



THIRD AVENUE VALUE FUND

THIRD AVENUE SMALL-CAP VALUE FUND

THIRD AVENUE REAL ESTATE VALUE FUND

THIRD AVENUE INTERNATIONAL VALUE FUND

## **LETTERS TO OUR SHAREHOLDERS**

Second Quarter Commentary

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April 30, 2005

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If you should have any questions, please call 1-800-443-1021, or visit our web site at: [www.thirdavenuefunds.com](http://www.thirdavenuefunds.com), for updated information or a copy of our 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 06/15/2005.



## Third Avenue Value Fund



**MARTIN J. WHITMAN**  
**CO-CHIEF INVESTMENT OFFICER**  
**& PORTFOLIO MANAGER OF**  
**THIRD AVENUE VALUE FUND**

Dear Fellow Shareholders:

At April 30, 2005, the unaudited net asset value attributed to the 92,878,702 common shares outstanding of the Third Avenue Value Fund (“TAVF”, “Third Avenue,” or the “Fund”) was \$53.33 per share. This compares with an unaudited net asset value of \$51.05 per share at January 31, 2005, and an unaudited net asset value at April 30, 2004 of \$43.08 per share adjusted for a subsequent distribution to shareholders. At June 9, 2005, the unaudited net asset value was \$54.73 per share.

### QUARTERLY ACTIVITY\*

Principal activities during the quarter were as follows:

#### Principal Amount or Number of Shares

\$59,750,000

#### New Positions Acquired

Collins and Aikman Products Co. Senior Notes 10% due 2011 (“Collins and Aikman Seniors” or “Seniors”)

#### Principal Amount or Number of Shares

2,385,000 shares

1,982,750 shares

1,665,500 shares

795,000 shares

2,713,000 shares

5,807,700 shares

1,200,000 shares

2,025,000 shares

278,200 shares

#### New Positions Acquired (continued)

Henderson Land Development Co. Ltd. Common Stock (“Henderson Common”)

RHJ International Common Stock (“RHJ Common”)

#### Increases in Existing Positions

AVX Corp Common Stock (“AVX Common”)

Guoco Group Ltd. Common Stock (“Guoco Common”)

Hutchison Whampoa Ltd. Common Stock (“Hutchison Whampoa Common”)

Liu Chong Hing Bank Ltd. Common Stock (“Liu Chong Common”)

MBIA, Inc. Common Stock (“MBIA Common”)

Posco American Depository Receipts for Common Stock (“Posco ADRs”)

Toyota Industries Corp. Common Stock (“Toyota Industries Common”)

\* 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, 2005: Sears Holding Corp., 6.49%; Toyota Industries Corp., 6.38%; USG Corporation, 6.09%; The St. Joe Company, 3.99%; MBIA, Inc. 3.15%; Tejon Ranch Co., 3.06%; Millea Holdings, Inc. ADR, 2.91%; Posco (ADR) 2.78%; Brascan Corp., 2.61%; and Hutchison Whampoa, 2.29%.

**Number of Shares**

27,000 shares

**Positions Reduced**Alico Inc. Common Stock  
("Alico Common")

654,897 shares

Sears Holding Corp. Common Stock  
("Sears Common")**Position Eliminated**

14,600 shares

LNR Property Corp.  
Common Stock ("LNR Common")

In terms of cash management, the Fund is following a program of keeping around 60% of its cash equivalents in short-term U.S. AAA securities, and about 40% in short-term United Kingdom Governments denominated in pound sterling. The United Kingdom Governments provide a yield of slightly over 4½%. The United Kingdom investment ought to be seen as an insurance policy against the possibility, however unlikely, that the U.S. dollar will collapse. In the prior quarter, TAVF had divided its "insurance policy" investment between United Kingdom Governments and New Zealand Kiwis. The switch to only United Kingdom Governments reflects a view that Third Avenue wants to avoid even one scintilla of credit risk in its cash management programs. The capital risk, *i.e.*, the U.S. dollar appreciating versus pound sterling, seems risk enough.

An explanation of the reasoning behind TAVF's investment in Collins and Aikman Seniors ought to be helpful in imparting understanding to Fund shareholders about Third Avenue's approach to investing in distressed credits.

Since the end of our fiscal quarter, Collins and Aikman sought relief by filing for Chapter 11 under the U.S. Bankruptcy Code. The prices for the Collins and Aikman Seniors collapsed. When it did, TAVF started to aggressively acquire Collins and Aikman Seniors. At the time of this writing, Third Avenue holds \$250,750,000 Principal Amount of Collins and Aikman Seniors, or slightly over half of the outstanding issue.

For the five years and nine months through September 2004, Collins and Aikman's annual operating income before non-recurring charges has ranged from a low of \$61,500,000 in 2001 to a high of \$224,600,000 in 2002. Annual interest charges for the Collins and Aikman Seniors together with the Collins and Aikman Subordinates total \$107,000,000 per year. In Chapter 11, these \$107,000,000 of cash costs are eliminated, offset in part by professional costs in Chapter 11 which ought to range from about \$4 million to \$6 million per month.

Third Avenue, as a leading creditor, will influence what the Collins and Aikman Plan of Reorganization ("POR") will be. I would be hopeful that the company can be reorganized in Chapter 11 relatively quickly, say within the 180 day Period of Exclusivity. If so, I would visualize a POR along the following lines:

- 1) Secured lenders — reinstated
- 2) Seniors — receive 90% of the new common stock capitalization
- 3) Subordinates — receive 10% of the new common stock capitalization
- 4) Old Common Stock — wiped out
- 5) Management — receive options on 5% of the new common stock capitalization

If future annual operating income is to average, say, \$150,000,000 then the Fund would have acquired its position in the new Collins and Aikman Common Stock at probably less than five times earnings. If Collins and Aikman can get annual operating income up to \$200,000,000, the PE ratio for TAVF would decline to around three times.

The Fund has now become the largest holder of Seniors. There are two very real risks in the Collins and Aikman investment:



1) Reorganization Risk. If TAVF and other creditors can not relatively quickly reorganize Collins and Aikman along the lines outlined above, and a protracted Chapter 11 ensues, the bulk of the values in Collins and Aikman probably will belong to the professionals — lawyers and investment bankers — not to pre-petition creditors. Unknowns, such as a need to renegotiate labor contracts, could prolong the Chapter 11 proceeding, even if the Company, itself, is cooperating with TAVF and other holders of Collins and Aikman Seniors. Old Collins and Aikman Common would be wiped out in any event.

2) Business Risk. Maybe operating income for this automotive supplier will never again approach the average levels of the past six years. 75% of Collins and Aikman revenues come from the “Big Three” automobile manufacturers who have been losing market penetration. Also, much of the company’s raw materials costs are in resins where prices are correlated to the price of oil. A persistent margin squeeze may be a fact of life.

All in all, Collins and Aikman Seniors seem an interesting distress speculation. There may be considerable downside risk if the control group, which would be the Debtor-in-Possession with the rights to a period of exclusivity in Chapter 11, were to be unreasonable in formulating a POR. On the other hand, if reorganization risks can be mitigated, it may be hard to lose money by owning Collins and Aikman Seniors at the prices the Fund has been paying.

Henderson Land is an extremely well financed, Hong Kong based holding company whose common stock is selling at a deep discount from readily ascertainable Net Asset Value (“NAV”). The Company’s operations entail interests in rental properties, property development, hotels, retailing, infrastructural products, security services, and a gas utility.

RHJ International is the first Leveraged Buy-Out (“LBO”) Fund concentrating on transactions in Japan to go public. The Fund’s entry price was the same as paid by

the founders and promoters. I’ve been intimately acquainted with RHJ’s Chief Executive Officer for the past 25 years and think ever so highly of him. It seems as if prices in Japan for control of smaller to medium sized businesses are akin to what prices were in the United States in the 1960’s and 1970’s. If true, RHJ Common might become a spectacular investment. One ought to know in, maybe, three to ten years.

Virtually all the increases in existing positions occurred when the price action of the particular common stocks reflected meaningful weakness.

The position in Alico Common was reduced because corporate governance at the company may not be as investor friendly as TAVF management once thought it was. The Fund remains with a holding in Sears Common with a market value in excess of \$300,000,000. Sears seems to be extremely well managed with good growth prospects from here. But success hardly will be a “slam-dunk.” Thus, it seems prudent to lighten up on the large position in Sears Common.

#### **VALUE INVESTING**

This year, I led seminars on value investing at the Schools of Management at both Syracuse University and Yale University. At the first session of the seminar programs, I contrasted the underlying assumptions pervading value investing with the underlying assumptions that seem to govern both academic finance and conventional research department analyses. Hopefully, it will be useful for TAVF shareholders if I share with them what I said at these first sessions, as well as how I believe the Fund’s investment approach comports with a number of the underlying assumptions.

Academic and research department concepts that are part and parcel of value investing revolve around Net Present Value (“NPV”) and Present Value (“PV”). NPV is pervasive in value analysis and is used much more broadly than merely measuring Discounted Cash Flows



(“DCF”). In Value Investing one tends to PV everything: asset values, liabilities, earnings, EBITDA, expenses; often converting fixed expenses into liabilities; and assured earnings and cash flows into asset values. For example, see the table below “Closed End Fund X”. An above normal expense ratio (4% rather than 1.5%) is capitalized as a liability and the present value of the excess is deducted from Closed End Fund X’s NAV. For value purposes Closed End Fund X’s common stock is deemed to be selling at a 6.7% premium over NAV, even though based strictly on Generally Accepted Accounting Principles (“GAAP”), it appears to be selling at a 20% discount from NAV.

#### Closed End Fund X

NAV	\$100,000,000	
# shares outstanding	10,000,000	Shares
NAV Per Share	\$10	
Annual Operating Expenses	\$ 4,000,000	
Expense Ratio	4%(a)	
Market Price of Common	\$8	
Market Price as Discount from NAV — as reported under GAAP	(20%)	
Adjust NAV to exclude Expense Ratio in excess of 1.5% from NAV \$2,500,000 capitalized at 10%	\$ 25,000,000	
Adjusted NAV	\$ 75,000,000	
Adjusted NAV — Premium over market price	6.7%	

(a) TAVF expense ratio was 1.12% for fiscal 2004.

#### 37 UNDERLYING ASSUMPTIONS OF VALUE INVESTING

Organized Under Five Titles:

Efficient Market Hypothesis (“EMH”)

Efficient Portfolio Theory (“EPT”)

Disclosure and GAAP

Economics and Markets

Security Analysis

#### Efficient Market Hypothesis

##### 1) The General Theory of Market Efficiency

Some markets will tend toward instantaneous efficiency.

Some markets will tend toward long term efficiency but rarely achieve it.

Some markets are inherently inefficient.

Which market exists is a function of four variables:

- i. Who the market participant is;
- ii. How complex is the security, or the situation, being analyzed;
- iii. What are the time horizons of the participants;
- iv. How strong are the external forces imposing disciplines on a market:
  - a) Government external forces;
  - b) Private sector external forces.

In markets where instantaneous efficiencies exist, participants do not earn excess returns. In other markets, earning excess returns is to be expected. TAVF, a buy and hold cash investor, tends to invest in complex securities where the work-out horizon is five years, or more. As such, the Fund operates in markets that rarely approach instantaneous efficiency.

2) Financial markets almost never approach instantaneous efficiency unless they are strictly regulated.

3) A market is defined as any financial, or commercial, arena where participants reach agreements as to price, and other terms, which each participant believes is the best reasonably achievable under the circumstances.



### Efficient Portfolio Theory

- 4) Diversification is a surrogate, and usually a damn poor surrogate, for knowledge, control and price consciousness. At April 30, 2005, the Fund had 104 common stock positions and the top ten issues accounted for approximately 40% of TAVF's portfolio. Most mutual funds of similar size seem to hold 300 to 400 positions.
- 5) The objective of some securities holders is total return; others emphasize cash return; and some holders seek elements of both. TAVF is strictly total return conscious in its common stock investing. However, much of Third Avenue's investments in credit instruments is cash return driven.
- 6) Portfolio analysis differs from individual securities analysis. For portfolios, there is no such thing as a value trap.

### Disclosure and GAAP

- 7) GAAP provide objective benchmarks, not truth, except in several special cases. For example, see Toyota Industries ("Industries"). Over half of Industries' assets at market prices are in a portfolio of marketable securities, principally Toyota Motor Common. For GAAP purposes, Industries reports only dividends and interest received from portfolio companies. On this basis, Industries Common is selling at around 22 times earnings. If Industries' income account is adjusted to include Industries' equity in the undistributed earnings of portfolio companies, Industries Common is selling at less than eight times earnings. GAAP for Industries is a good first approximation of periodic cash flow. Picking up the equity in undistributed earnings of portfolio companies is a good first approximation of Industries' periodic wealth creation.
- 8) Every GAAP number is derived from, modified by, and a function of, other GAAP numbers.
- 9) Documentary disclosures to creditors and investors have never been better, or more complete, than they are now, at least in the U.S. Some of the credit for this goes to the Plaintiffs' Bar.

10) In value investing and control investing, what the numbers mean tend to be much more important than what the numbers are.

11) GAAP are more useful insofar as this accounting system is designed to meet the needs of long-term creditors rather than stock market speculators. Fund management basically analyzes all securities, including common stocks, as if the securities were long-term debt instruments.

### Economics and Markets

12) The concept of risk is not useful unless a modifying adjective precedes the word "risk". Market risk — fluctuations in securities prices — is a different animal from investment risk — changes affecting a business' operations or investments. Other risks include commodity risk, terrorism risk, credit risk, failure to match maturities risk, weather risk, reorganization risk. See the contrast discussed above under cash management between credit risk on the one hand and capital risk on the other.

13) Once instantaneous efficiency is not present, measuring investment risk and market risk involve three factors:

- i. Quality of the issuer;
- ii. Terms of the issue;
- iii. Price of the issue.

Assuming price equilibrium, there is no need to factor in price of issue. If one factors in price, the lower the price the less the risk of loss and the more the potential for gain. When factoring in price, no risk/reward trade-off exists. Fund management is first safety conscious, and then, price conscious.

14) The basic interest of most market participants is wealth creation, an asset value concept, not DCF. DCF is just one method of creating wealth, and frequently a method that carries tax disadvantages. Over 80% of TAVF's common stock portfolio consists of securities,



which were acquired at prices well below estimates of readily ascertainable NAVs. Current and immediately prospective Price Earnings Ratios are either downplayed in a TAVF analysis or completely ignored.

15) Debts — whether incurred in the private sector or by governments — are usually never repaid. Rather they are refinanced by those wealth-creating entities which are able to remain credit-worthy. The Fund sells common stocks immediately when the businesses no longer appear to be credit-worthy. To Fund management, this spells a permanent impairment.

16) There is a long-term arbitrage between business value and common stock prices:

Common stock prices high relative to business value — Go Public;

Common stock prices low relative to business value — Go Private, or semi-private.

17) Assets can have an in use value separate and apart from any market value.

18) Fairness in financial dealings is that price, and other terms, that would be arrived at in a transaction between a willing buyer and a willing seller, both with knowledge of the relevant facts, and neither under any compulsion to act. In a going private situation, one is faced with a willing buyer (who frequently is also a fiduciary)—coerced seller situation. Fairness opinions are then used, and should be based on simulating the prices and other terms that would have existed were there actually a willing buyer-willing seller situation. TAVF, and its sister funds, complain loudly and/or take other actions when we become a forced seller at prices we think constitute a “takeunder” rather than a “takeover”.

19) You can't understand corporate finance if all you do is look at corporations and securities wholly, or mostly, from the point of view of common stockholders who are Outside Passive Minority Investors (“OPMIs”). To understand corporate finance, you have to be cognizant of the interests and beliefs of other important

constituencies — Managements, Creditors, Promoters, Underwriters, Governments.

20) Assuming relative political stability and an absence of violence in the streets, macro factors tend to be unimportant for value investing. The Fund's satisfactory investment experience after 1997 in Japanese non-life insurance common stocks is a good example of this. At the time these investments were made, Fund management had no idea that the Japanese business depression would turn out to be as deep and protracted as it was, and that interest rates would stay so low for so long.

21) Any and all resource conversion activities (*e.g.*, mergers and acquisitions, initial public offerings, restructuring troubled companies, refinancings) involve huge costs payable to investment bankers, brokers, lawyers, accountants, lenders, and promoters. This is something Fund management has to consider for most of its investments. This expense problem seems exacerbated for small-cap companies.

22) There exist strong Wall Street pressures to have periodic IPO booms:

- i. Huge gross spreads;
- ii. Exclusive Product;
- iii. Easy Sell.

23) Passive investment products tend to be sold by salesmen, rather than bought by investors.

24) The markets for top management compensation and top management entrenchment tend to be inefficient. Therefore, top managements, as a group and individually, earn excess returns. This, too, is a factor in Fund management's decision making.

25) All financial relationships combine communities of interest and conflicts of interest. Agency costs are a non-starter.



26) In the financial world it tends to be misleading to state, “There Is No Free Lunch.” Rather the more meaningful comment is, “Somebody Has To Pay For Lunch.”

#### Security Analysis

27) Substantive Consolidation of the interests of the Company itself and its OPMI stockholders is a relatively rare special case. The Company is the Company. The Company is not the management. The Company is not its stockholders. All TAVF analyses treat the company as a stand-alone. For example, Fund management recognizes that stock options are a stockholder problem, and only rarely, a company problem.

28) The worth of any security is the present value of the future cash bailouts to be received by security holders. Cash bailouts come from three sources:

- i. Cash Distributions by issuers in the forms of interest, principal, premium; dividends, and securities repurchases;
- ii. Sales to a market;
- iii. Control.

29) Passive securities, for most economic purposes, are a different commodity from control securities, albeit they are identical in legal form. From a TAVF point of view, if a passive security is to become a control security, the holder (hopefully Third Avenue) is entitled to a premium price.

30) Outside of a Court Proceeding, usually Chapter 11, no one in the U.S. can take away a creditor’s right to a money payment for interest, principal, or premium unless that individual creditor so consents. A creditor has only contract rights, not residual rights.

31) Equities represent ownership and only very rarely require cash service. Equity owners have residual rights *vis-à-vis* the company and its management; *e.g.*, management has a duty to deal fairly with stockholders.

32) In all transactions, consider the use of proceeds. Corporations can only use cash proceeds in four ways:

- i. Pay expenses;
- ii. Expand the asset base;
- iii. Service and/or repay liabilities;
- iv. Distribute to equity via dividends and/or buy-backs.

**“In the financial world it tends to be misleading to state, ‘There Is No Free Lunch.’ Rather the more meaningful comment is, ‘Somebody Has To Pay For Lunch.’”**

Distributions to equity are almost always a residual use of corporate cash. The principal exception is where the payment of dividends gives capital hungry companies better access to capital markets than they otherwise would have. (TAVF tends not to invest in the common stocks of such companies.) Excluding this consideration, buying in common stock is almost always a preferable

method of distributing cash to shareholders from both a company point of view and a TAVF point of view compared with paying cash dividends. This tends not to be the case from the point of view of short-run oriented OPMIs.

33) In passive investing, decisions should be based more on a “reasonable worst” case basis than on a “base case” basis.

34) Management appraisals involve looking at managements not only as operators but also as investors and financiers.

35) Weighted Average Cost of Capital (“WACC”) is a non-starter for two reasons:



i. From a creditor's point of view (and without getting into the issue of effective differences in cost between, say, short-term senior secured issues and long-term subordinates), the cost of creating corporate creditworthiness is very different in the case where the company issues debt securities which have a required cash cost on the one hand, and where the company issues equity securities which don't require cash payments on the other hand.

ii. The vast majority of equity financing takes place via having the company retain earnings, rather than having the company market new issues of common stock. The PE ratio, or cap rate, at which a common stock sells in an OPMI market, has no particular meaning for a company increasing its equity base through retaining earnings. Here Return on Equity ("ROE") gives a better estimate of the "cost" of equity capital to the company than does a cap rate measured in part by OPMI market prices, albeit many cash conscious managements and companies will view retaining earnings as a cost free method of increasing equity capital.

36) The liability side of the balance sheet is a lot more than obligations and net worth. Rather, it is a layer cake consisting of at least the following:

- Secured obligations;
- Unsecured obligations;
- Subordinated obligations.

Liability reserves which analytically have an equity component:

- Preferred Stocks;
- Common Stocks;
- Common Stock Derivatives.

Whether an issue is debt or equity depends on where you sit. To senior lenders, subordinated debt is a form of equity. To common stockholders, subordinated debt is debt.

37) Many disciplines can be helpful in contributing toward making one a successful value investor. There are three areas, though, where it is essential that the participant needs to be well informed, *i.e.*, needs to be knowledgeable enough so that at the minimum, the analyst can be an informed client. These three disciplines are as follows:

1. GAAP;
2. Securities Laws and Regulation;
3. Income Tax.

I will write you again when the report for the period to end July 31, 2005 is published.

Sincerely yours,

Martin J. Whitman  
Chairman of the Board



## Third Avenue Small-Cap Value Fund



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

Dear Fellow Shareholders:

At April 30, 2005, the end of the Fund's fiscal second quarter, the unaudited net asset value attributable to the 61,304,522 common shares outstanding of the Third Avenue Small-Cap Value Fund ("Small-Cap Value" or the "Fund") was \$21.84 per share. This compares with the Fund's unaudited net asset value of \$22.15 per share at January 31, 2005, and an unaudited net asset value at April 30, 2004 of \$19.09 per share adjusted for a subsequent distribution to shareholders. At June 9, 2005, the unaudited net asset value was \$23.18 per share.

### QUARTERLY ACTIVITY\*

During the quarter, Small-Cap Value established 3 new positions, added to 25 of its existing positions, eliminated 3 positions and reduced its holdings in 2 companies. At April 30, 2005, Small-Cap Value held 77 positions, the top 10 positions of which accounted for approximately 21% of the Fund's net assets.

### Number of Shares

360,300 shares

1,467 contracts

1,467 contracts sold

100,000 shares

70,200 shares

164,293 shares

206,000 shares

100,000 shares

### New Positions Acquired

American Axle and Manufacturing Holdings, Inc. Common Stock ("Axle Common")

Sears Holding Corp. \$120 put options, expire 1/20/07 ("Sears Puts")

Sears Holding Corp. \$155 call options, expire 1/20/07 ("Sears Calls")

### Increases in Existing Positions

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

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

Bel Fuse, Inc. Class B Common Stock ("Bel Fuse Common")

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

The Dress Barn, Inc. Common Stock ("Dress Barn 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, 2005: Sears Holding Corp., 2.94%; Brascan Corp., 2.51%; Whiting Petroleum Co., 2.39%; Fording Canadian Coal Trust, 2.10%; The St. Joe Company, 2.10%; Pogo Producing Co., 1.99%; TimberWest Forest Corp., 1.80%; Forest City Enterprises, Inc., 1.77%; Superior Industries International Inc., 1.53%; and Agrium, Inc., 1.50%.



<b>Number of Shares</b>	<b>Increases in Existing Positions (continued)</b>	<b>Number of Shares</b>	<b>Increases in Existing Positions (continued)</b>
76,620 shares	Electro Scientific Industries, Inc. Common Stock ("ESI Common")	136,700 shares	Tidewater, Inc. Common Stock ("Tidewater Common")
64,468 shares	Electronics for Imaging, Inc. Common Stock ("EFI Common")	115,400 shares	Trinity Industries, Inc. Common Stock ("Trinity Common")
69,878 shares	Herley Industries, Inc. Common Stock ("Herley Common")	161,200 shares	Whiting Petroleum Co. Common Stock ("Whiting Common")
69,500 shares	JAKKS Pacific, Inc. Common Stock ("JAKKS Common")		<b>Positions Reduced</b>
309,600 shares	Leapfrog Enterprises, Inc. Common Stock ("Leapfrog Common")	30,325 shares	Alico, Inc. Common Stock ("Alico Common")
107,200 shares	Lindsay Manufacturing Company Common Stock ("Lindsay Common")	425,047 shares	IXYS Corporation Common Stock ("IXYS Common")
38,054 shares	National Western Life Insurance Co. Class A Common Stock ("National Common")		<b>Positions Eliminated</b>
478,100 shares	NewAlliance Bancshares, Inc. Common Stock ("NewAlliance Common")	284,840 shares	AMN Healthcare Services, Inc. Common Stock ("AMN Common")
210,644 shares	Origen Financial, Inc. Common Stock ("Origen Common")	456,964 shares	Hollywood Entertainment Corp. Common Stock ("Hollywood Common")
76,694 shares	PAREXEL International Corp. Common Stock ("Parexel Common")	388,100 shares	LNR Property Corp. Common Stock ("LNR Common")
17,950 shares	Pogo Producing Co. Common Stock, ("Pogo Common")		
420,900 shares	Russ Berrie and Co. Common Stock ("Russ Berrie Common")		
169,800 shares	St. Mary Land and Exploration Co. Common Stock ("St. Mary Common")		
59,300 shares	Superior Industries International, Inc. Common Stock ("Superior Common")		
840,302 shares	Sycamore Networks, Inc. Common Stock ("Sycamore Common")		
172,762 shares	Synopsys, Inc. Common Stock ("Synopsys Common")		
550,965 shares	Tellabs, Inc. Common Stock ("Tellabs Common")		

#### **QUARTERLY ACTIVITY**

A more volatile period for equities this past quarter, particularly for smaller company securities like the ones on which the Fund is focused, helped Fund management to allocate nearly \$90 million toward the purchase of existing and new securities. Offsetting these purchases were the receipt of proceeds from the sales of securities, including two holdings taken out in Merger and Acquisition ("M&A") activity.

The Fund initiated a new position in American Axle and Manufacturing Holdings, a Tier I supplier to the automotive industry, and a leading manufacturer of driveline systems and powertrain components. Any investor looking for Baron von Rothschild's proverbial "blood in the streets" would find it among the U.S. auto supply industry. As the saying goes, when the "Big 3" catch a cold, the auto suppliers catch pneumonia, or



possibly, worse. Unfortunately for U.S. auto suppliers, General Motors (“GM”) and Ford in particular, have something much worse than a cold. General Motors, American Axle’s main customer, continues to steadily lose market share to Toyota, Nissan and others. Revenue in the company’s biggest market, North America, fell nearly 13% in the first quarter. GM’s dependency on SUVs and light trucks was grimly illustrated in the last quarter as sales of those high margin vehicles fell off a cliff. The company faces increasingly massive health care costs, as well. According to *The Detroit News*<sup>1</sup>, GM “foots the health care bill for 1.1 million workers, retirees and family members, which cost the company about \$5.8 billion last year.” It’s estimated that GM pays for the health care of 339,000 retirees, a number that grows every year. Toyota, by contrast pays for fewer than 3,000 retirees’ health care, a number that remains fairly static.<sup>2</sup> (Partly as a result of decades of downsizing and layoffs, every active GM worker today supports 2.5 aged retirees.) And, according to *Fortune*, “GM now buys more from Michigan Blue Cross than it does from any steel or rubber producer.”<sup>3</sup> GM management has stated that payments for retirees’ health care add about \$1,525 to the cost of every vehicle the company sells. In recognition of these and other negative trends, on May 5, 2005, rating agency Standard & Poor’s cut GM’s debt rating to “junk” status. (As we write, rating agency Fitch also downgraded GM.) Muhammad Ali once said about his nemesis Joe Frazier “Frazier is so ugly that he should donate his face to the U.S. Bureau of Wild Life.” If Ali had it right, then the U.S. auto industry and Joe Frazier have something in common.

Despite the terrible adversity engulfing the U.S. auto industry, Fund management believes that companies like

American Axle, as well as Superior Industries, another auto supplier holding in the Fund — with historically strong businesses and solid capital structures — will weather the current storm. American Axle continues to make strides with other original equipment manufacturers (“OEMs”), including foreign OEMs, and has meaningful opportunities to increase its bill of materials with its customers (*i.e.*, by providing a broader range of components or larger, more complex systems and increasing its content per vehicle). Axle Common was purchased near GAAP book value and around seven times 2004’s fully diluted earnings (earnings that are down considerably from the past couple of years’ results, owing to production cuts at GM, higher steel costs, and debt refinancing charges). Thanks to a major refinancing in 2004, the right side of the company’s balance sheet improved markedly (indeed, the company’s interest expense has been nearly cut in half, and were it not for the new financing, it’s not at all clear Fund management would have purchased Axle Common.)

Special investments demand special treatment, and such has been the case with the Fund’s investment in Kmart, now Sears Holdings. Two years ago, when the Fund made its investment, Kmart emerged from bankruptcy with a valuation approximating \$1 billion. In late March, 2005, Sears and Kmart completed their historic merger and the new entity, Sears Holdings (Nasdaq: SHLD), today boasts a market capitalization of approximately \$23 billion. With a 13-fold unrealized return on its investment, the Fund has benefited mightily from its investment. Nevertheless, today’s valuation is a much more demanding one — from a business perspective — in terms of what’s necessary to support the current market capitalization. Because the Fund is focused on

<sup>1</sup> *The Detroit News*, “Autos Insider,” Ed Garsten, February 10, 2005.

<sup>2</sup> *AutoWeek*, “Japan’s health care gives Toyota edge; Country Picks up Tab for Automaker’s Retirees,” James B. Treece, April 1, 2005.

<sup>3</sup> *Fortune*, “At GM, There’s Health to Pay,” Alex Taylor III, February 18, 2005.



smaller company equities (as Kmart was when it emerged from bankruptcy), it has a near zero probability of ever being able to buy Sears Common again, even in the case of a massive decline in the share price. And Fund management is, by nature, i) a reluctant seller of any security where more value creation seems likely, as is the case with Sears, and ii) loathe to create a large tax burden for its shareholders, as would be the case with a sale of Sears Common. Viewed from these multiple perspectives, Fund management elected to, in essence, purchase a form of insurance on at least a portion of its shares to protect the value of the position, as an alternative to an outright sale of the shares. The insurance, in the form of a “costless collar,” and purchased on one half of the Fund’s position, limits some of the Fund’s “upside” but similarly limits its “downside.” In short, Fund management hedged its position by simultaneously purchasing Sears Put options and selling Sears Call options when Sears Common traded around \$130 per share. The collar was initially “costless” because the premium received by selling the Call options equaled the cost of the premium incurred in purchasing the Put options. Having written, or sold, Call options with a strike price of \$155, the Fund may find itself getting its shares “called” away by the buyers of the call options at \$155 (the Fund’s limited upside). The Fund’s Put options, with a strike price of \$120, enable the Fund to “put” the stock to the option holder at a price of \$120 (the Fund’s downside protection should the stock fall below \$120). I wouldn’t anticipate using a collar or other options for other investments anytime soon, but the circumstances around this investment were so extraordinary, Fund management felt that extraordinary measures were warranted. During the quarter, the Fund also exercised its option to acquire 13,770 shares of Sears

Common at \$13 per share, an option granted with our initial investment in May, 2003.

#### **THE FLAWED QUEST FOR ACCOUNTING PRECISION**

Nearly three years ago, Congress enacted the Sarbanes-Oxley Act and President Bush signed it into law. As an attempt to reform and improve corporate disclosure and governance and to expand accountability rules, the law remains the most dramatic securities reform legislation since the 1930’s. By forcing corporate executives to attest to their corporations’ accounting accuracy, the Act also embodies the notion that Generally Accepted Accounting Principles (“GAAP”) can, and should in fact, produce the “truth.”

A recent article in *Barron’s*<sup>4</sup> suggested that GAAP continues to serve investors poorly, when the author asked “why can’t we trust financial reports?” The author implies that most corporate management teams are crooked or abusive of GAAP accounting, and that work by auditors ought to be supplemented by “independent experts” who could provide unbiased “market values” for corporate assets. In the author’s view such a movement toward market-based valuations would rid the world of irrelevant, historical cost-based accounting, eliminate biased management judgments, reduce ugly accounting surprises and generally make accounting easier (and easy) for everyone. Lastly, the author asserts, a market-based test for corporate assets and liabilities would produce financial statement numbers that are “understandable, current and relevant.”

A certain limited set of assets might lend itself to such a scheme (*e.g.*, an office building under long-term lease, or a utility with long-term contracts), and such an approach does have some precedent in certain

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<sup>4</sup> *Barron’s*, “Statements of Quality,” Walter Schuetze, May 30, 2005.



accounting settings. (In the U.K., for example, accounting rules require that owners of investment properties have properties appraised every six months. Those properties are stated at market value on the corporation's balance sheet, not at historic cost).

The author of the article, Walter P. Schuetze, comes with plenty of heavy-weight accounting experience: member of the Financial Accounting Standards Board ("FASB"), chief accountant at the Securities and Exchange Commission and partner at a national accounting firm. Nevertheless, I found his ideas symptomatic of the "Accuracy Movement" in corporate accounting, a Movement that will never find its Holy Grail. A few different examples should help to illustrate that a market value based-approach — like other attempts at accounting accuracy — is flawed, and won't get investors any closer to accounting "truth."

- Oil and gas exploration and production ("E&P") companies use outside engineering firms to help calculate their reserves of oil and gas. But the value of a company's reserves encompasses a host of critical assumptions about future production and expenses. The use of outside experts has not prevented either surprise or routine write-ups and write-downs of oil and gas company reserves.
- How would an "outside expert" develop a market value for one of Intel's semiconductor manufacturing plants, or one of U.S. Steel's steel making facilities without making some assumptions about future production levels and prices for those products? Are there outside "experts" who know more about Intel's planning than does Intel management?

**"Despite long-running debate, observers still question the best treatment of stock options for accounting purposes. I bet if you ask five 'experts' today, you'll get six different answers."**

- Property and casualty insurance companies already use actuaries to develop reserve estimates for future losses. How would an "outside expert" develop market values for a firm's liabilities related to environmental claims ten years hence, for example, or next year's wind storms in Europe or typhoons in Japan, without using some form of human judgment and making some basic assumptions?
- Many U.S. companies, with which I am familiar, value their inventories at the "lower of cost or market."

This accounting approach doesn't prevent a periodic write-down of those assets. Similarly, management is obligated to look at the accounting goodwill on a yearly basis and make a determination whether or not it is impaired. This is a market test that relies on management judgment. But how would an outside expert produce market values for these types of assets

without input from management?

- Despite long-running debate, observers still question the best treatment of stock options for accounting purposes. I bet if you ask five "experts" today, you'll get six different answers.

Could such market-based evaluations be accomplished in a timely fashion? Would the costs in both management time and energy and corporate costs make such an exercise worthwhile? A market-based approach for certain kinds of assets might bring with it a heightened volatility to the corporation's reported financial results. Such volatility may be equated with higher investment risk, raising the firm's cost of capital. In many cases, what's not on the balance sheet — for example, off-balance sheet liabilities, the firm's human capital, distributor relationships, brand names or changes in the competitive or regulatory landscape — may be much more important than the accounting assets and liabilities.



That the S&P 500 and Dow Jones Industrial Average trade at large multiples of their underlying companies' accounting net worth, and have for many years, suggests that investors may already value those elements not on the balance sheet far more than those on the balance sheet. If so, it's not clear that investors would benefit from having a "current and relevant" balance sheet.

The "Accuracy Movement" in accounting, as typified by the above-noted market value-based approach, fails to recognize that GAAP accounting is not designed to produce the "truth," in so far as it is supposed to present an easy-to-understand picture of the economic reality of the corporation. The Movement fails to recognize that human judgments and assumptions will always be an important part of GAAP accounting. The Movement may be motivated or encouraged by earnings-focused, investor-speculators who desire an easy solution to investing (*e.g.*, "give me a precise, single answer for a

company's earnings per share"). At Third Avenue, we have long recognized that GAAP accounting doesn't give us the "truth," but only some objective benchmarks by which we can judge a business over time. We weigh much more heavily than others the quality and quantity of resources in a business than we do a company's reported earnings under GAAP. And we try to align ourselves with management teams who do not need to rely on accounting sleight of hand to propel their company's stock price higher, and ones who have the proper economic incentives guiding their behavior. We think it's a recipe that works, which is why we are happy "eating our own cooking."

I look forward to writing you again when we publish our Third Quarter Report dated July 31, 2005.

Sincerely,

Curtis R. Jensen  
Co-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, 2005, the end of the second fiscal quarter of 2005, the unaudited net asset value attributable to the 88,740,216 shares outstanding of the Third Avenue Real Estate Value Fund (the "Fund") was \$27.55 per share. This compares with an unaudited net asset value of \$26.36 per share at January 31, 2005, and an unaudited net asset value of \$21.09 per share at April 30, 2004, adjusted for a subsequent distributions to shareholders. At June 9, 2005, the unaudited net asset value was \$28.97 per share.

### QUARTERLY ACTIVITY\*

During the second quarter of fiscal 2005, the Fund's outstanding shares increased to 88.7 million shares from 79.4 million shares — an increase of 11.7%; net assets increased to \$2.44 billion from \$2.09 billion — an increase of 16.7%; and net asset value per share increased to \$27.55 from \$26.36 — an increase of 4.5%. Net cash and short-term investments at quarter-end totaled 23.7%

of net assets, compared to 21.8% at the end of the last fiscal quarter.

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

Principal Amount or Number of shares	New Positions Acquired
28,500 shares	Agree Realty Corp. Common Stock ("Agree Common")
72,700 shares	Bedford Property Investors, Inc. Common Stock ("Bedford Common")
1,000,000 shares	Crystal River Capital, Inc. Common Stock ("Crystal River Common")
350,000 shares	Feldman Mall Properties, Inc. Common Stock ("Feldman Common")
5,260,000 shares	Henderson Land Development Company Ltd. Common Stock ("Henderson Common")
298,000 shares	PHH Corp. Common Stock ("PHH 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, 2005: The St. Joe Company, 8.62%; Forest City Enterprises, Inc., 7.39%; Catellus Development Corp. 6.34%; Vornado Realty Trust, 4.68%; Brascan Corp., 4.47%; ProLogis 4.05%; PS Business Parks, Inc., 2.89%; Sears Holding Corp., 2.68%; Brookfield Properties Corp., 2.52%; and British Land Company PLC, 2.01%.



<b>Principal Amount or Number of shares</b>	<b>New Positions Acquired (continued)</b>	<b>Principal Amount or Number of shares</b>	<b>Increases in Existing Positions (continued)</b>
2,443 contracts	Sears Holdings Corp. \$120 put options, expire 1/20/07 ("Sears Puts")	848,300 shares	Catellus Development Corp. Common Stock ("Catellus Common")
2,443 contracts sold	Sears Holdings Corp. \$155 call options, expire 1/20/07 ("Sears Calls")	4,500 shares	CRIIMI MAE, Inc. Common Stock ("CRIIMI MAE Common")
		356,300 shares	CRT Properties, Inc. Common Stock ("CRT Common")
		711,293 shares	Derwent Valley Holdings plc Common Stock ("Derwent Common")
\$4,475,000	<b>Increases in Existing Positions</b> Frank's Nursery & Crafts, Inc. Prime + 1% Debtor-in-Possession Loan due 9/9/05 ("Frank's DIP Loan")	323,800 shares	Fairmont Hotels & Resorts, Inc. Common Stock ("Fairmont Common")
686,100 shares	Acadia Realty Trust Common Stock ("Acadia Common")	7,939 shares	Frank's Nursery & Crafts, Inc. Common Stock ("Frank's Common")
640,300 shares	Affordable Residential Communities Inc. Common Stock ("Affordable Common")	350,000 shares	Jones Lang LaSalle, Inc. Common Stock ("Jones Lang Common")
188,400 shares	American Financial Realty Trust Common Stock ("American Financial Common")	500,000 shares	Killam Properties, Inc. Common Stock ("Killam Common")
800 shares	American Land Lease, Inc. Common Stock ("American Land Common")	895,207 shares	Liberty International plc Common Stock ("Liberty Common")
751,400 shares	Anthracite Capital, Inc. Common Stock ("Anthracite Common")	1,238,000 shares	Midland Realty Holdings Ltd. Common Stock ("Midland Common")
1,157,700 shares	Associated Estates Realty Corp. Common Stock ("Associated Common")	400,400 shares	ProLogis Common Stock ("ProLogis Common")
220,400 shares	Brascan Corporation Common Stock ("Brascan Common")	236,000 shares	PS Business Parks, Inc. Common Stock ("PSB Common")
629,951 shares	British Land Company plc Common Stock ("British Land Common")	1,319,448 shares	Quintain Estates & Development plc Common Stock ("Quintain Common")
13,000 shares	Capital Lease Funding, Inc. Common Stock ("Capital Lease Common")	150,000 shares	The St. Joe Company Common Stock ("St. Joe Common")
		2,306,615 shares	Unite Group plc Common Stock ("Unite Common")
		202,800 shares	Vornado Realty Trust Common Stock ("Vornado Common")



<b>Principal Amount or Number of shares</b>	<b>Decrease in Existing Position</b>
\$2,089,766	Frank's Nursery & Crafts, Inc. 10.15% Post-Petition Loan due 5/21/05 ("Frank's Post-Petition Loan")
	<b>Positions Eliminated</b>
\$10,000,000	Winn-Dixie 8.181% Pass-Through Trust Certificates due 9/1/24 ("Winn-Dixie Notes")
1,430,850 shares	Falcon Financial Investment Trust Common Stock ("Falcon Common")
500,000 shares	Kmart Holding Corp. Common Stock ("Kmart Common")
22,951 options	Kmart Holding Corp. \$13 options, expire 5/6/05 ("Kmart Options")
1,955,200 shares	LNR Property Corp. Common Stock ("LNR Common")
312,199 shares	Sizeler Property Investors Inc. Common Stock ("Sizeler Common")

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

During the quarter ended April 30, 2005, the Fund initiated positions in the common stocks of a Hong Kong property developer and investment holding company, four U.S. REITs and a U.S. mortgage lender. Additionally, the Fund received Sears Common in exchange for Kmart Common, upon Kmart's acquisition of Sears. The Fund eliminated its positions in the common stocks of two REITs (one as a result of M&A activity) and a real estate operating company (also as a result of M&A activity). The Fund also eliminated its position in the lease pass-through notes of a grocery retailer. As usual, the Fund continued to increase its positions in many of its existing holdings, as opportunities arose to acquire securities at reasonable prices. As noted above, the Fund's net cash and short-term investments as a percentage of net assets increased from 21.8% at the end of last quarter to 23.7% at the end of the current quarter. A significant portion of the

increase was the result of two resource conversions (LNR Common and Falcon Common) that generated cash proceeds of \$134.1 million (or approximately 6.4% of net assets at 1/31/05). While it appears that the Fund's cash balances are building, further analysis illustrates that the Fund has been investing more cash than the net proceeds from subscriptions and redemptions of Fund shares. The following table highlights the Fund's cash activity for the quarter.

#### **Summary of Quarterly Cash Activity (\$000's)**

Net cash and short-term investments at 1/31/05	\$ 458,044
Net proceeds from subscriptions/redemptions	252,564
Proceeds from LNR Common acquisition	123,373
Proceeds from Falcon Common acquisition	10,731
Proceeds from sale of other securities	11,672
Purchases of securities	(284,102)
Other cash sources/uses (net) plus unsettled trades	<u>17,404</u>
Net cash and short-term investments at 4/30/05	<u>\$ 589,686</u>

As noted in last quarter's report, the LNR Property Corp. acquisition by a private fund closed in February 2005. The Fund received cash proceeds of \$63.10 per share. LNR Common was one of the Fund's oldest and largest holdings with an average cost of approximately \$40 per share. Fund management was very pleased with the overall return on LNR Common. The other takeout during the quarter was not a positive outcome. Falcon Financial Investment Trust was acquired by iStar Financial Inc. for \$7.50 per share. The Fund participated in Falcon's IPO in December 2003, purchasing shares at \$9.00. Falcon was unable to fully implement its business strategy of funding loans to automotive dealerships and securitizing the loans through the issuance of asset-backed securities. While we were disappointed with the outcome of the investment, we were pleased that the company's management and board of directors moved quickly to make the right decision (sell the company)



when it became clear that the environment for their product had changed and continuing as a stand-alone public company would not be in the best interest of shareholders. The Fund lost money on the Falcon Common investment, but if not for swift decisions made by the company, it could have been much worse.

The Fund originally purchased Winn-Dixie Notes at approximately 75% of par value in February 2004. The Fund sold the Winn-Dixie Notes at approximately 80% of par value after the company filed Chapter 11 Bankruptcy. During the one-year holding period, the Fund received cash interest payments with about an 11% current yield on cost. The Fund had also purchased \$5.00 put options on Winn-Dixie common stock expiring in January 2005 and January 2006. The Fund closed out the January 2005 options prior to expiration. The January 2006 options are “in the money” since Winn-Dixie filed Chapter 11 and its common stock is trading for about a dollar per share. The overall investment return on the Fund’s Winn-Dixie investment was very good. It’s just too bad we didn’t buy more. The Fund also sold its small position in Sizeler Common for \$11.85 per share after the company, in an apparent move to entrench management while in the midst of a potential proxy contest with an activist shareholder, issued new common shares at below-market prices. The Fund’s cost basis in Sizeler Common was \$8.47 per share.

Kmart completed its acquisition of Sears on March 24th. The Fund received one-for-one shares in the new company, Sears Holdings Inc. Additionally, the Fund exercised its option to acquire an additional 22,951 shares of Sears Common at \$13.00 per share. The option was granted in May 2003 in connection with our initial investment in Kmart. The Fund’s investment in Sears Common has increased nearly thirteen-fold since May 2003. Our original thesis in May 2003, when the Fund purchased Kmart Common for \$10.00 per share, was that Kmart controlled a lot of extremely valuable real estate

that protected our downside in the event the reorganized company failed as a retailer. Kmart management has done a fabulous job of harvesting some of that real estate value and built a war chest of cash that enabled it to acquire Sears. The jury is still out on whether or not the combined company can realize synergies and effectively compete with other retailers like Wal-Mart and Target. While Fund management has a high level of confidence in Eddie Lampert (the Chairman of Sears Holdings) and his management team, we recognize that the enterprise value of Sears/Kmart is no longer fully supported by real estate values. Clearly we were tempted to take some of our profit off the table by selling at least a portion of the position despite the obvious tax consequences to Fund shareholders. But instead of selling some of the Fund’s holdings, the Fund was able to purchase a zero-cost collar for approximately half its holdings by purchasing put options, expiring in January 2007 with a \$120 strike price, and selling call options, expiring in January 2007 with a \$155 strike price. This effectively created a floor price of \$120 per share and a ceiling of \$155 per share at no cost to the Fund when Kmart Common was trading at about \$130. Fund management does not profess to be experts in options trading, but this transaction seemed like a no-brainer.

Substantial new additions to the Fund during the quarter include Crystal River Common, Feldman Common, Henderson Common and PHH Common. Crystal River is a newly formed mortgage REIT that primarily invests in mortgage-backed securities. The company is externally managed by Hyperion Capital Management, a company with a long history of performance in mortgage and asset-backed securities. Hyperion was founded by Lewis Ranieri, one of the pioneers of the securitized mortgage market in the United States. Hyperion recently agreed to be acquired by Brascan Corp. (one of the Fund’s largest holdings). Brascan also owns 5.7% of Crystal River Common. The Fund purchased unregistered shares of Crystal River



Common in the company's initial offering to qualified institutional buyers. The company has committed to filing a registration statement with the SEC within 270 days of the offering. Feldman Mall Properties is a REIT that specializes in acquiring and redeveloping regional malls. The company completed its initial public offering ("IPO") in December 2004 at \$13.00 per share. The Fund declined to participate in the IPO based on the initial price, but recently began acquiring shares at a substantial discount to the IPO price. Henderson Land is one of the largest property developers in Hong Kong with investments in office buildings, retail centers, residential developments, land holdings and hotels in Hong Kong, Kowloon and the New Territories. The company also has strategic investments in other listed companies including Hong Kong and China Gas Company, the sole supplier of piped gas in Hong Kong, serving over 1.4 million local customers. Henderson Land has a very strong financial position with debt-to-assets of approximately 12%. The Fund acquired Henderson Common at a substantial discount to net asset value. PHH Corp. is one of the largest originators and servicers of residential first mortgage loans in the United States. The company was spun-off from Cendant Corporation in January 2005. PHH markets its full line of mortgage products to consumers through relationships with corporations, financial institutions (*e.g.*, Merrill Lynch and American Express) and real estate brokerage firms, including Cendant's franchises (Century 21, Coldwell Banker and ERA) as well as independent realtors and other mortgage banks. The company also operates a vehicle fleet management service that leases vehicles to corporate customers. PHH's fleet management business has provided stable and predictable returns for several years, and represents approximately 40% of the company's

assets and projected EBITDA. While the mortgage origination business is susceptible to volatility as mortgage interest rates fluctuate, the market price for PHH Common does not appear to give much value to the company's \$144 billion mortgage servicing portfolio. PHH earns servicing fees on each loan for as long as it remains outstanding. Since loans can be prepaid at any time, a mortgage servicing portfolio is subject to valuation changes. As mortgage rates increase, loan prepayments tend to decrease and the servicing portfolio remains more stable (and theoretically more valuable). The Fund acquired PHH Common at a discount to tangible book value and a substantial discount to other mortgage companies primarily because it is a recent spin-off, there is no Wall Street sell-side coverage yet, and it is a complicated business to analyze. A perfect fit for Third Avenue.

**“From experience, I can tell you that a primary benefit to investing in real estate through the common stocks of extremely well capitalized public real estate companies is the ‘sleep at night’ factor.”**

#### **INVESTING IN REAL ESTATE — DIRECT OWNERSHIP OR REAL ESTATE SECURITIES?**

Since the Fund's investment objective is long-term capital appreciation, we focus our investments in common stocks of well-capitalized real estate operating companies and REITs. We try to make investments in solid companies that offer prospects for excellent long-term capital growth, while reducing overall investment risk with our “safe and cheap” philosophy. Earlier in my career, as a real estate developer and investor, I was intimately involved in making direct property investments. From experience, I can tell you that a primary benefit to investing in real estate through the common stocks of extremely well capitalized public real estate companies is the “sleep at night” factor.

There are several ways to invest in real estate where the desired result is cash flow and capital appreciation — in



essence, owning equity stakes in real estate. Each investment type has distinct advantages and disadvantages as outlined below.

- Direct investments (purchase fee ownership to property)
- Real estate limited partnerships or limited liability companies
- Common stocks of real estate companies (REITs, etc.)
- Real estate mutual funds

### **Direct Investments**

Examples of direct investments would include purchasing fee ownership of a rental home, apartment building, shopping center, office building, *etc.* Since we all have to live somewhere, I do not include a primary personal residence in this category.

The advantages of owning property directly include control, tax write-offs and the ability to obtain financing on favorable terms. The ability to make decisions regarding the maintenance, leasing, management and sale of property can be very desirable — especially for experienced property investors. Owning property affords an investor the opportunity to take advantage of certain tax benefits (primarily depreciation deductions) that can shelter some or all of the property's cash flow from income taxes. In certain instances, the investor can offset taxable income from other sources with non-cash losses generated from property investments. Properties can easily be financed based upon the quality and quantity of net cash flow that is generated from tenant leases. In many cases (again, depending upon the experience of the investor) lenders will make non-recourse loans secured only by the property without personal guarantees. If all goes well, a property can be refinanced a few years later and the investor can cash in on appreciation without realizing

capital gains. This, theoretically, can be repeated over and over again as the property continues to appreciate.

The disadvantages of owning property directly include lack of liquidity, lack of available financing, management issues, and lack of diversification. Quality investment properties are relatively easy to sell if priced and marketed properly. However, it is not unusual for a property sale to take months from the time a decision is made to sell to the actual receipt of sale proceeds. Financing for property investments at favorable rates and terms is often difficult to obtain — especially during periods of credit tightening. Less experienced investors may not be able to obtain non-recourse mortgage financing and often must provide personal guarantees. Most loans on investment properties do not fully amortize over the term of the loan and require a balloon payment at maturity. Takeout financing may not be available at maturity and the investor may be forced to sell at an inopportune time. Investment properties require management. Depending upon the property type, management activities can be very intensive or they could be minimal. For example, owning a multi-tenant retail property requires maintenance, bookkeeping, collection, legal, leasing, construction and other routine activities. Many of these management functions can be contracted with third parties, but absentee ownership entails other risks. On the other end of the spectrum, owning a single tenant, triple-net leased property is much less management intensive and generally requires more upfront due diligence in determining the tenant's credit quality and the property's alternative uses. Finally, unless an investor has significant capital to invest in a diversified portfolio of properties, it is difficult to avoid concentration risks — including property type, geographic location and tenant mix.

### **Limited Partnerships and Limited Liability Companies**

Real estate limited partnerships (LP) were very popular prior to the enactment of tax law changes in 1986. Many limited partnerships were registered with the SEC and



partnership interests were offered to the public. Private limited partnerships and limited liability companies (LLC) are still very common vehicles for real estate ownership.

LPs and LLCs offer the advantages of pass-through of tax losses, limited liability, defined term, and expert management. LPs and LLCs are not subject to federal income taxes and all income, gains and losses are passed through to its partners based on ownership interests. Similar to direct ownership, limited partners and LLC members can shelter cash flow from taxes primarily due to the pass-through of depreciation deductions. Limited partners and LLC members are only at risk for the amount of capital invested in the LP or LLC and creditors of the LP or LLC generally cannot collect from them. LPs and LLCs generally have a defined life. Therefore, it is assumed that at some point in the future the properties will be sold and the proceeds distributed to the equity holders. The general partner of the LP or managing member of the LLC normally has (or at least claims to have) the necessary expertise to acquire, manage, operate, lease, finance and sell properties.

Disadvantages of LP and LLC investments include lack of liquidity, limited voting rights (control), and complex tax reporting. There is a very limited market for publicly-traded LP units and no market for private LP interests. Therefore, liquidity is only available when properties are sold or refinanced and the general partner or managing member either distributes cash or offers to repurchase LP or LLC interests (usually at some discount to fair market value). Additionally, limited partners have no say in managing the affairs of the partnership except for limited voting rights that typically relate to major decisions such as a sale or liquidation. Limited partners and LLC members report their share of the company's earnings and losses based upon information provided by the general partner on a Schedule K-1. The tax reporting is

often complex and investors may be required to file tax returns in multiple states.

### **Common Stocks**

There are an abundance of publicly-traded real estate companies (PRCs) whose common stocks can be bought and sold on major stock exchanges. For purposes of this discussion, I combine real estate investment trusts (REITs) and real estate operating companies (REOCs) in the same category. These companies come in all shapes and sizes — some are highly diversified by property type or geographic area, and others are very concentrated.

Investing in PRCs provides distinct advantages over direct ownership or limited partnerships including:

- Price — Common stocks of many PRCs often trade at discounts to net asset value, enabling investors to effectively buy real estate cheaper than making direct investments.
- Liquidity — Common stocks of most PRCs are traded on major exchanges and can (in most cases) easily be converted to cash.
- Voting rights — Shareholders elect a board of directors; and shareholders generally must approve major corporate transactions.
- Simplified tax reporting — Shareholders receive a Form 1099 from the PRC for dividends received. There is no complicated record keeping (as with direct ownership) or complex reporting requirements (as with partnerships).
- Professional management — Many PRCs have experienced real estate operators, developers and managers running the company. Not enough can be said to illustrate the importance of quality management.
- Diversification — PRCs have total market capitalizations ranging from a few million dollars to several billion dollars. A large capital base enables PRCs to spread risk among multiple assets. An investment of



only a few thousand dollars in the common stock of one PRC can mean investing in several hundred properties in various geographic locations.

- Access to capital markets — PRCs have access to much cheaper forms of capital (both debt and equity) than most individual investors or limited partnerships. This enables them to increase their portfolios and enhance investment returns.
- Ability to use margin — Most PRC common stocks can be bought on margin. Though buying stocks on margin adds obvious elements of risk, it is possible to enhance returns with leverage. Theoretically it is possible to more highly leverage an investment in a PRC than in a direct investment. For example, an investor can usually borrow up to 70% of the appraised value of an investment property — requiring 30% equity. If an investor uses 50% margin to buy common stock in a PRC that also uses 70% leverage, the investor has effectively created 85% leverage. (It should be noted that this is not a strategy we recommend.)

Investing in PRCs also has its disadvantages, including:

- Limited control — While shareholders do have voting rights, investment and operating decisions are controlled by management.
- Lack of tax benefits — PRCs do not provide flow-through deductions like direct ownership or partnerships. REITs enjoy a special tax exempt status provided they distribute 90% of their taxable income to shareholders. REIT dividends are generally taxable to shareholders at ordinary income tax rates. Real estate operating companies are usually corporations that are subject to corporate income tax. If the corporation pays dividends, they are also generally taxable to shareholders at the 15% tax rate, resulting in double taxation.
- Difficult to choose good ones — With an abundance of PRCs to choose from, it can be difficult for investors to properly evaluate each company's

portfolio, financial stability and quality of management.

In recent years, private REITs have become a popular choice for many investors. Private REITs offer many of the same advantages as public REITs except for price and liquidity. The price to acquire common shares in a private REIT is often based upon the projected dividend yield as opposed to underlying net asset value and there are usually significant front-end fees paid to brokers and/or sponsors. By definition, the common shares are privately held, and there is little or no liquidity if an investor desires to sell.

#### **Real Estate Mutual Funds**

There are also an abundance of mutual funds that specialize in investing in securities of PRCs. Real estate mutual funds may have as their objective either current income, total return or capital appreciation. Each fund's objective will dictate whether its investments will be concentrated in REITs or REOCs, and their investment discipline will dictate price consciousness and tolerance for risk. The advantages to investing in real estate mutual funds include liquidity, diversification, investment expertise, minimal investment costs and simplified tax reporting.

Overall, the real advantage of investing in real estate through the Third Avenue Real Estate Value Fund ought to be price. The Fund tries to acquire common stocks in real estate and real estate related companies at prices that represent discounts to prices being paid for direct investments or by limited partnerships. Historically — though not always — it has been a lot easier to obtain these discount prices when buying common stocks in public markets rather than being a direct investor in the private market or a limited partner.

#### **FUND CLOSING TO NEW INVESTORS**

Fund management has recently made the decision to close the Fund to new investors effective July 1, 2005.



Existing investors will still be able to add to their holdings in the Fund without restrictions. The motivation to close the Fund is primarily the desire to invest the Fund's excess cash without the pressure of continuing inflows from new investors. As I noted in recent shareholder letters, Fund management has expanded its search for well-capitalized real estate companies outside the U.S. borders. Our efforts have born fruit and we expect to invest more in the common stocks of non-U.S. companies. However, this process may take awhile, and it seems prudent to stem the flow of new money coming into the Fund that could cause existing shareholder returns to be diluted. We cannot predict whether or not the Fund will be permanently closed to new investors. If we are successful in our efforts to find suitable investments and reduce excess cash balances, the Fund would likely reopen to new investors.

I look forward to writing to you again when we publish our quarterly report for the period ending July 31, 2005.

Sincerely,

Michael H. Winer  
Portfolio Manager,  
Third Avenue Real Estate Value Fund



## Third Avenue International Value Fund



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

Dear Fellow Shareholders:

At April 30, 2005, the unaudited net asset value attributable to the 61,814,211 shares outstanding of the Third Avenue International Value Fund (the "Fund") was \$19.18 per share. This compares with an unaudited net asset value at January 31, 2005 of \$18.59, and an unaudited net asset value of \$14.77 per share at April 30, 2004, adjusted for a subsequent distribution to shareholders. At June 9, 2005, the unaudited net asset value was \$19.39 per share.

### QUARTERLY ACTIVITY\*:

In the most recent quarter of operations, the Fund established new positions in the common stocks of two companies, added to positions in the common stocks of 22 companies, reduced one position and eliminated its holdings in one company.

#### Number of shares

28,511 shares

42,300 shares

#### New Positions Acquired

CNP-Cie Nationale a Portefeuille  
 ("CNP Common")

Fujitsu Business Systems, Ltd.  
 ("Fujitsu Common")

#### Number of shares

310,400 shares

10,038,000 shares

3,976,000 shares

9,131,069 shares

302,175 shares

26,208,700 shares

89,000 shares

50,300 shares

401,800 shares

160,800 shares

862,900 shares

610,000 shares

#### Increases in Existing Positions

Asatsu-DK Inc ("Asatsu Common")

BIL Int'l. Ltd. ("BIL Common")

Boardroom Ltd. ("Boardroom")

BRIT Insurance Holdings, plc  
 ("BRIT Common")

Canfor Corporation  
 ("Canfor Common")

Chuan Hup Holdings Ltd.  
 ("Chuan Hup Common")

Del Monte Pacific Ltd.  
 ("Del Monte Common")

Dundee Precious Metals Inc.  
 ("Dundee Common")

Farstad Shipping ASA  
 ("Farstad Common")

Futaba Corporation  
 ("Futaba Common")

Golar LNG Ltd. ("Golar Common")

Guoco Group Ltd. ("Guoco 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, 2005: Toll NZ Ltd., 3.52%; Hutchison Whampoa, 3.06%; Aker Kvaerner ASA, 2.61%; Zinifex Ltd., 2.26%; Siem Offshore, 2.25%; Skandia Forsakrings, 2.21%; BRIT Insurance Holdings PLC, 2.20%; Telecom Corporation of New Zealand, 2.10%; Chuan Hup Holdings Ltd., 1.88%; and Asatsu-DK, 1.87%.



<b>Number of shares</b>	<b>Increases in Existing Positions (continued)</b>
5,257 shares	Hal Trust NA ("HAL Common")
1,662,000 shares	Hutchison Whampoa Ltd. ("Hutchison Common")
4,682,000 shares	Liu Chong Hing Investment Ltd. ("LCHI Common")
220,800 shares	Nichicon Corp ("Nichicon Common")
477,400 shares	Noranda, Inc ("Noranda Common")
4,006,196 shares	Rubicon Ltd. ("Rubicon Common")
4,052,000 shares	Skandia Forsakrings AB ("Skandia Common")
1,582,700 shares	Telecom Corp of New Zealand Ltd. ("Telecom Common")
1,915,917 shares	Toll NZ Ltd. ("Toll Common")
6,752,000 shares	Vitasoy International Holdings Ltd. ("Vitasoy Common")
	<b>Position Reduced</b>
15,000 shares	Ganger Rolf ASA Common Stock ("Ganger Common")
	<b>Position Eliminated</b>
<b>Number of shares</b>	Fomento de Construcciones y Contratas SA ("FCC Common")

## REVIEW OF QUARTERLY ACTIVITY

### Purchases

Compagnie Nationale a Portefeuille ("CNP") is a business development and investment company listed in Belgium. The assets of CNP comprise cash, a portfolio of minority interests in listed securities, a private equity portfolio and a controlling interest in Pargesa SA ("Pargesa"). Pargesa is a listed company in Switzerland also trading at a discount to net asset value. Pargesa's primary asset is a controlling interest in Groupe Bruxelles Lambert ("GBL"), which is also listed in Belgium and also trades at a discount to its net asset value. GBL has ownership interests in well-managed companies such as

Total S.A., Suez S.A., Imerys S.A. and Bertelsmann AG. Historically, the management teams of CNP, Pargesa and GBL have had a successful long-term record of investing, focused on building and periodically realizing business value. In our investment in CNP we have purchased, through a series of discounts, a high-quality portfolio of companies, each of which, on a stand-alone basis, appear to be reasonably valued. Based on the market value of its holdings and a conservative estimate of the value of its unlisted assets, our purchase price of CNP offered a significant discount to net asset value.

Fujitsu Business Systems Ltd. ("FBS") is a listed subsidiary of the Japanese electronics and computer firm Fujitsu Ltd. ("Fujitsu"). Its main business is resale and installation of Fujitsu equipment and related software customization and IT consulting services, to small and medium enterprises throughout Japan as well as to local governments. FBS also services large clients of the parent company in the locations where the parent has no presence, such as in smaller towns and rural areas. FBS shares some of Fujitsu's network and business infrastructure. Most importantly, FBS benefits from Fujitsu's brand name and product innovation; unlike independent resellers, it has no need to spend money on brand building and marketing.

The business generates strong cash flows, and FBS has built up a sizable cash position. We were able to buy common stock of the company at prices below the value of its cash, paying nothing for its relationship with Fujitsu and its ongoing business relationships with Japanese small and medium enterprises.

### Sales

During this period we sold our holding in Fomento de Construcciones y Contratas SA ("FCC"), a diversified Spanish company with activities *inter alia* in the construction sector, provision of public services such as



water supply to towns, etc. and the production of cement. The sale was conditioned upon a number of factors:

- A valuation that amply exceeded our estimates, which seemed even more so in light of the imminent diminution of the European Union funding for construction funds to Spain which had been a driver for much of the construction contracts of which FCC was a beneficiary;
- More significantly, we feel that the actions by the controlling shareholder to entrench themselves, so as to prevent the participation of the company in the inevitable consolidation in the industry, is likely to be deleterious to the company's prospects and by implication, to the other shareholders. While our experience with this investment has been financially rewarding and satisfactory by most measures, we felt that these actions by the management signaled an indifference (or hostility) to outside shareholder interests — resulting in our sale of these shares.

### Resource Conversion

In our last quarterly letter, we wrote about the purchase of Skandia Common, noting that it was a collection of “three distinct (and importantly freestanding and separable) groups of businesses: the business in Sweden, in the UK, and the rest (Continental Europe and Latin America).” We note, with some dismay, that Skandia has been the subject of a merger approach from Old Mutual plc (“OM”), a South African life insurer. While on one hand we are pleased, in that such overtures validate, to some degree, our judgment about the attractiveness of Skandia's various businesses and the business values embedded in our investment, the dismay stems from the potential “pre-empting” by this possible bid of the improved valuation that would have been realized were the current, new management in place long enough to realize the operational improvements that could be effected by imposing some discipline upon this loosely structured collection of regional fiefdoms. While there is

some doubt whether OM will actually bid for Skandia, and if so, whether it will succeed, our preference should be clear — we would be happier were it not to take place, at the present time or at the price levels that have been bandied about in the press.

### Is the Fund a hedge against a falling US dollar?

The US dollar decline in recent history has led some investors to seek out “hedgies” against such a decline, one of which has been investment in mutual funds investing in equity securities of companies domiciled outside the US. The purpose of this section is to hopefully disabuse investors (existing or prospective) of the idea that the Fund is managed with such a purpose in mind.

To that end, we would note:

- 1) That the US dollar has declined considerably in relation to some of the other major currencies should not be a basis for an automatic extrapolation that it continues to decline, and even less a basis for any investment we make. Significant declines in a currency's exchange rate normally set into motion forces, which ultimately would result in some form of reversal of such declines (*e.g.*, increased competitiveness of certain industries, *etc.*). That said, some of the factors behind the US dollar decline are still intact, *e.g.*, the need for continued sizable foreign issuance of securities to finance the ongoing trade deficits. Nonetheless, while extrapolation of the declining dollar has not been a consideration in our investment approach, we have always been watchful for any currency mismatches within the balance sheets or income statements of our investee companies, which might be adversely affected were the US dollar to decline considerably.
- 2) One of the ideal hedges against a declining US dollar would be low-duration, high-grade or sovereign fixed-income paper in the “appreciating” currency (ideally those which also enjoy an above-average yield). Knowing which currency is apt to appreciate against the US dollar presupposes prescience on a scale we



consider ourselves incapable of. Our liquid, investable reserves are therefore currently held in US treasury paper. To the extent we have earmarked meaningful purchases in a particular country, which we plan to execute over longer periods of time, we hold such amounts in short-duration, sovereign paper of the country where these securities trade. Accordingly, our cash balances, which are currently largely US dollar-denominated would NOT serve to hedge against US dollar declines.

3) Turning then to the principal asset of the fund, its holdings in non-US equity securities, we note while these are foreign companies, a number of them have significant US dollar or US dollar-linked revenue. For example, most of our companies operating in the area of natural resources have revenue streams that are US dollar-denominated or US dollar-linked. That is, notwithstanding the fact that it might be domiciled in Australia, Canada or Norway, its business activities link it firmly to the US dollar.

Resource companies aside, as a company gets larger and more global in scope, its revenues are increasingly likely to have an increasing portion of its revenues US dollar-denominated or linked.

There is a further nettlesome issue relating to the US dollar-sensitivity of a foreign company with a totally domestic customer base, which might be glossed over by a casual reader. Take for example, our largest holding, the common shares of Toll NZ Ltd., which provides rail and other transport services in New Zealand. While the customer base is composed of domestic companies (*e.g.* forest products, dairy products, *etc.*), the competitiveness of many of these companies, and hence the demand for these companies' products, is linked to the NZ dollar-US dollar exchange

rate. By implication, the demand for Toll NZ' s services which is a function of the demand for these companies' products, could be adversely affected by an excessive appreciation in the NZ dollar vs. the US dollar. As a result, here is a company which serves a purely domestic client base with a revenue stream in a non-US dollar currency, but will nonetheless be affected by a declining US dollar.

The conclusion from the above is merely to say, that our investments in foreign securities might have a greater US dollar exposure than would be inferred by a casual reading of their financials.

4) A corollary to the last item in the preceding paragraph: a significant decline in the US dollar could have adverse consequences even for purely domestic companies (*i.e.*, non-exporters) domiciled in countries with appreciating currencies, given their indirect sensitivity to the US dollar. So, owning purely domestic companies in foreign markets would be unlikely to be a successful hedge in the wake of a meaningful US dollar decline.

The above is not to say that we are entirely oblivious to currencies and their levels. It is merely to say that much of our thinking about currencies is in the context of the businesses that we buy, rather than engaging in any speculation about changes in currency values, *per se*. For the reasons mentioned above, we would submit that the Fund, notwithstanding its foreign securities holdings, would provide a limited hedge against declines in the US dollar.

**“Much of our thinking about currencies is in the context of the businesses that we buy, rather than engaging in any speculation about changes in currency values, *per se*.”**



### GEOGRAPHICAL DISTRIBUTION OF INVESTMENTS

At the end of April 2005, the geographical distribution of equity securities held by the Fund was as follows:

	<u>%</u>
Norway	10.63
New Zealand	6.74
Hong Kong	6.37
Canada	6.24
Japan	5.29
Singapore	4.16
Sweden	2.40
United Kingdom	2.36
Australia	2.26
France	2.00
Netherlands	0.89
Belgium	0.52
Switzerland	0.46
Panama	0.40
Argentina	<u>0.20</u>
Equities—Total	50.92
Foreign Government Debt	3.48
Cash & Other	<u>45.60</u>
Total	<u>100.00</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 have noted in 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.

### CLOSING THE FUND TO NEW INVESTORS

As of July 1, 2005 the Fund will not be accepting investments from new investors, however existing investors can continue to add to their investments. This action has been motivated by the rapid inflow of new cash, which given the price sensitive nature of our investment discipline for purchasing securities has translated into a rising cash balance — notwithstanding the sharp increase in the rate at which we have deployed the new cash. The Fund normally operates with a 10% cash position as a precautionary minimum, in order to meet redemptions and the like, and is unlikely to let it drop below that level. Accordingly, if the cash in excess of that level is employed and attractive investment opportunities present themselves, the Fund will then reopen for new investors. Conversely, should these two conditions not be realized, the Fund is unlikely to reopen for new investors.

I look forward to writing to you again when we publish our next quarterly report for the period ended July 31, 2005.

Sincerely,

Amit Wadhwaney  
Portfolio Manager,  
Third Avenue International Value Fund

**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 carefully before you send money. The investor should consider the investment objectives, risks, charges, and expenses of the investment company carefully before investing. 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.**

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