

February 20, 2007

Peter Hajas
CEO
Telluride Asset Management
1000 Parkers Lake Rd
Wayzata, MN 55391

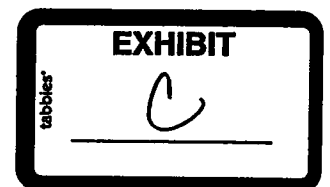
Dear Peter,

As we discussed on the phone Friday, I have and will continue to fully comply with every provision of the Employee Confidentiality and Non-Solicitation Agreement dated January 22, 2004 that I signed. Specifically, I will not mention my track record at Telluride nor disclose or use any Confidential Information of Telluride as specified in articles 2 and 3 relating to the Ownership of Material and Ideas and Confidential Information.

My intended strategy has significant similarities and differences to what I did at Telluride. The similarities include practices that I consider to be in the public domain, and therefore not Confidential Information to Telluride. First, I intend to apply a strategy to equities worldwide. Also, I use equity factors to help estimate expected returns, specifically profitability [1], accruals [2], and changes in equity [3], and volatility [4] (see footnotes for relevant references). These factors are often referred to as "anomalies" in the literature, because they imply arbitrage opportunities, which is a straightforward contradiction to the efficient market hypothesis in that they imply profit opportunities, long-short (i.e., costless) trading strategies that generate abnormal profits (i.e., greater than what is implied by risk-adjusted models, see Huang and Litzenberger, 1988, pages 105-106). Anomalies underlie the rise of *Behavioral Finance* (see Richard Thaler, 1993), which challenges the Efficient Markets Hypothesis by asserting that many profit opportunities exist due to persistent cognitive biases (e.g., anchoring, representativeness and availability heuristics, as well as the more prosaic overconfidence bias, see Kahneman, Slovic, and Tversky, 1982). These factors/anomalies have all been documented and discussed in academic finance's most well-known journals by finance's most well-known economists, from an empirical, practical and theoretical perspective, as the articles referenced below will attest (Eugene Fama's recent *Dissecting Anomalies* working paper addresses these anomalies, and he is one, if not the, most prominent active financial economist. Daniel Kahneman's work, seminal to the Behavioral Finance literature, won him the Nobel Prize in 2002).

I intend to apply a Markowitzian mean-variance optimization algorithm that varies the weight of individual positions based on their contribution to the marginal Sharp ratio of the portfolio, as I did to my sub-strategies at Telluride, and this is a tactic widely described in introductory MBA finance (see Brealey and Meyers, 2002).

The differences in my proposed strategy are proprietary strategic changes based on insights I developed outside my employment at Telluride.



Yours truly,

Eric Falkenstein

From: Peter Hajas [mailto:peter@tridecap.com]
Sent: Thursday, February 22, 2007 11:32 AM
To: 'Eric Falkenstein'
Subject: RE: My proposed strategy

Dear Eric,

In your February 20, 2007 letter you state:

My intended strategy has significant similarities and differences to what I did at Telluride. The similarities include practices that I consider to be in the public domain, and therefore not Confidential Information to Telluride.

Please identify all similarities between your proposed strategy and to what you did at Telluride not just the similarities that are in the public domain. Also please identify the similarities with detailed particularity including by providing me with copies of any computer software programs, excel spreadsheets and back testing information.

You further state in your February 20th letter that:

I intend to apply a Markowitzian mean-variance optimization algorithm that varies the weight of individual positions based on their contribution to the marginal Sharp ratio of the portfolio, as I did to my sub-strategies at Telluride, and this is a tactic widely described in introductory MBA finance (see Brealey and Meyers, 2002).

Please identify the specific algorithms that you used on "my sub-strategies at Telluride" and that you intend to use in your proposed strategy. Please further provide me with copies of those algorithms.

Also, as you know, the employment agreement that you signed with Telluride on January 22, 2004 provides that :

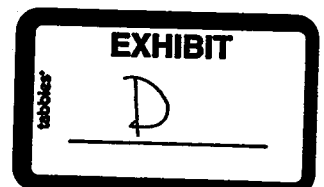
2. Ownership of Materials and Ideas. Employee agrees that all inventions, discoveries, computer software programs, trade concepts, designs, patents, ideas and copyrightable and/or patentable materials made, conceived or developed by Employee during the term of this Agreement shall be owned in full by the Firm. The Parties acknowledge and agree that this paragraph does not apply to an invention for which no equipment, supplies, facility or trade secret information of the Firm was used and which was developed entirely on the Employee's own time, and (1) which does not relate (a) directly to the business of the Firm or (b) to the Firm's actual or demonstrably anticipated research or development, or (2) which does not result from any work performed by the employee for the Firm.

The agreement further provides that:

5. Surrender of Confidential Information and Company Property upon Termination. Promptly upon termination of Employee's employment with the Firm, whether voluntary or otherwise, and at any time upon the Firm's request, Employee shall immediately and unconditionally surrender to the Firm all Confidential Information and all property belonging to the Firm, including but not limited to equipment, products, supplies, records, notes, materials, code, drawings, photographs, computer programs, analytical and numerical methods, computer-generated or computer-retrievable data, and other writings or recordings of any kind, whether in physical, documentary, audio, visual, electronic or any other format, relating to the actual or anticipated business of the Firm.

Please confirm that you have surrendered all Confidential Information and all property belonging to Telluride as required by Paragraph 5 of the agreement. Please further confirm that you returned all materials-- including but not limited to any and all records, correspondence, emails,

3/20/2007



charts, notes, files, spreadsheets, summaries, presentations or data compilations, in whatever form (paper, electronic or otherwise)—that you may have had in your possession, custody or control concerning any and all materials and ideas of Telluride as described in paragraph 2 of the agreement and any and all confidential information and property of Telluride as described in paragraph 5 of the agreement.

Please note that you are obligated to return any and all such materials that may have been stored on any of your computers, cd's, dvd's, email accounts, internet accounts or anywhere else in cyberspace. Your obligation extends not only to any and all "inventions, discoveries, computer software programs, trade concepts, designs, patents, ideas and copyrightable and/or patentable materials made, conceived or developed by you during the term" of your employment with Telluride but also any and all "inventions, discoveries, computer software programs, trade concepts, designs, patents or ideas and copyrightable and/or patentable materials made, conceived or developed" by you at anytime in which you used Telluride's equipment, supplies, facility, resources, data or trade secrets.

Very truly yours,

Peter Hajas

Peter Hajas
Telluride Asset Management
1000 Parkers Lake Road
Wayzata, MN 55391
Direct: 952-653-6444
Main: 952-653-6400
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If you have received this message in error or are not the intended recipient, please contact the sender immediately

From: Eric Falkenstein [<mailto:efalken@gmail.com>]
Sent: Wednesday, February 21, 2007 1:09 PM
To: Peter Hajas
Subject: Re: My proposed strategy

Peter,

That presentation contains proprietary information. I therefore condensed only those items relevant to your concerns about Telluride's intellectual property and my obligations to Telluride in the letter I attached.

Yours,

Eric

On 2/21/07, Peter Hajas <peter@tridecap.com> wrote:

Eric

Thanks for sending me your letter yesterday. In our phone call last week you agreed to send me all presentations and back tests that you submitted to Irv or any other prospective employer or business partner. Can you please forward those as we had agreed?

Thanks

Peter

From: Eric Falkenstein [<mailto:efalken@gmail.com>]
Sent: Tuesday, February 20, 2007 11:11 AM
To: Peter Hajas
Cc: Irv Kessler

3/20/2007

Subject: My proposed strategy

Peter,

Attached is a letter outlining similarities in my new strategy.

Eric
612-799-1168

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Eric
612-799-1168

BY Hand Delivery

**Eric Falkenstein
9300 Cold Stream Lane
Eden Prairie, MN 55347**

Re: Telluride's Trade Secrets and Confidential Information

Dear Eric:

I am very concerned that you have not responded to my February 22, 2007 email to you. The email is attached for your convenience and reference.

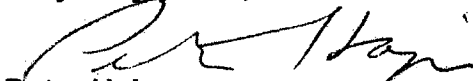
The email raises serious issues requiring your immediate attention concerning your confidentiality and other obligations to Telluride under the employment agreement. Specifically, I request that you:

- (1) immediately return any and all property, trade secrets and confidential information belonging to Telluride as described in my February 22nd email and in Telluride employment agreement;**
- (2) immediately identify all similarities between your proposed strategy and the strategies that you used, modified, developed or created at Telluride and provide me with copies of any computer software programs, excel spreadsheets and back testing information; and**
- (3) immediately identify the specific algorithms that you used on the "sub-strategies at Telluride" and that you intend to use in your proposed strategy and provide me with copies of those algorithms.**

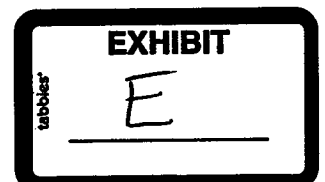
Please provide me with the requested materials within seven (7) days and no later than March 9, 2007.

I also have requested my attorneys to send you a letter concerning your duty and obligation to preserve any and all evidence concerning Telluride, your work at Telluride, your use of Telluride resources, your presentations to potential backers and investors and your proposed strategy.

Very truly yours,



**Peter Hajas.
CEO/CIO
Telluride Asset Management LLC
1000 Parkers Lake Road, Wayzata, MN 55391**



March 9, 2007

Peter Hajas
CEO/CIO
Telluride Asset Management LLC
1000 Parker's Lake Rd
Wayzata, MN 55391

Dear Peter,

As I stated in my resignation letter dated 9/1/06 and in my email correspondence to you dated 2/20/07, I have and will continue to abide by each and every item in the employment agreement I signed on 1/22/04. In regard to the statements you highlighted within that agreement in your letter dated 3/2/07, please let me emphasize again that I have no confidential Telluride property, including all the items you specified, and I am not using any Telluride trade secrets.

I would like to resolve our dispute amicably and hope you have the same objective. As you can understand, my professional objective, before and after working at Telluride, is to work as an investment strategist, building on my academic and real world experience. I ask that we find a correct balance between your rights under my 1/22/04 agreement with Telluride and my rights to use general know-how and prior experience, in particular to develop new tools from the resources I am familiar with in the field.

Let me first address the concern in the letter your lawyer (Mr. Zayed) sent about preserving documents and electronic records. I have entrusted a forensic data service to create an image of my hard drive and keep this warehoused at Dorsey & Whitney, LLP, until it may be needed. We have arranged to have that image created today.

Our dispute appears to arise from your concern that I have incorporated in investment strategies I wish to use with a new employer materials or ideas conceived or developed while employed at Telluride. As I stated before, I have not taken from Telluride, on my computer or otherwise, any strategy materials I developed or confidential information I learned during my employment at Telluride. In presenting my skills and my new tools to potential employers I have returned to the many sources of information that I learned about in academia and that I continue to follow. Let me be more specific.

To the extent there are similarities in my newly developed strategies and what you may recall of my work at Telluride, they are general, public domain ideas such as mean-variance optimization. This objective is so central to the primary criteria of investment performance that every quantitative portfolio manager applies it in some sense. Maximizing a Sharpe ratio involves maximizing a portfolio return (the numerator) and minimizing the volatility (the denominator); this is known as "mean-variance optimization." While common knowledge among academics, students, and practitioners, specific algorithms are not trivial to create. I wrote a new one that took me several days.



The other similarities I mentioned included using factors for estimating expected returns. The characteristics in my current proposed strategies that may seem similar to my work at Telluride include only those that are the public domain. Given I am trying to maximize a return subject to minimizing volatility, I estimate expected returns for various securities. To the extent you think my application of these factors to estimating returns violates my continuing obligations with Telluride, you are mistaken. My implementation is not based on Telluride code, algorithms, documentation, backtests, or any confidential information to Telluride. Profitability, Accruals, Volatility, and Capital Issuance are all public domain factors that contain information relevant to estimating a security's expected return, as I tried to document in my 2/20/07 email. Further, I used some of these factors prior to Telluride. I used volatility as a factor at my own Falken Fund prior to Telluride. My PhD dissertation was on the absence of a return to volatility, and the implied arbitrage from going long low volatility and short high volatility stocks.

In general, my new expected return function is a nonlinear function of a linearly separable model of nonlinear functions applied to firm characteristics. This is an approach that is based on the *RiskCalc*TM model I worked with several years ago (see references). One characteristic is a composite of several characteristics related to default probability, an insight I developed prior to joining Telluride, and presented to the NBER in 2000, later documented by Ilia Dichev and John Campbell (see references). The nonparametric function maps the vector of inputs of firm characteristics into an expected return, very different from what I recall doing at Telluride. I created my specific factors and nonparametric function subsequent to my employment at Telluride, using proprietary datasets bought subsequent to Telluride.

The specific formulation of the equity portfolio model I am now using has proprietary value and is integrally related to a default model I am planning to sell to financial institutions. For that reason, although I am willing to provide you some evidence that my new formulation is not based on Telluride confidential information or code, I am reluctant to simply provide the entire model to you. Also, as my algorithms, backtests, etc, are meaningless on their own (I do not document my code and spreadsheets as if an outsider were to read them), they would need considerable comment on how various programs and databases relate to each other, and what various unlabeled data represent. Further, I need to have a better idea of the specific information that you think is Telluride confidential information, so that I can limit disclosure of my proprietary information while still addressing your concerns. If you wish, you or your representative can arrange a visit with me at my lawyer's office, Stuart Hemphill of Dorsey & Whitney LLP, where I will try to demonstrate how my new algorithm works and its sources while maintaining the proprietary aspects of my new strategy. If we do that, I would expect you then to be specific as to any material you think is owned by Telluride, so that I have an opportunity to respond and to show you these are "available by proper means through sources outside the Firm" (per the 1/22/04 agreement).

Please be mindful that I am currently involved in potential business ventures that may be affected by your actions. Your statements about me, if unsubstantiated and damaging to my ability to seek employment and support my family, would be unfortunate and could lead to liability.

Yours Truly,

Eric Falkenstein

- Campbell, John Y, Jens Hilscher and Jan Szilagyi, 2005. "In Search of Distress Risk." Harvard Institute of Economic Research. Working Papers 2081.
- Dichev, Ilya. 1998. "Is the Risk of Bankruptcy a Systematic Risk?" *Journal of Finance* 53, 1131-1148.
- Falkenstein, Eric. 2002. "Credit Scoring for Public Companies", *Credit Ratings*, RiskWaters Publishing, Michael Ong Editor.
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