Rubicon Common")
1,846,471 shares	WBL Corporation Limited Common Stock ("WBL Common")

Principal Amount or Number of Shares	Positions Eliminated
1,397,603 shares	Montpelier Re Holdings Ltd. Common Stock ("Montpelier Re Common")
\$2,401,000	WBL Corporation Limited 2.5% Convertible Bonds due June 2014 ("WBL Converts")
Number of Shares	Decrease in Existing Position
11,599,707 shares	Brit Insurance Holdings NV Common Stock ("Brit Common")

\* Portfolio holdings are subject to change without notice. The following is a list of Third Avenue International Value Fund's 10 largest issuers, and the percentage of the total net assets each represented, as of April 30, 2010: WBL Corp., Ltd., 8.89%; Netia S.A., 5.55%; Vitera, 5.13%; United Microelectronics Corp., 2.88%; Mitsui Fudosan Co., Ltd., 2.73%; Yuanta Financial Holding Co., Ltd., 2.72%; Allianz SE, 2.70%; Guoco Group, Ltd., 2.67%; Compagnie Nationale A Portefeuille, 2.66%; and Asatsu-DK, Inc., 2.57%.

## REVIEW OF QUARTERLY ACTIVITY

Throughout the quarter we increased existing positions when we were able to find attractive pricing. We did not initiate any new positions during the quarter. Two positions were eliminated, one in name only as the underlying shares of WBL Converts were converted into WBL common stock.

The other investment which was disposed of during this quarter, Montpelier Re Common, was first purchased in late 2007 during the early stages of the financial crisis. The thesis underlying this investment was that, as a sensibly run reinsurer operating in a period of declining pricing, the company would reduce its underwriting volume, thereby augmenting the portion of its capital that would be reasonably deemed to be in excess of its underwriting needs. This would allow the company to engage in a variety of shareholder friendly actions, such as holding the capital for a rainy day when an industry loss event (or events) would allow the company to deploy this capital in a more attractive underwriting environment. Alternatively, some of this excess capital could be returned to shareholders through a cash return of capital or a stock repurchase.

The company took the second path and repurchased roughly 14.4 million shares in 2008 and 2009 (14.5% of 2007 year-end shares outstanding). Regarding the underwriting operations, 2009 was an unusually benign year for weather-related loss events, which allowed the company to do so well, in fact, that the year's performance appeared to be an outlier even when accounting for the sensitivity of its results to weather conditions. Such an outcome almost seemed to be "as good as it gets," especially in light of the renewed weakening in rates and the low likelihood of persistently favorable underwriting conditions. The combination of the insured losses since year-end from the Chilean earthquake, the winter storm Xynthia in Europe, and most recently the drilling rig disaster in the Gulf of Mexico appear to be highlighting how atypically favorable the year 2009 had been.

Our investment thesis having played out as expected, these considerations contributed to our decision to close the book on this particular investment – a profitable one – in the context of the Fund's continued investments in other well-capitalized reinsurance businesses (most notably, that of Munich Re).

## RELATIVE STRENGTH MATTERS

A cornerstone of the Fund's investment approach is the avoidance of any manner of risk by which we are exposed to the possibility of permanent impairment of the value of the businesses we own. As a result we prefer investing in financially strong companies which have a relative absence of liabilities, both on and off the balance sheet. Our evaluation of a company's financial strength does not follow a mechanical, check-the-box process which relies, for example, on hard and fast, reported statistics meeting predetermined benchmarks. Instead, we try to think beyond the disclosed numbers and understand the environment in which the company operates and its dynamics. Very often, this leads us to consider matters of relative financial strength, with an eye toward evaluating a company's financial position in the context of its industry and competitors.

Considering matters of relative strength has at times enabled us to identify and sidestep potential risks which might have been otherwise overlooked, had we merely examined an individual company's financial position in isolation and based upon it meeting objective, statistical criteria. For example, consider a situation in which a number of companies within a given industry boast uniformly strong balance sheets. While a cursory evaluation of the financial strength of any one of these companies, in isolation, would likely provide comfort in the form of a perceived lack of financial risk, this perception could ultimately prove misguided. This is because such an approach fails to consider the fact that a company's financial position is dynamic, and could change meaningfully over time due to a number of reasons,

including conditions faced by competitors and the industry as a whole.

Returning to our example of a uniformly well-financed industry, there is a less than obvious danger that, for example, such widespread financial strength may lay the foundation for a price war, which could break out and continue until all of the participants wreck their once strong financial positions. We do not need to look back far for an example, as such a scenario played out in 2007 in the Dynamic Random Access Memory industry (DRAM)

where, after a few years of unusually high profits, many manufacturers boasted strong cash positions and minimal debt. When examined separately, they seemingly displayed more than adequate financial strength; however, when considered in light of the industry structure and dynamics, a more worrisome picture emerged. The DRAM industry is highly cyclical; in downturns, producers do not curtail production until prices fall below variable cash cost (and sometimes not even at that point).

We feared that the abundant financial resources of the industry would be used to fund high and persistent cash losses in the next downturn, and that the benefit of strong balance sheets would accrue to customers rather than to shareholders as DRAM manufacturers undercut each other. This has, indeed, turned out to be the outcome, as the DRAM industry experienced one of the longest and most severe slumps in its history. Those companies that survived the downturn have destroyed much of their previous, absolute financial strength along the way.

The converse of the situation highlighted above can also be true: even a less than stellar financial position, on an absolute basis, can be more than adequate in an industry in which other participants are much weaker. As an

example, consider the North American building products distribution industry, a highly fragmented field where a significant portion of industry capacity comes from small operators which are usually overleveraged and financed by bank loans. Our investment in this industry, a New Zealand-domiciled company called Tenon, has a balance sheet that we would not characterize as pristine; but its obligations are far from onerous, unlike those of many of its peers. During the current downturn in the North American homebuilding industry, as more stressed

competitors have been preoccupied with their fight for survival, Tenon has been able to expand market share, capture attractive customer relationships with the likes of the nationwide Lowe's chain, and continue to increase the long-term value of its business.

At the risk of generalizing, we are wary of industries where balance sheets look uniformly good across the board, especially if the industry is subject to cyclical swings and has a low variable cost structure.

Conversely, industries with a wide

dispersion of financial quality among its various players can provide interesting opportunities for the financially stronger participants; excess capacity can be removed quickly and without extreme pain. The "last man standing" in such a fight does not have to be super strong, and the injuries inflicted on him by weak adversaries should heal quickly.

Furthermore, the discrepancy in financial strength among an industry's players may offer attractive acquisition opportunities. Companies with weaker balance sheets could be faced with a stark choice between bankruptcy and a distressed sale of assets to better financed competitors. One of our portfolio companies, Seino Holdings of Japan, took advantage of the difficult economic environment in

**“Industries with a wide dispersion of financial quality among its various players can provide interesting opportunities for the financially stronger participants; excess capacity can be removed quickly and without extreme pain.”**

early 2009 to acquire a competitor, Seibu Transportation, from a highly motivated seller – a holding company that had been delisted, taken over, and reorganized by private equity investors. Not surprisingly, there were not many bidders willing and able to finance an offer for a Japanese trucking company in the middle of the deepest Japanese recession in decades. Seino's cash pile enabled it to purchase Seibu Transportation at a very attractive standalone valuation, even without accounting for any cost synergies coming from consolidation of their overlapping networks. Seino provides an example of why we tend to be attracted to companies which are financially strong relative to their competitors – specifically, because such relative strength can potentially empower and enable a company to take actions which lead to an industry's rationalization, whether by improving efficiency through the wringing out of excess capacity, by encouraging more rational pricing, or through any other form, with these benefits ultimately accruing to shareholders.

Relative financial strength is not a static indicator. Companies with good track records on execution, but hampered by their lack of financial strength, may be able to improve their balance sheets with a timely capital raising, whether by private placement, rights issue, or other forms. This capital can then be used to acquire distressed or undervalued assets and drive industry consolidation, with such a company ideally benefitting both from cost synergies (from eliminating duplicate costs and assets) and from improved industry dynamics as the number of competitors declines (especially as distressed competitors often underprice their products in a desperate attempt to generate cash and stave off bankruptcy). We have been willing to back a company's efforts to raise capital to be used for such purposes, so long as we are satisfied with management's track record and the opportunity is compelling.

We have in the past supported companies in our portfolio when they made a compelling case for a capital raising in order to acquire weaker competitors. Such was the case

with Viterra Inc. (then called Saskatchewan Wheat Pool Inc.) when it announced its bid for Agricore United in November 2006. We participated in a private placement that was used to raise part of the acquisition funding. We expect that further such opportunities will arise, and we have sufficient cash in the portfolio to fund reasonably-sized capital raisings. Obviously, we cannot forecast the timing, size, and actual participants in such offerings, but would not be surprised to see resource conversion activities in North American building products and distribution industries, in U.K. life insurance, and in Australian agricultural supply chains, among others.

#### **GEOGRAPHICAL DISTRIBUTION OF INVESTMENTS**

At the end of April 2010, the geographical distribution of equity securities held by the Fund was as follows:

	%
Canada	11.43
Japan	11.37
Singapore	9.51
United States	5.86
Taiwan	5.60
Poland	5.55
Germany	5.22
Hong Kong	5.16
United Kingdom	4.87
New Zealand	2.89
Finland	2.82
Belgium	2.66
South Korea	2.49
France	2.37
Chile	2.34
Austria	1.79
Sweden	1.62
Denmark	0.96
Securities—total	<u>84.51</u>
Cash & Other	<u>15.49</u>
Total	<u><u>100.00</u></u>

*Portfolio holdings are subject to change without notice.*

Note that the table above should be viewed as an *ex-post* listing of where our investments reside, period. As we note in this and 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.

I look forward to writing to you again when we publish our next quarterly report for the period ended July 31, 2010.

Sincerely,

A handwritten signature in black ink, appearing to read 'Amit Wadhwaney', with a stylized flourish at the end.

Amit Wadhwaney  
Portfolio Manager,  
Third Avenue International Value Fund

## Third Avenue Focused Credit Fund



**JEFF GARY**  
PORTFOLIO MANAGER OF THIRD AVENUE  
FOCUSED CREDIT FUND

Dear Fellow Shareholders:

Thank you for your continued interest in the Third Avenue Focused Credit Fund (the “Fund”). This has been another eventful quarter – both in terms of the credit markets and activity in the Fund. While markets such as these require caution, the Fund has benefitted from recent volatility and we are pleased to report that the Fund delivered strong absolute and relative returns for the fiscal quarter ended April 30th, and bested the returns of 73% of the high-yield mutual funds tracked by Morningstar<sup>1</sup> for the period. The Fund’s assets grew from \$545 million as of January 31, 2010 to \$795 million as of April 30, 2010, due to continued inflows and the appreciation of the portfolio.

### QUARTERLY ACTIVITY\*

The following is a summary of issuers in which the Fund made significant purchases or sales during the quarter.

#### Significant New Positions Acquired

ATP Oil & Gas  
Ainsworth Lumber

Aveos Aerospace  
CF Industries  
Chaparral Energy  
Crosstex Energy  
Denbury Energy  
Frontier Communications  
International Coal  
Stallion Oil

#### Significant Increases in Existing Positions

Cengage Learning/TL Acquisitions  
CIT Group  
Clear Channel  
Harrah’s Entertainment  
HCA  
Hertz Corp  
Lyondell  
Nuveen Investments  
Tronox Corp

#### Position Significantly Decreased

Blockbuster

#### Positions Eliminated

Antero Resources  
ATP Oil & Gas  
Clearwire Corp  
Crosstex Energy  
Culligan Corp.  
Hercules Offshore Energy  
Terra Industries

While we do not attempt to time the market, we will take profits when security prices offer less upside versus the downside risk. Accordingly, we took some profits in April and early May, as we became increasingly concerned about the macro risks concerning Greece and the European Union (as we discuss later).

<sup>1</sup> Data according to Morningstar, for the 565 mutual funds included in the High-Yield Bond category.

\* Portfolio holdings are subject to change without notice. The following is a list of Third Avenue Focused Credit Fund’s 10 largest issuers, as of April 30, 2010: CIT Group Inc., 4.14%; Swift Transportation, 3.39%; Lyondell Chemical Company, 3.14%; Hertz Corp., 3.05%; Aveos, 2.85%; Energy XXI Gulf Coast Inc., 2.66%; FMG Finance Ltd., 2.65%; Stallion Oilfield Holdings, Ltd., 2.61%; HCA Inc., 2.36%; and GMAC Inc., 2.33%.

As the market rallied throughout the quarter, we were able to invest in several high quality companies that had less leverage, such that they could better weather any economic slowdown we may encounter. Several of these companies included CF Industries, Consol Energy, CCO and Frontier Communications, all of which have public equity market caps of several billion dollars. The Fund does not own the debt of any companies located in Europe, primarily because we are concerned over the slower growth outlook for the Eurozone, but also because there are plenty of attractive opportunities in the U.S. and Canada.

Positive performance in the recent quarter can be partially attributed to solid returns from CIT, Capmark, Swift, DAE Aviation, Marsico, Connacher, Harrah's, Aveos, Tronox, Ainsworth and Clear Channel. We had a few securities that underperformed the index, even though they posted positive returns. These included Blockbuster, Trico Marine, Stallion Oil and TXU. We were also underweighted to the financial sector, which performed well.

#### PORTFOLIO COMPOSITION

The following is a summary of how the portfolio was positioned as of April 30, 2010.

#### TOP 10 ISSUERS

	4/30/2010	1/31/2010
CIT Group	4.1%	3.0%
Swift Transportation	3.4%	4.2%
Lyondell Chemicals	3.3%	2.9%
Hertz Corp	3.0%	1.8%
Aveos	2.9%	0.1%
Energy XXI	2.7%	3.8%
Fortescue/FMG	2.7%	2.7%
Stallion Oilfield	2.6%	0.1%
HCA, Inc.	2.4%	1.4%
GMAC	2.3%	1.5%

The Fund also benefited from the appreciation of some of our CCC rated bonds, which have been outperforming for nearly a year. The two primary drivers for the outperformance in CCC rated bonds are:

- 1) Better than expected economic data has made investors feel more comfortable with riskier assets.
- 2) The robust credit and equity markets. At first, it enables lower rated companies to refinance loans and extend maturities which significantly reduced default risk and rates. Some companies have been able to access the equity market to pay down debt. There have been several instances, such as NXP and Freescale, where a company's bonds were trading at a meaningful discount to par at the time the company announced its IPO. While many of these are still in process, the bond prices of these companies increased multiple points on the date they announced plans to do an IPO.

#### PORTFOLIO BREAKDOWN – BY INVESTMENT CATEGORY

Performing Bonds	38%
Performing Loans	4%
Stressed/Distressed Performing	32%
Capital Infusions/Debt-for-Equity Restructurings	14%
Cash	12%
<b>Total Portfolio</b>	<b><u>100%</u></b>

**PORTFOLIO SORTED BY SECURITY TYPE**

	<u>4/30/2010</u>	<u>1/31/2010</u>	<u>10/31/2009</u>
First Lien Secured Bonds	7%	14%	11%
Second Lien Secured Bonds	20%	13%	6%
Unsecured High-Yield Bonds	35%	31%	32%
First Lien Secured Loans	23%	25%	23%
Post-Reorganization Equities (1)	<u>3%</u>	<u>0%</u>	<u>0%</u>
Total Invested	88%	83%	72%
Cash	<u>12%</u>	<u>17%</u>	<u>28%</u>
Total Portfolio	<u>100%</u>	<u>100%</u>	<u>100%</u>

(1) These are equities the Fund received in exchange for debt positions in certain companies

What follows is a discussion of three fund investments, each representing a different spot on the credit continuum.

**Terra Industries – Performing Credit**

Terra Industries is a large publicly held nitrogen fertilizer company. In 2009, rival CF Industries made a hostile bid to takeover Terra. In response, Terra issued \$600 million in high-yield bonds in the fourth quarter of 2009 in order to fund a special dividend to its shareholders. We had been looking for an investment opportunity in the fertilizer industry, as one of our analysts was in the midst of an exhaustive analysis of the industry in connection with the purchase of a fertilizer stock for a sister Third Avenue fund. Terra is a high quality company with low debt levels. The bond issuance and potential takeover by CF Industries both represented catalysts that could drive the investment higher.

In analyzing the covenants of the Terra high-yield bond deal, we figured out that if CF Industries did buy Terra, CF would most likely have to tender for these bonds at a big premium. We bought bonds in the new issue deal and

added to the position after they started trading. Terra successfully fended off CF in late 2009. During the market selloff in January, the bonds became available near the new issue price and we doubled our position size to 2% of assets under management. A month later, Yara, a Norwegian fertilizer company, made a takeover bid for Terra and Terra agreed (maybe it had something to do with management keeping their jobs ....). CF subsequently made a higher offer and won the bidding for Terra. As we expected, CF needed to tender for Terra's bonds and we received a price of 121% of par.

Interestingly, after Terra accepted CF's bid, we were contacted to participate in a bridge financing to fund CF's takeover of Terra. We bought into this financing and we received a very solid return. In addition, when CF came to the high-yield market to sell a new high-yield issue to repay the bridge financing, we received a higher allocation on the new issue because we had bought the bridge financing.

**Clear Channel Communications – Distressed Credit**

Clear Channel Communications, Inc. is a global media and entertainment company composed of two primary businesses – radio and outdoor advertising. The radio business is the world's largest radio broadcaster, with approximately 894 stations, including 149 operating in the largest 25 markets. The outdoor business operates in the U.S. and internationally, with approximately 834,000 displays (approximately 30% in the Americas segment).

We initiated an investment in the Guaranteed Notes due 2016 with an interest rate of 11% (or 11.75% PIK) to capitalize on a value proposition in a cyclical downturn. The company's securities declined dramatically in 2009 as advertising revenues throughout the broadcasting industry collapsed. During 2009 leverage rose dramatically and exposed Clear Channel to the possibility of covenant violation of its senior secured credit facility and possible bankruptcy. We came to the conclusion that the company was experiencing a cyclical and not secular downturn, and that it had several options to boost liquidity and remain in covenant compliance.

Clear Channel's publicly-traded outdoor media subsidiary issued \$2.5 billion of notes to reduce the parent company's credit facility and provide breathing room from the restrictive covenant. Additionally, the company has begun to see the fruits of its bold cost-cutting measures in boosted margins, and stands to benefit from a recovery in the top-line. First quarter results showed recovery in both the radio and outdoor businesses, and the trends appear strong for the rest of the year. Clear Channel has been aggressively buying back the PIK notes in the market at a discount to face value and has reduced the amount outstanding by 50%.

We believe that the company has generated adequate liquidity to allow recovery in the underlying business, which will lead to increased profitability and decreased leverage.

#### **Aveos Fleet Performance – Debt-for-Equity Restructuring**

Aveos is a leading independent, full service maintenance, repair and overhaul ("MRO") provider to the commercial airline industry in the Americas, formed in 1937 as the in-house maintenance division of Air Canada. Aveos separated from Air Canada in September 2004 and three years ago acquired 80% of El Salvador-based Aeroman, the leading narrow body MRO provider in Central America.

We initiated an investment in the pre-restructuring first lien bank debt, with an average price in the 40s, at approximately four times latest twelve months cash flow (EBITDA), which is a significant discount to where comparable companies trade. The bank debt was trading at such distressed levels because of the challenging outlook for the aerospace industry, operational risks associated with Air Canada, and Aveos' over-levered capital structure. We believe that the value of Aeroman covers most of our cost basis, providing us a cheap option on the Canadian operations. Since our investment, the company has completed an out-of-court restructuring, where the company reduced its debt load from \$800 million to approximately \$200 million, leaving it much better capitalized to reinvest in the business. As part of this

negotiation, Air Canada received 17.5% of the new equity in Aveos and has a Board seat, which we view as favorable to Aveos' future success.

Aveos continues to perform well despite the challenges in the commercial airline industry. We continue to believe that market prices undervalue the intrinsic value of the company. The new equity owners have installed a high quality Board of Directors to help management steer its improvement. As a result of the restructuring, Third Avenue currently owns approximately 10% of the stock of Aveos.

#### **BOTTOM-UP INVESTING IN TURBULENT MARKETS**

Our strategy is to use in-depth bottom-up research to find undervalued securities backed by assets that can protect us in case something goes wrong. We seek strong credits with catalysts and invest in performing loans, distressed loans, and debt for equity restructurings. We also analyze the larger economy because companies with levered balance sheets can be more vulnerable to macroeconomic issues.

In the first quarter of 2010 credit markets experienced extreme volatility as Greece could potentially have defaulted on its debt without assistance from the European Union ("EU"). The E.U.'s response, a \$1 trillion Stabilization Plan that brings the Eurozone into uncharted territory, was announced after the quarter ended but will have a long and pronounced impact on the global debt markets. Given the recent news from Europe we want to share some of our thoughts on several short term drivers for the credit markets, as well as some long-term hindrances to growth.

#### **Positive Drivers**

- Economic recovery has been gaining momentum
- Earnings have been strong
  - Through early May, nearly 80% of the S&P 500 companies have beaten their estimates – the highest percentage since the first quarter of 2004.

- Many companies extended their debt maturities and/or paid down debt with equity offerings
- Liquidity has been ample, especially with the stimulus plans from many countries
- Housing appears to have stabilized
- Developing countries have posted strong growth
- Lack of a material amount of distressed selling of residential or commercial real estate which many had feared
- Extremely low interest rates on a worldwide basis
  - This has enabled many companies to reduce their interest expense with LIBOR near zero

#### Headwinds

- Extremely high debt levels and sizeable budget deficits for many countries across the globe means higher sovereign debt risk worldwide
  - Includes almost every state and municipality in the United States.
- Higher taxes and/or reduced spending by governments will likely result in slower growth
- The continued need by governments, financial institutions and consumers to deleverage
- New regulations and increased enforcement
- Aging populations in many countries
  - Increased funding needs for off-balance sheet liabilities including health care, pensions, Social Security, etc.,
- The eventual need for the U.S., U.K., Europe, China and others to wind down their stimulus plans

Chairman Ben Bernanke recently reiterated the Federal Reserve's view that it intends to keep an accommodative monetary stance and plans to maintain short-term interest rates low for the foreseeable future. Europe is also likely to maintain low short-term interest rates possibly even longer

than the U.S. This is a result of their recent Stabilization Plan and the potential for slower growth given all of the austerity measures (i.e., substantial spending cuts) the PIIGS (i.e., Portugal, Italy, Ireland, Greece and Spain) countries need to implement to cut their deficits. Continued low rates could bring money off of the sidelines and into the capital markets.

Not many people can pay for their retirement with a zero percent interest rate on their money market accounts. This has incentivized investors to move hundreds of billions of dollars from money market accounts primarily into fixed income, commodities and international equities. Nevertheless, there remains nearly \$2.75 trillion in money market assets which is still above the long-term average. If investors begin to believe that Europe has delayed its problems they may start to feel brave again. This could continue to drive the solid flows into Fixed Income and Credit securities.

One of the key risks that concerns us is what we refer to as the Debt Supercycle. The concept is that each successive round of government intervention that we have had in more recent history simply sets the stage for even greater excesses down the road. As a result, there is an incentive for authorities to borrow and/or print money to reflate the economy each time economic and financial problems breakout. This, in turn, encourages an additional build up of debt in the economy as politicians seek to kick their problems down the road. An indication that the endgame may be in sight is when it becomes more difficult for the governmental bodies to borrow. The enormous response during the recent credit crisis and now for the Eurozone suggests we may be getting closer to seeing the limitations on worldwide debt levels. We see this as an issue in the U.S., U.K., PIIGS and other countries in addition to many state and local governments in the U.S. As a result, the "margin for error" for many countries is very thin.

If financing remains available and the world economy continues to improve, there's the possibility that Bernanke could find himself raising short-term interest rates earlier

and more quickly than he anticipated. We do know that the Fed has nowhere to go but up so the Fund will eventually have to operate in a rising rate environment. As rates rise in the U.S. they will likely rise in Europe too. We believe this will ultimately be good for our investors because:

- Approximately 23% of the Fund is invested in bank loans which have interest rates that float with LIBOR. Therefore, if LIBOR rates rise, the interest rate on these loans will also increase.
- It is not only the absolute market spread to Treasuries (i.e., the risk free rate) that is relevant but also the ratio of spreads to Treasury rates. We refer to this as the “bang for the buck” an investor gets for moving from a risk free investment to a more risky investment. While not at its all time high, the ratio of high-yield spreads to comparable risk free rates is well above the long-term average.

- According to a JPMorgan Chase study, returns for high-yield bonds tend to exceed those of investment grade bonds during time periods when interest rates increased by 100 basis points or more.

Once again, thank you for your continued interest in the Third Avenue Focused Credit Fund. We promise to continue to work diligently to outperform and add value to the capital you have entrusted to us. As we have said before, the investment team is invested right along side you, so our interests are aligned.

Sincerely,



Jeff Gary  
Portfolio Manager,  
Third Avenue Focused Credit Fund

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