Black Mesa Capital
A LIMITED LIABILITY COMPANY

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Much has happened since the end of July and we have taken a pause from the hectic activities of this past week to write this letter to update all of our investors.

First of all, the fund is down approximately 7.5% net, for the month of August, through August 7. We are likely to be down more by the time you read this letter, perhaps as much as 10% MTD. We have worked overtime to understand the causes of these losses and, as a result of these analyses, began delevering our portfolio (already delevered from 3.5x per side to 2.75x per side in July) starting on Monday, August 6. Since then we have continued to liquidate positions and, as you read this, the portfolio is somewhere between 0.5x and 0x levered, i.e. between 50% and 100% in cash.

These are unprecedented actions on Black Mesa's part, but they are a response to unprecedented market events. In brief, we believe a very large (or several very large) trading entities, possibly very large hedge funds or investment banks or both, are liquidating massive market-neutral portfolios. Since Black Mesa generally attempts to make money by intercepting cash flows moving from securities of lesser value to those of higher value, investment flows that ignore security-specific value, such as broad liquidations to meet margin calls, can cause losses to Black Mesa's portfolio. In effect, Black Mesa bets on market participants making historically-precedented, value-oriented security selections. We are therefore susceptible to high or sustained levels of market activity that run contrary to such selections.

So, too, are other market-neutral funds who bet on fundamental factors or on mean reversion of one type or another. From speaking with our colleagues and large allocators in the market-neutral space, we understand that many market-neutral funds have suffered 5-to-15% losses so far in August. We have communicated with several market-neutral funds directly, some of which are long-existing and quite large, and many report having experienced multiple and significant down days in the past two weeks. Clearly, something is amiss in the markets that few in our strategy, if anyone, have experienced before.

For Black Mesa, the first clues came on the afternoon of Wednesday, July 25 when, using proprietary tools, we detected an intraday pattern of liquidation. This continued very consistently through the next day and into Friday morning when we detected a pause in activity. However, major liquidation resumed late Friday afternoon. During this three day period, Black Mesa suffered its largest losing day ever (on Friday) of 3.0%, our largest two-day loss of 4.2%, and its second worst peak-to-trough drawdown of 5.4%.

Starting that Friday and continuing through the weekend, we analyzed the losses (as reported extensively in our July 30 letter to investors). To summarize, the losses were found not to be attributable to common market risks, such as the BARRA factors (actually slightly positive), industry factors (neutral) or to an unknown factor lurking in our residual (reassuringly small), or to execution or risk constraint issues. The losses were in our proprietary factors or, in other words, attributable to risks to which we deliberately expose ourselves.

In the past, gains to these factors have been generally quite strong and consistent over time and losses have been brief and strongly reversionary. The most recent comparable instance was on September 15, 2006 when we experienced similar losses to these factors followed by a sharp rebound within two weeks. As we learned only on Monday, September 18, that previous Friday, September 15, Amaranth had likely liquidated most of its large market-neutral equity book to meet margin calls in its energy trading. Black Mesa's attribution analysis for that liquidation closely match what we saw when we analyzed the market activity and portfolio results of Wednesday through Friday, July 25-27, 2007. On Sunday night, July 29, we concluded that, ***if*** the entity(ies) that had liquidated the previous week were done, our portfolio would begin to revert to profitability as soon as Monday. That's exactly what happened; Monday and Tuesday demonstrated strong positive return attributions to the same factors that had backed-up the week before.

But, in hindsight, we can see that Monday and Tuesday was a "head-fake." Either the original liquidators had just paused, and/or others had begun to liquidate their market-neutral books on Wednesday August 1. Starting that day and through yesterday, August 7, we have detected continued signs of liquidation that match those of the Amaranth liquidation and of the July 25-27th liquidations. By Friday, August 3, there seemed to be no abatement in the liquidations and over the weekend, we confirmed with other market-neutral managers that they were suffering similar losses. We discussed internally the possibility that these already unprecedented levels of liquidations could continue even further. We also discussed how others in the market-neutral space, learning as we had of these liquidations and also losing money, could begin to delever their own books in response. There was (and is) the possibility that, as great as liquidations had been so far, that it was just the beginning of a spiral of me-too liquidations. The question was, when will it end?

The answer is, we don't know. It could last another two days, two weeks, two months, or two quarters. On the one hand, by delevering we could miss the opportunity for profits associated with a large reversion when the liquidations stop. On the other hand, if liquidations were to continue we would pretty much be assured of continuing losses for whatever period they persisted. Our decision was to let our fear overrule our greed and start a move to the sidelines. Since Monday, August 6, we have been steadily delevering our portfolios and expect to be well below 1x today, August 8. We have done our best to delever our funds and managed accounts down on a *pari passu* basis.

In this relatively rapid liquidation process we have had to consider the trade offs between statistical confidence in our analyses, speed, costs, and operational considerations. Our losses on the losing days since July 25th have averaged 1%. We estimate the incremental costs of liquidating our portfolio at an accelerated (and possibly suboptimal) rate to be about 50 basis points. While this is clearly only a minute fraction of the cost of waiting through an additional day of portfolio losses, one also has to consider the costs of rebuilding the portfolio when the markets return to "normal." Between our point of conviction on Sunday, August 5 and delevering to near zero on August 8, we moved as quickly as we believe was possible while still paying prudent attention to our own confidence levels, operational factors and costs. Should we have delevered sooner? In hindsight, yes. Could we have delevered sooner given the rapidity at which we could analyze and act on the data in real-time? We don't think so. Irregardless, by delevering when we did, we now know that we have thus far saved our investors an additional 10% loss, or about $70 million dollars.

So now what? As most of you know, we run our model every day whether we trade or not. We plan to scrutinize our attributions and other diagnostics every day to discern when the markets have returned to "normal" and we can safely rebuild our portfolio. We have the tools to know on a daily (indeed, intraday) basis if the liquidations are continuing, and we will know as well when they stop. We guess that about three days without the liquidation footprint could allow us to get back in and capture the enormous profit opportunities our forecasts are now indicating. In sum, when we observe some statistical stability in returns to our factors, we will re-enter the market. Until then, we will remain on the sidelines.

As a point of historical interest, Dave experienced a similar situation at The Prediction Company starting in the Spring of 1998. At that time he was trading a more technical, mean reversion portfolio and the issue wasn't across-the-board market-neutral liquidations. There was, however, a precipitous regime change that had his short book of mostly large-cap stocks going up and his long book of mostly small-cap stocks going down. This capitalization mismatch caused large daily losses. Of course, the problem was only obvious with some hindsight and it took a couple weeks for Dave to analyze and hedge this specific exposure and staunch the losses. Through September 1998, the hedged portfolio, already down about 5% for the year, experienced only small additional losses. Then came 3 months of reversionary behavior. The portfolio ended up with its best year ever.

History never repeats in the same way twice, and we aren't forecasting that we will be up 70% (or at all) for 2007. But we are keen students of past experiences and hope to gain useful perspective thereby. We suspect that soon, perhaps within months, we will better able to understand and contextualize current market conditions. Meanwhile, we are doing our best make sense of what we see in the noisy present and to act in the best interests of our investors. We look forward to updating you with our continued observations in the near future.

Best regards,

Dave DeMers and Jonathan Spring