October 20, 2021

Dear Partner:

The Greenlight Capital funds (the "Partnerships") returned -2.6%[1] in the third quarter of 2021 compared to 0.6% for the S&P 500 index. Longs detracted 4.5% in the quarter while shorts added 1.2% and macro added 1.0%.

Over the summer, the Federal Reserve characterized inflation as "transitory." As inflation has refused to resolve itself quickly and on its own, Fed Chair Powell revised his description to "frustrating." But why should he feel frustrated? It's not like he has done his best to fight inflation without success; he hasn't lifted a finger to fight inflation. Instead, he has maintained a policy designed to *create* inflation. As a result, inflation is here and it appears poised to worsen.

So, why complain?

We think the reason is that if the Fed were to actually fight inflation, it would harm the financial markets and trigger a fresh recession that our fiscal and monetary policies aren't capable of addressing. We don't think our leaders are prepared to take responsibility for doing so. As a result, the Fed is left with a strategy of obfuscating inflation, claiming it's transitory and just hoping that it goes away on its own. Or, at worst, it can be dealt with over time by gradually reducing bond purchases and ultimately gradually increasing interest rates.

Unfortunately, this seems increasingly unlikely.

As we discussed last quarter, some price spikes due to bottlenecks are likely to reverse at some point. Others, however, are likely to persist. Last quarter we discussed how the lack of cheap equity capital for capital-intensive companies is likely to suppress investment and prevent high prices from becoming the cure for high prices.

Another factor that we overlooked is the impact of ESG investing. ESG stands for Environmental, Social and Governance. However, in practice, social and governance are mostly overlooked.

Environmental is mostly about climate change. Climate change is mostly about carbon emissions. Carbon emissions are mostly about fossil fuels. The result is that ESG investing has led to an aversion to investing in fossil fuels. Now, energy prices are soaring, contributing to inflation. Given the ESG concerns, huge shortages and higher prices are not stimulating expansion of, say, coal supply. In this political climate, who is going to invest in a new mine that won't come online for a few years?

[1] Source: Greenlight Capital. Please refer to information contained in the disclosures at the end of the letter.

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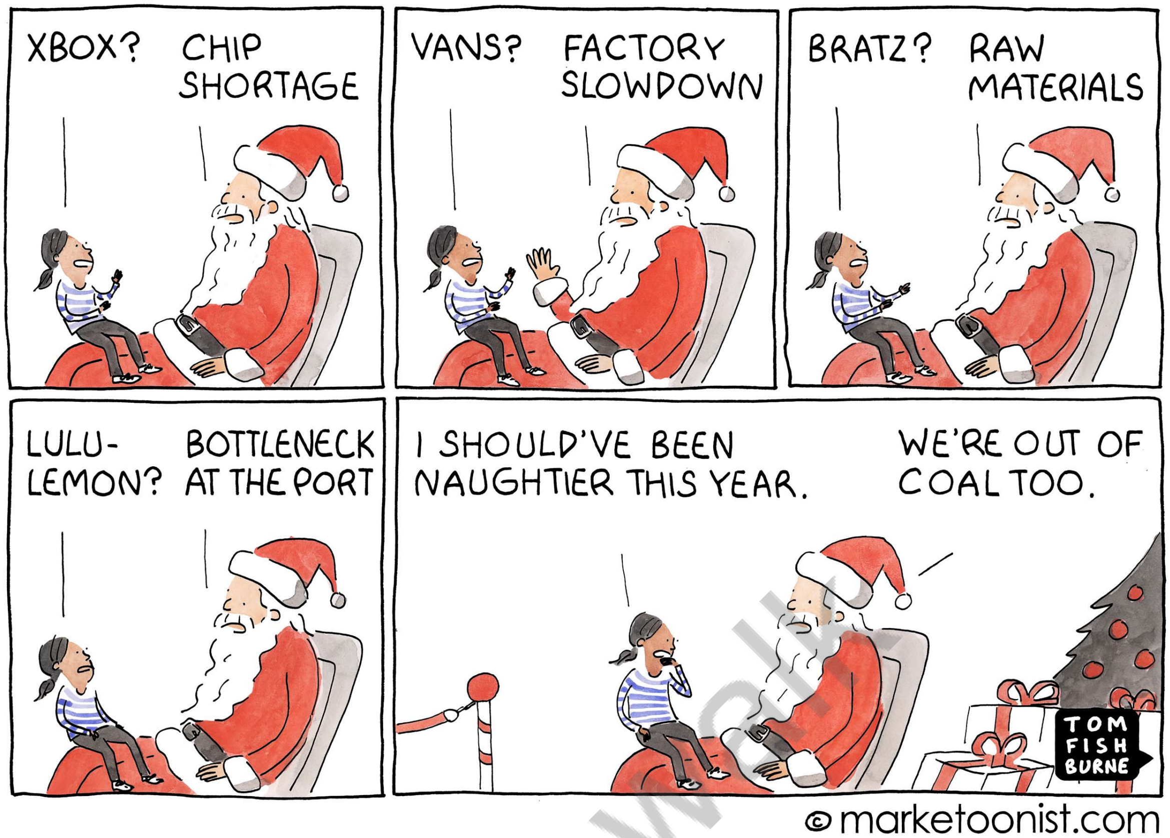

The structural problem around the current global energy crisis – which is why it isn't going away anytime soon – is that politicians have decarbonized supply faster than they can decarbonize demand. In order for prices to fall, demand needs to be destroyed, which leads to a growth problem well before anyone gets a chance to raise rates.

It should go without saying that demand destruction means less use by those least able to afford it. So, it will be the poorer countries and citizens that go without. Inflation, in general, disproportionately affects those with the lowest incomes. The unpleasant truth is that often the goals of ESG run counter to the goals of reducing or eliminating poverty and wealth inequality.

Furthermore, two of the most important drivers of inflation – housing rents and labor – are likely to continue to drive the U.S. Consumer Price Index (CPI) higher. Housing rents (both rentals and owners' equivalent rent) are the largest component of CPI and they flow through with a lag. When rents go up, not everyone has to renew their lease immediately. The price increases happen at renewal. Currently, rents on renewed leases are up 9.2% year-over-year through July according to Zillow; it will take a full year for that impact to roll through CPI.

And we unquestionably have a labor shortage. In the most recent employment report, wage inflation is now up 4.6% year-over-year and accelerating. The labor participation rate has fallen by a few percent. While many believed that extended unemployment benefits and the need to take care of children out of school were suppressing labor supply, the termination of those benefits and the return to school have come and gone and the labor shortage persists.

We have heard a number of theories including that the COVID shutdown sent many undocumented workers back to their countries of origin, as there was no work here; that older workers are reluctant to return to work for fear of getting sick; and that those receiving benefits were working the whole time, but for cash off the books. We have no way to refute or substantiate any of these, and they may all have a kernel of truth.

However, one theory that resonates with us based on our own anecdotes is that some are not joining or returning to the workforce because they don't need to. Homeowners have seen the values of their houses go up by an average of 20% in the last year. Those near retirement have seen their 401(k) retirement plans swell with the stock market. These older citizens are choosing not to return to the workforce. And some younger people have made so much money in cryptocurrencies, non-fungible tokens (NFTs) and meme stocks that they can sit at home rather than enter the workforce. More power to them.

However, this means that as the economy reopens, the labor shortage is likely to persist. Employers need to compete for labor, which means rising wages. Rising wages means rising costs. And rising wages combined with the benefits of fiscal stimulus and rising asset prices means healthy demand.

It's a recipe for demand-pull and cost-push inflation at the same time.

For a Fed that is desperate to avoid taking measures to fight inflation, it's a tough predicament. No wonder Chair Powell finds inflation "frustrating." The risk is that the capital markets lose confidence in the Fed policy and develop a view that the Fed is "behind the curve" in dealing with sustained inflation.

What we (and we assume you) find frustrating is our inability to achieve satisfactory investment results. We believe we were correct in our top-down view, long-short positioning and individual company performance and we still had a down quarter. This one-step-forward-two-steps-back result is…well, pick your own adjective.

As noted above, we had a positive quarter in short selling and in macro. The problem this time was in the long portfolio. It is easier to explain when we can highlight an analysis that we missed, developments that went against us, or just a difficult macro environment. However, none of that was evident last quarter. We simply lost money in the face of what we thought was excellent performance by our companies. In fact, many of our longs not only exceeded consensus expectations, they exceeded our internal (even more optimistic) expectations.

Let's start with Green Brick Partners (GRBK). The shares declined 9.8% this quarter from \$22.74 to \$20.52. In the June quarter, GRBK earned \$1.02 per share (up 54% from the prior year and up 260% from 2019), easily exceeding analyst estimates of \$0.85 per share. 2021 full-year consensus estimates rose from $3.34 to $3.68 per share and 2022 estimates rose from $3.80 per share to $4.06.

In August, the company held an analyst day where it highlighted that revenues and pretax income have grown 28% and 44% per year compounded since its 2014 IPO. Recent growth has been even faster. The company now generates a 30% ROE. GRBK highlighted that it has a very favorable land and market position that positions it for continued success. Nonetheless, the P/E on 2021 earnings shrank from an undemanding 6.8x to a very hard to explain 5.6x.

Yes, we have heard a bear thesis on housing that amounts to claims that overbuilding combined with higher prices will drive future buyers away. From what we can see, there is no sign of this. Demand remains very strong, and with rents rising quickly, owning is becoming a more attractive option.

The real problem is supply chain shortages, which are extending industry build times and making it hard to complete houses. To the extent that this pushes closings out, it merely de-risks the forward year estimates and indicates that current results are likely far from peak and therefore deserve more respect from the market.

A couple weeks ago we sent you a link to an interview that David gave on Real Vision. In it he said:

> *Companies can report stupendous news and have very, very minimal share-price reaction to it. It's not that the stocks are hated; there's nobody actually listening. There's nobody on the call, there's nobody performing analysis, there's nobody recommending the stock. There's nobody there to buy the stock.*

If GRBK is an example of this, we'd like to elaborate on an even better example: Brighthouse Financial (BHF).

BHF reported what can only be called a stupendous result. BHF had adjusted operating earnings of $5.05 per share during the quarter compared to estimates of $3.28 per share. Full-year consensus moved from $13.75 to $16.18. The stock fell about 1% during the quarter to close at $45.23.

There is more to the story. BHF's core business is variable annuities and to a lesser extent life insurance. But it also has something called a "closed block," which is a bunch of legacy businesses that MetLife burdened BHF with at the time of the spin-off. These are business lines which are no longer being originated. BHF has them contained in a Delaware subsidiary for which there is minimal financial disclosure.

Skeptical investors have worried that this subsidiary could be a "black hole" that will drain the value from the rest of BHF. Well, something very strange happened to that theory this quarter: the regulators approved a $600 million dividend out of the Delaware subsidiary.

Management, true to form, has given no hints as to what extent there will be more dividends to come.

To us, it seems that what was suspected to be a “black hole” is actually a “cookie jar.” We just don’t know how many cookies are in the jar. Either way, the consensus view that the run-off business will be a drain ought to be discarded.

$600 million is a lot of money. To BHF, it equates to more than $7 per share. Nobody expected this development. There are 11 analysts following BHF (1 buy, 7 holds, 3 sells), and not one of them changed their view of value based on this announcement. Moreover, one would think that if you found $600 million under the mattress, you would count that and ask whether anyone checked the couch cushions as well. But, as David noted, *companies can report stupendous news*…

We could go on and detail the quarterly results of several other companies in our portfolio, but we don’t wish to overkill the point.

It’s more productive to discuss how we think this situation will resolve itself. Share repurchases over time will unlock the value. We just don’t know when the market will notice.

Going back to the BHF example, the company has already shrunk its share count by 30% from 120 million to 84 million. This has helped take stated book value per share from $120 to $175. In the most recent quarter, BHF authorized another $1 billion in buybacks, which is about a quarter of the company at the current price. As BHF continues in this fashion, eventually either the shares will re-rate or there won’t be many left.

We continue to hold the quaint view that shares represent a fractional ownership of a business. As the denominator of shares goes down, the fraction of the business that each share represents goes up. There are several companies in our portfolio, BHF included, that appear poised to return their current market caps to shareholders over the next few years.

We added a new position in Countryside Properties (United Kingdom: CSP) and expanded what was a small position in Sonos (SONO) to a size that makes it worthwhile to discuss.

We initiated a small long position in CSP after the company announced plans to wind down its traditional U.K. Housebuilding division and focus exclusively on its faster-growing and higher-return-on-capital residential Partnerships division. Partnerships works with local authorities and housing associations in the U.K. to develop projects that offer a mix of rental properties, properties for sale and affordable housing. CSP is hosting a Capital Markets Day on November 30, where we think management will articulate the system of capabilities it has built that makes Partnerships considerably more attractive than its legacy traditional U.K. Housebuilding business. We purchased CSP shares at £5.14 or 6x our estimate of Partnerships’ standalone earnings power (adjusted for the cash distributions from the Housebuilding division that is in run-off). CSP shares ended the quarter at £5.06.

We've owned SONO, which manufactures multi-room wireless smart home sound systems, for about a year. We were initially attracted by the strength of the brand and IP, SONO's ecosystem dynamics, and signs that the company was under-earning. We've been impressed with management's ability to consistently outperform both guidance and expectations amidst a rapidly changing macro environment. We think that there is a long-term household penetration story here: SONO products are currently in approximately 11 million homes globally, a number that has grown by at least 20% in each of the last 4 years and stands to grow further as SONO adds more accessible price points, expands into new verticals, and introduces new products and services. While we acknowledge that there are near-term headwinds in the form of supply chain disruptions and a cyclical normalization in consumer electronics demand, we think these will prove to be temporary distractions in an otherwise bright growth story. Between an elevated backlog of orders that will support demand well into the next year and strong pricing power, we see earnings growing close to 25% annually for the next few years. The stock currently trades at just over 15x FY2021 adjusted earnings net of the $5 cash per share on the balance sheet today. We purchased our stake at an average price of $28.45 per share. SONO shares ended the quarter at $32.36.

We also exited longs in SYNNEX and APi Group to redeploy into new ideas. Both positions were profitable and had high returns.

After six years at Greenlight, Regan Gilbride will be leaving this month to pursue another opportunity closer to home. We wish her well.

Please save the date for our annual partner meeting, which will be held on Wednesday, January 26, 2022. The event will be held virtually again given continued concerns over COVID and gathering large groups of people together.

Finally, we returned everyone to the office, much of the time. It is fun to be around our colleagues… and have daily free lunch.

At quarter-end, the largest disclosed long positions in the Partnerships were Atlas Air Worldwide, Brighthouse Financial, Change Healthcare, Green Brick Partners and Teck Resources. The Partnerships had an average exposure of 127% long and 70% short.

"Prediction is very difficult, especially if it's about the future."

– Physicist Niels Bohr

Best Regards,

Greenlight Capital

Greenlight Capital, Inc.

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