Dear Partner:

Davian Capital LP I and Davian Capital LP II (collectively, the “Partnerhips”) returned (4.39%), and (3.21%) net of fees and expenses, respectively, in the third quarter of 2012, bringing the respective year to date net returns to +8.05% and +20.31%.

“Stock market bubbles don’t grow out of thin air. They have a solid basis in reality, but reality as distorted by a misconception.” – George Soros

The latest bubble is the liquidity bubble we are forced to endure caused by central banks around the world. Liquidity distorts asset prices because liquidity flows like water, seeking the path of least resistance. In this case, the path of least resistance is stocks, bonds and commodities.

Central banks have long believed that if you shove enough liquidity into the markets then the stock market will rally causing a “wealth effect” of sorts. People will be willing to spend more money if their portfolios are gaining value. It simply makes people feel richer and in turn they will be more willing to take that vacation, buy that car, or build that house. While this holds true in the short term, the asset distortion caused by liquidity is a double-edged sword.

The people most hurt by central banks printing unlimited amounts of money are the savers, those on fixed income and those with low or middle income. The Federal
Reserve has vowed to keep rates at or near zero percent until 2015! Ben Bernanke, the Chairman of the Federal Reserve, concedes that low interest rates do hurt savers but argues that they benefit from higher asset values and a growing economy.

Those on fixed income and low or middle-income fare even worse in this environment. As liquidity flows into commodities, driving the prices higher, everyday items become increasingly less affordable for this group of people. Fixed income folks only have so much money every month to make ends meet. It becomes difficult to do this when the dollar does not purchase as much as it used to. Combine this liquidity price surge with the drought we experienced in the Midwest and we are on track to see record commodity prices across the board.

We have witnessed several economic contractions in the global economy since 1987 and consistently the response from the Federal Reserve is to slash interest rates and print money. The economy starts to recover as asset prices rise. Once this happens, central banks need to raise interest rates and concentrate on keeping inflation at the targeted level. While this works in the short term, it has caused the boom bust cycle to occur with more frequency. In the United States alone we have experienced three fairly severe economic contractions, the NASDAQ bubble, the recession in 2001, and the Great Recession from 2008-2009.

We were in the camp that the U.S. Federal Reserve would embark on another round of quantitative easing but we were a few months early in this prediction. Being early in the investing world is as good as being wrong. Our timing was off by about 60 days so we hedged too early, reduced our net exposure too soon and by too much. This not only caused the partnership to miss the rally sparked by the central banks but our
hedges pulled us into negative territory for the quarter.

There is a silver lining to all of this. So far in October the liquidity euphoria induced by the central bank has started to wear off. Another round of earnings season has started and companies are missing their projections causing stocks and the broader indices to sell off. Our hedges returned to near breakeven and our ability to select tremendous short positions has the partnership back on track as we head into the winter months.

Due to the pressures on savers, fixed and low-income individuals expressed above, we expect the economy to soften into the winter and the fourth quarter of 2012 possibly producing a disappointing holiday season in the U.S. The partnership opened a new short position that will be profitable should the thesis unfold. There are multiple other reasons we chose this short position that we will discuss later in this letter.

During the quarter the partnership closed one meaningful long position and opened one new meaningful short position.

"We've had one of these before, when the dot-com bubble burst. What I told our company was that we were just going to invest our way through the downturn, that we weren't going to lay off people, that we'd taken a tremendous amount of effort to get them into Apple in the first place -- the last thing we were going to do is lay them off." - Steve Jobs

The above quote was chosen because during the last quarter the partnership(s) sold every last share of Apple Inc. It was rather sad as we have owned shares in Apple since 2004, well before Apple was the hot tech stock that it is today.
Apple stock in the end returned over +2,300%, so it was a home run investment. To us, it was an easy investment thesis. Here was a technology company struggling to stay afloat, until the iPod changed everything. Anthony had a second-generation iPod and later bought an iBook G4 laptop. He was one of the few people in college at the time with a Mac and some people laughed. They laughed even harder when he told them he owned the stock!

At the time, Microsoft owned roughly 97% of the entire PC market. Anthony modeled Apple stock valuations should it be able to take just ten percent of the market, which was a conservative estimate. Since those days, the Mac now captures greater than ten percent of the computer market, owns approximately ninety percent of the tablet market and also owns a significant portion of the smart phone market. The easy money has been made. It is much easier for a company to grow from a hundred million dollars to a several hundred billion dollars capitalization than it is to grow from $700 billion to a $1 trillion market capitalization.

Apple has dominated every segment of the technology space and the final one it is to capture is the television segment. It will most likely roll out an iTV and it will be a great product. The only downside is that selling televisions is a lower margin business. We believe Apple will reinvent the television, but that is not enough to maintain the type of growth it has enjoyed over the past years.

Anthony bought his first shares in Apple in 2004 when Apple stock was under $30 a share. We sold those and all of the partnership(s)’ shares last quarter near $700. It has
been a beautiful ride, but it is time to move on.

As alluded to earlier, the partnership(s) opened a meaningful short position in Activision Blizzard, Inc. (ATVI). According to Bloomberg, “Activision Blizzard, Inc. publishes, develops, and distributes interactive entertainment software and peripheral products. The company's products cover diverse game categories, including action/adventure, action sports, racing, role playing, simulation, first-person action, music-based gaming and strategy.”

ATVI has completely missed the explosion of games on tablet computers and smartphones. The company heavily relies on cash flows from its two biggest franchises, World of Warcraft (WoW) and Call of Duty (CoD). The WoW model is simple – buy the game and pay a monthly/annual fee to play the game online. This business model has worked for years, but the explosion of free to play games is taking its toll on ATVI's WoW cash cow.

We are also starting to see fatigue in the first person shooter category, which is the style of ATVI's Call of Duty franchise. Preorders for previous generations of CoD saw consistent explosive growth but that is changing. We are not seeing the usual massive increase in the latest CoD preorder set to launch in November. There is no doubt that this will be a successful game launch; the issue is that the growth is waning.

ATVI currently trades 10 times FY2013 earnings and when adjusting the EPS down for WoW and CoD sales erosion, we believe FY2013 EPS could be $0.88–$0.99 as opposed to the analysts’ current projection of $1.10. Attach the same multiple of 10 times EPS and the stock is worth $8.80–$9.90. We feel investors will be reluctant to pay
10 times future EPS when growth is slowing and this should cause multiple compression. Under a conservative multiple compression scenario ATVI stock is worth $7-$8 by the end of 2013. The partnership established our short position at $11.91 and shares ended the quarter at $11.28.

Housekeeping: “Excuse the mess, but we live here.” – Roseanne Barr

There is a major change coming at the end of 2012. As most know, we started trading a 100% short small cap trading system called “Gravity.” The Gravity system was started because of the demand from a handful of investors and we never anticipated that it would become its own fund. The success of the system has changed that. We have been able to create a 100% short small cap system that takes very little risk and generates significant returns. The demand for a system like this is very high.

Trading the Gravity system as a “carve out” inside of Davian Capital L.P. II has been a significant challenge for the back office but they have stepped up to the challenge and excelled. The way the system is currently structured has made the accounting process complex. Having an unnecessarily complex system inherently makes routine tasks take much longer to complete and will cost the partnership more in accounting, audit, and legal fees.

The above reasons combined with the support of our limited partners caused us to spin out the Gravity 100% short small cap trading system into its own fund! We are extremely excited about this and in the long run this will be best for the partnerships.

The new Rubber City Gravity L.P. will launch on January 1, 2013 and will begin taking subscriptions at the end of October 2012. If you are a current partner in the
Gravity carve out we will be returning your capital in the middle of December and it can be used to subscribe in the new free standing Rubber City Gravity L.P. We are only allowing capital inflows into the Rubber City Gravity L.P. fund until January 1, 2013 and then closing it down for the year. If a partner would like exposure to this fantastic fund we strongly urge you to allocate on the maximum end of your allocation spectrum as there will be no new capital inflows allowed until the fourth quarter of 2013.

The reason for the short capital inflow window is due to liquidity concerns. Gravity trades small-capitalization stocks and they are difficult to borrow and short sell. We want to ensure that the initial capital raised for this fund is put to work effectively before we allow new outside capital.

As mentioned, we are enthusiastic about the launch of this new fund. The Gravity system has proven that not only does it generate significant returns, it manages risk very well. Due to the limited number of spots and capital being accepted into the new Gravity fund we encourage our partners to contact our offices immediately for the marketing materials and required paperwork.

We have one new addition to the team. The team is proud to welcome Sean-Michael Kvacek to the team as Director of Investor Relations and Marketing. Sean-Michael graduated from the University of Akron with a Bachelor’s Degree in Accounting. He worked at Deloitte and Touche as a financial auditor and went on to Jones Day where he traveled the world on their internal audit team. Sean-Michael will be responsible for direct capital raising and investor communications. With the launch of the new Rubber City Gravity L.P. we are sure you will get to talk with him soon!
At quarter end, the largest disclosed long positions in the Partnerships were United States 12 Month Natural Gas (UNL), Volkswagen AG, eBay Inc., Kona Grill and Urban Outfitters Inc.

Best Regards,

Davian Capital Advisors, LLC
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Performance returns for 2012 are estimated pending the year-end audit. Past performance is not indicative of future results. A partner’s actual returns may differ from the returns presented.

Positions reflected in this letter do not represent all the positions held, purchased, or sold by the Partnerships, and in the aggregate; the information may represent a small percentage of activity in the Partnerships. The information presented is intended to provide insight into the noteworthy events, in the sole opinion of Davian Capital Advisors, affecting the Partnerships.

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