

21 August 2010

Dear Unitholder

Response to misleading and deceptive material provided to some unitholders

The Board of Balmain Trilogy Investment Management Pty Ltd (**Balmain Trilogy**) has become aware of a letter that has been produced by Allan Garnham and circulated to some, but not all, unitholders in the Pacific First Mortgage Fund (**Fund**). The letter concerns the upcoming unitholder meeting that is to be held on September 1 2010 (**Meeting**) and purports to critique elements of Resolutions 1 and 2 in respect of which Unitholders will vote at that meeting.

The Board of Balmain Trilogy consider the claims, statements, inferences and assertions contained in Mr Garnham's letter to be defective in significant and material respects and that the author/s of the letter have made these claims, statements, inferences and assertions without appropriate consideration (or understanding) of the information provided to unitholders by Trilogy Funds Management Limited (**Trilogy**) and Balmain Trilogy. Additionally Mr Garnham has made no effort to discuss any of these matters with Trilogy to improve his understanding of the Fund. Further, we have received legal advice that these claims, statements, inferences and assertions are misleading and deceptive.

The opinions expressed in the letter are indicative of the author/s lack of any qualification, experience or knowledge of the workings of the Fund or even cursory knowledge of the mortgage funds management industry in general. Whilst the author/s are entitled to their opinion, they have failed to present an accurate or balanced view in respect of the proposed New Strategy prepared by Trilogy and Balmain Trilogy. Trilogy and Balmain Trilogy are concerned that the litany of misleading and illogical statements will deceive and confuse Unitholders.

Attached to this letter are a series of statements that have been extracted from Mr Garnham's letter along with our specific comments in relation to those statements.

Your vote is yours alone. It is important that you are able to exercise that vote with a solid understanding of the material presented and not be deceived by misleading information.

The independent directors of Trilogy and directors of Balmain Trilogy again reaffirm their recommendation that you vote in favour of Resolution 1 (New Strategy), in favour of Resolution 2 (Current Value Redemption Facility) and against Resolution 3.

Yours sincerely



Rodger Bacon

Joint Chief Executive



Andrew Griffin

Joint Chief Executive

Comment

Garnham: (para 2)

I am very concerned that the proposals offered by the manager are no more than an attempt at a BIG cash grab... with the \$8.3m in fees paid to the manager (2009 — 2010) for (managing) less than 45 loans.

Response 1

- The number of loans is not determinative of the work being done by Trilogy. The Fund is no longer a passive mortgage fund holding standard 'performing' loans (i.e. loans not in default and producing income) but consists of mortgage assets/securities that require 'intensive care' management where the borrowers are in default and no income is being generated. The majority of the assets are either incomplete developments or require significant work to restore value. The workload in respect of managing a performing loan is negligible (the Balmain Group alone manages well over 5,000 performing loans). The workload of managing 'defaulting' loans is significantly greater and requires the establishment of comprehensive recovery strategies for each loan and daily management of lawyers, receivers, administrators, valuers, agents and associated property consultants.
- There has been a significant reduction in management fee since Trilogy became the responsible entity of the Fund, specifically:
 - o Fees paid to City Pacific Limited (CPL) in 2008: \$30.0m
 - o Fees paid to CPL in 2009: \$25.1m
 - o Fees paid to Trilogy in 2010: \$8.3m
- Notwithstanding this significant reduction in fees the New Strategy proposes a further reduction of 33% in base management fees of 67%, the Balmain Trilogy team managing the Fund's portfolio of assets comprises over 20 executives. This compares to the three executives 'managing' the Fund under CPL's stewardship.

Garnham: (Para 4)

The following article appeared on the internet:- BusinessDay, 18 November 2009, "... But Balmain Trilogy's other chief executive, Rodger Bacon, sees the potential for redemption. He visited the Martha Cove development yesterday and told BusinessDay the project was a "spectacular asset" that could unlock investor value in the long term. "There is a huge amount of value to unlock," he said. Net tangible asset backing of the \$1 units could head towards 80c from the current 48c ..."

Response 2

- The Board of Balmain Trilogy specifically refuted this claim as false via a statement posted on the website on 20 April 2010. Mr Bacon did not make this statement.

Garnham: (paras 5 & 8)

Please note Mr. Bacon's comments about Martha Cove, "a spectacular asset", "There is a huge amount of value to unlock", and of course "units could head towards .80c" - so just try to think how much 20% of that 'huge amount' is worth: from \$0.48 (today's value) to \$0.80 (Mr. Bacon's projection), let's assume it takes 4 years and the cash rate remains at 4.5%. For example, indexing \$415m over 4 years: Year 1, \$415m + 4.5% = Year 2, \$434m + 4.5% = Year 3, \$451 m + 4.5%, = Year 4, \$472m + 4.5%, = \$493m. To reach \$0.80 with 887m units, the fund value would be \$710m. The increase = \$710m - \$493m = \$217m. The manager's share would be \$21.7m * .2 = \$43.4m.

This is especially interesting when one takes into account Bacon's 'spectacular asset,' the \$0.80 unit price, and the 'huge amount of value to unlock' then there's 50,000,000 bucks up for grabs – yes, the risk of a no-cap fee is that \$50m is potentially up for grabs, and that is significant. In my opinion, such a potential is extraordinary and completely unwarranted.

Response 3

- This illustration is misleading for the following reasons:
 - I. it is based on a fictional unit price (see Response 2) of \$0.80.
 - II. it ignores the proposed reduction in the base management fee from 1.5% to 1%. This proposed reduction reduces the base management fee by approximately \$9m (if Mr Garnham's incorrect calculations are used) or by \$4.45m if the correct calculations are used (i.e. redemptions of \$295m occur in accordance with the New Strategy prior to October 2012). Balmain Trilogy will need to increase the net assets of the Fund to \$479m (which is 15% above the Fund's current net asset value) just to earn the same fee that it currently earns (i.e. 1.5%).
- The purpose of the Performance Fee is to align the interests of Balmain Trilogy with those of unitholders. If we do not increase the value of the net assets by at least the RBA Cash Rate from a current base of \$415m then Balmain Trilogy will get paid less than it is currently entitled to be paid.
- We believe that most unitholders welcome the opportunity of securing the resources of Balmain Trilogy's development expertise based on the payment of a fee that is conditional upon performance.
- There is no cash grab. The new fee structure penalises Balmain Trilogy for under-performance (i.e. reduces fees from the current levels) and provides an incentive to Balmain Trilogy for over-performance.

Garnham: (para 9)

LITIGATION - The 20% Performance Fee doesn't stop with asset improvement, it carries on into any award/s of damages from legal actions. BT have already done a deal with the IMF. No need to bother investors with the tiny details, just keep it a secret and do it. Never mind the expense to investors. EM Page 19, "... Following the completion of the legal review of the Fund commissioned by Trilogy, it was identified that specific parties that have been fully or partly at fault in causing the significant losses of Fund should be pursued. To facilitate this process in the most efficient manner, Trilogy has entered into a Funding Agreement with IMF (Australia) Pty Ltd (IMF)...." There is NO disclosure about the deal BT have signed with the IMF - I'm not at all pleased they've taken this step without consultation with investors. What's the IMF's percentage of the take? 30/40%.

Response 4

- Without the involvement of a litigation funder the projected cost of the intended litigation would need to be set aside (i.e. not available for redemptions) and, in the event that the litigation is not successful, would be 'lost' (to pay for the Fund's legal expenses and any adverse cost orders). We believe that the likely costs of the intended litigation will run in to 10's of millions of dollars whether or not the Fund is successful. We do not believe that it is in the best interests of unitholders for the Fund to either withhold this sum from available redemptions or put it at risk from unsuccessful litigation.
- The litigation funder (IMF) pays for 100% of the costs of the Fund in respect of the intended litigation and is liable for 100% of any adverse cost orders in the event that the litigation is not successful. The Fund is free to offer maximum redemptions to unitholders without the need to retain monies to cover the costs of lawyers or adverse costs orders.
- Balmain Trilogy's role remains as acting on behalf of the Fund. We are directly involved with instructing the Fund's lawyers and are fully involved in the conduct of the proceedings. IMF's role is that of funder, not of manager.
- Litigation funders take on substantial risk with regard to both party-party legal costs and any adverse costs orders issued by the court. It is a matter of commercial reality that they are compensated for this risk by a share of any damages recovered in successful matters. Their remuneration is 26% of the proceeds from successful litigation (i.e. \$0 if proceeds are nil and \$2.6 if proceeds are \$10m) notwithstanding that they are liable for 100% of any losses from unsuccessful litigation. Were IMF asked to provide significant management support in addition to funding the litigation this share of any damages would have been significantly higher.
- We do not believe unitholders want to place further significant sums of money at risk to pursue litigation which may take many years to resolve and comes without any guarantee of success (as does any litigation).
- The 'split' of the legal recovery entitlement units ensures that even unitholders that have been fully redeemed in respect of their existing units, will be entitled to their share of the litigation proceeds (if any).

Garnham: (para 15 & 16)

HARDSHIP - Hardship is able to be paid either under a CVRF (VUP) or \$1.00 (see Table, EM Page 29). Hardship cases will qualify pursuant to ASIC guidelines only, but how much hardship cases get will really depend on the unit price. Hardship cases WILL receive more under the \$1.00 unit price because they are not forced to redeem sub-par (less than \$1.00) - there is no loss incurred.

*Let's say a hardship member holds 40,000 * \$1.00 units (fund NTA = \$0.47), Equity = \$18,000, and let's say that the member redeems \$18,800. Under the \$1.00 unit price, 18,800 * \$1.00 units are redeemed, retaining 21,200 * \$1.00 units (Equity = zero) remain in the fund. An increase in NTA will add to unfulfilled units. So if an increase of \$0.20 occurs, then the member would hold 18,800 * \$1.00 units (Equity = 18,800 * \$0.20 = \$3,760).*

Under the CVRF (VUP), a redemption of \$18,800 would cost the member all of his/her vup units. For this member there would be no future.

Response 5

- The difficulty in responding to this point is that it does not make any sense and Mr Garnham seems to be ignorant of the concepts of how a fixed price redemption program can be implemented equitably.
- If any unitholder is redeemed at \$1.00 (hardship or otherwise) the value of the remaining units must be reduced (because the redeeming unitholder is receiving a price higher than the current value of his/her unit). Consequently unless all unitholders redeem equal proportions (i.e. unitholders have no choice as to whether or not they redeem) \$1.00 redemptions are incontrovertibly unfair to any unitholder not redeeming at \$1.00.
- Mr Garnham's example refers to a unitholder redeeming the full value of their entire unit holding, but also 'retaining' units in the Fund. This is manifestly unfair to the remaining unitholders for the same reason as in the previous paragraph.
- Mr Garnham does not appear to understand the mechanics of any redemption programme which is at the root of many of his false and misleading comments about variable and fixed price redemption programs.
- Balmain Trilogy gains no advantage in its capacity as manager or fiduciary from the method of redemptions adopted by the Fund. Whether Current Value or Issue Price redemptions are made the same dollar quantum of redemptions are made to unitholders, the same reduction in the remaining value of the Fund occurs as a result of the redemption and consequently the same reduction in the manager's base management fee will occur. We do, however, unreservedly recommend that unitholders support Current Value redemptions as this will enable all unitholders to have the choice as to whether they accelerate or delay their individual exit from the Fund.
- We respectfully suggest that Mr Garnham, or any other unitholder still confused about redemption facilities, should both read the letter from BT to unitholders on 25 May 2010 and seek the advice of a professional financial advisor to better understand this issue.

Garnham: (para 19-23)

UNIT PRICE (EM, page 23) - CVRF (Current Value Redemption Facility) = VUP There are no offers, only 'offers'. Huh? Surprised? Well, typically a non-liquid fund would make either (a) offers, or (b) payments. Well, BT have come up with the payment which can be opted out of. It's no different to an offer, except instead of opting in, an investor opts out, and then in - and then out, in .. and so on.

Here is the payment, EM Page 23, "...All Unitholders will receive the Fixed Redemption payment without the need for any further action (i.e. no further application or notification to Trilogy will be required)...."

Here is the opt out, EM Page 23, "...If a Unitholder does not wish to receive the Fixed Redemption, they can opt out by giving written notice to Trilogy. The notification will not have effect for 30 business days...."

Here is the opt in again, EM Page 23, "... Any such notice will mean that the Unitholder has opted out of all future Fixed Redemptions unless and until it opts back in to receiving the Fixed Redemption by giving Trilogy further written notice (which again will not be effective for 30 business days)...."

A disclaimer, EM Page 25, "... Ultimately the amount of any redemption will depend on when the Fund's Assets are realised, the amount received in respect of those Assets and the capital required to remain in the Fund to meet the future costs and expenses of the Fund. Accordingly, the Additional Redemptions and Fixed Redemptions maybe less or more than those projected above...." (emphasis added).

Response 6

- We are not entirely sure what point Mr Garnham was attempting to make here.
- Both the Fixed and Additional Redemptions are optional for all unitholders under the proposed current value redemption program. This is in accordance with one of the key foundations of Balmain Trilogy's proposed strategy, namely, to give unitholders a choice. A Current Value redemption program is equitable and fair to both the remaining and redeeming unitholders. Issue Price redemptions do not allow for individual unitholder choice.
- Obviously Balmain Trilogy needs to forecast future cash flows to plan a schedule of redemptions. Forecasts can never be perfect (as they are attempting to predict the future) but we believe our forecasts to be reasonable and the Independent Expert's Report concurs that Balmain Trilogy's estimates are reasonable.

Garnham: (para 29)

EM Page 27, "... If the Fund were to redeem \$100 million worth of Units by value at their subscription price of \$1.00, the Fund would be left with a net asset value of \$315 million (being \$100 million less) and have 787 million Units (being 100 million less) remaining on issue. Consequently the remaining Units would only be worth \$0.40. This would not be fair outcome for any Unitholders that did not participate in the redemption...." (emphasis added) This is not true - A breach of Corporations Act s. 607 FC(1)(d); would occur if payments to one member were deducted from another member's account. The Act prohibits 'robbing Peter to pay Paul' (so to speak). The NTA shift is easily adjusted by accounting.

Response 7

- The quoted section from the Information Memorandum is correct and is an illustration of the dilution that would occur anytime a unitholder is able to redeem units from the Fund at more than their true current value. There will be less of the value of the Fund per unit available for the remaining unitholders.
- Mr Garnham's interpretation of this section of the Explanatory Memorandum is entirely incorrect. His assertion that the proposal breaches the Corporations Act is also incorrect and further demonstrates his lack of understanding of this issue.
- His comment that "the NTA shift is easily adjusted by accounting" lacks any logical basis, lacks any verification and is completely incorrect.

Garnham: (para 29)

BT stated on page 26, "... Unitholders will all have a pro rata proportion of their Units mandatorily redeemed from time to time at \$1.00 per Unit...." (emphasis added), yet in the example immediately above, BT speaks to "Unitholders that did not participate in the redemption, but there is no opt in/opt out in a compulsorily made payment. So the example has nothing to do with the proposal, it's simple an effort to infer that payments made by way of the \$1.00 issue price are unfair. Such payments are not unfair. BT had to completely disregard it's own proposal in order to make a perverse example. The proposal speaks to 'mandatory' payments, yet the example speaks to 'accept/reject'. As BT themselves state on EM Page 26, "... No Unitholder will be unfairly disadvantaged by the redemptions because all Unitholders will be required to compulsorily participate in the Issue Price Redemptions..." (emphasis added) It is fair, but BT infers unfairness in the example.

Response 8

- Mr Garnham seems to be confused about the fundamental distinction between the 2 redemption programs.
- Under the proposed Current Value redemption program unitholders can elect whether they participate or not, because their election has no impact on the value of the other unitholders' holdings.
- Under a \$1 fixed price redemption program, there can be no unitholder election. This is because if not all unitholders participate, those that do not will have the value of their holdings diminished.

Garnham: (para 48)

Trilogy Capital has three small funds, Healthcare REIT, Medilink Property Income Syndicate, and Melbourne Campus Office Syndicate - each of their funds have a 0.5% management fee. The Trilogy First Mortgage Income Trust "... The fee is calculated at 0.70% p.a. plus other management costs at 0.24% p.a. of the total gross value of mortgage loans held in the Fund. The Responsible Entity has waived its 0.70% p.a. proportion of its management fee since September 2008...."

Response 9

- The management of passive property investment funds can in no way be compared to the management of the PFMF which holds complex development assets all of which require significant improvement from a large and dedicated team of professionals. The Independent Expert's Report has concluded that the New Strategy is fair and reasonable when taken as a whole (and inclusive of the new management fee).

Garnham: (paras 50&51)

PROCUREMENT OF A INSTITUTIONAL LIQUIDITY OFFER - This single enterprise by the manager is extremely concerning. Expert Report Page 73, "... It is probable that any takeover offer would be priced at a discount to the current net asset value of PFMF of 47 cents per unit. That discount may well be significant, recognising the risk that the offering party is taking on in acquiring the assets and liabilities of PFMF in their current position...." (emphasis added)

"...Under these circumstances the acquiring party may accumulate enough Units in PFMF to gain 50% or greater control. In this position, the offeror would, have the ability to influence the future direction of PFMF including replacement of the current responsible entity, or implementing a different strategy for PFMF to that contemplated under the Proposal at hand...." (emphasis added).

Response 10

- Both the extracted comments made by the Independent Expert are valid.
- Balmain Trilogy's sole purpose in expending considerable time and energy in attempting to procure a liquidity offer from a large institutional investor was to add to the range of choices available to a unitholder.
- Any offer will be simply that ... an offer. It can be accepted or thrown in the bin. Any person suggesting that a unitholder is better off if they do not receive an offer to broaden their investment choices (even if the offer in itself is not one that they wish to accept) clearly does not understand the value in having a choice.

Garnham: (paras 53-56)

TRILOGY FUNDS MANAGEMENT - some time ago, a firm of solicitors (MRDN Lawyers) in Brisbane started up a company called Lawyers Private Mortgages Pty. Ltd. ("LPM")

From ASIC's website, "... In August 2003, ASIC brought the class action against Lawyers Private Mortgages Pty Ltd (LPM) to obtain damages for the mostly retired investors from south-east Queensland. LPM was a practitioner nominee company of the Brisbane legal firm McCarthy Durie Ryan Neil Solicitors (MDRN), which promoted the solicitors' mortgage scheme (the scheme). ..." - Mr. Philip Ryan was the solicitor principally responsible for the conduct of LPM's lending business. (Mr. Ryan was the "R" in MDRN, and now is the managing director of Trilogy Capital Group and a director of BT).

"... The Federal Court subsequently found that MDRN made misleading statements as well as negligent misstatements when they promoted the mortgage scheme to investors...." This matter is generally referred to as the "ASIC Case". www.moneymagik.com links to further information.

In a separate matter, Mr. Ryan (amongst others) was found to have breached a client's trust in the matter of *Jessup v Lawyers Private Mortgages Ltd & Ors* [2006] QCA 432.

Response 11

- Over 10 years ago and prior to the Managed Investments Act, the law firm in which Phil Ryan was a partner employed a senior banker to prepare investment summaries for its mortgage lending practice. Certain statements contained in the summaries were found to be misleading in one case and a breach of trust in another. While the partners **were NOT found to be culpable**, they were, as partners, vicariously liable for the acts of their employee. All investors were compensated for their loss. Phil Ryan has been and remains a director under the AFSL administered by ASIC.

Garnham: (paras 57-60)

A new company, MDRN Investments Limited ("MDRNI") was formed, and that company's name was changed to Trilogy Funds Management Limited, the present manager of our fund. While as MDRNI, the company engaged in what many would regard as risky lending, mezzanine (second mortgage) lending. This lending practice continued on after the name change to Trilogy Funds Management ("Trilogy").

One such fund was the Principal Mortgages Mezzanine Mortgages Finance Fund ("PMMMF") in association with Laton Capital Group. Investors in this fund LOST EVERYTHING. On the 30 September 2009, Mr. Bacon, the chairman of Trilogy wrote to investors informing of that loss. The fund was wound up around the very time Trilogy took over the CPFMF (now PFMF).

Balmain (the other half of the Balmain / Trilogy enterprise) also engages in what some regard as risky mezzanine lending.

Members of the fund should be entitled to know the history of both the fund's manager and its management team. If BT had been forthright about Trilogy's involvement in the 100% loss of investors' money in the PMMMF then I WOULD NOT HAVE VOTED FOR THEM - I would have rather seen the fund wound up

Response 12

- MDRN Investments Ltd (MDRNI) was asked to be a temporary responsible entity for a corporate financier acting on behalf of a number of investors. MDRNI was not involved in the sourcing of the loan in question. This was a specific 2nd mortgage fund which did not lend on 1st mortgages and risks were highlighted to investors that the 1st mortgagee had priority in case of default. The borrower defaulted and the 1st mortgagee sold the property with nil proceeds available for the fund. While a loss was realised some years ago, the Fund was kept on foot as there were ongoing investigations into various potential legal actions against the borrower and other parties, including the quantity surveyor and valuer. The fund was subsequently wound up last year.
- In respect of mezzanine lending it is also important to understand that mezzanine debt is not suitable investment for all investors. In particular, it is not suitable for investors that have a preference for low risk (or a need for high capital stability) ahead of the higher returns that may result from investment in mezzanine lending programmes. There is, however, significant demand from investors for mezzanine products. Mezzanine funds should, however, always be clearly and concisely identified in their respective product disclosure statements and potential investors fully appraised of the risk/return profile of this type of fund.
- It is clear that the PFMF was, under the management of CPL, more like a mezzanine lender than a senior debt lender. This broke the first rule of funds management because investors were not fully aware of the types of risk the Fund was actually taking.

Garnham: (para 62)

Wind up is not so bad \$0.47 already INCLUDES" ... (i.e. the likely recovery of the loan allowing for all the costs associated with achieving the sale including building works, consultant fees, holding charges, selling costs etc)....

Response 13

- Mr Garnham is again wrong and misleading in his assertion that asset values under the "wind up" would equate to the current valuations of the Fund's assets. The assets are not currently valued on the basis of a "fire-sale" however this is what would occur (i.e. fire-sales) if the Fund was to be subject of a wind-up.
- If the Fund was wound up, assets would be placed on the market in their current form. Placing incomplete/part assets on the market would achieve values considerably less than the current value ascribed.
- The purchasers of these incomplete assets would require market returns from their investment in these assets and these returns would be reflected in a reduced price for the assets when compared to the current valuations of these assets.
- Mr Garnham does not appear to understand the market for impaired mortgage assets or underlying properties in the current economic climate.