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December 22, 1997

Dear Fund Shareholder,

We are pleased to report strong results for the year ended October 31, 1997. For the twelve months, the Fund achieved a total return of 27.04% despite holding on average over 20% of its net assets in cash during the period. Our result was, however, somewhat below the exceptional return for the S&P 500 of 32.11% over the same period.

As in the last few years, the Fund benefited from international diversification, posting significant gains from European and Russian equities, as well as from U.S. shares. Corporate liquidations and distressed debt holdings also contributed importantly to results. Market declines in our Korean and Hong Kong positions had a small dampening effect on overall performance. A breakdown of the year's largest gains and losses appears in Table 1 below. A chart depicting the diversification of our holdings at October 31 appears below as Table 2.

Table 1
 The Baupost Fund
 Largest Gains and Losses (Realized and Unrealized)
 For the Twelve Months Ended 10/31/97
 (\$ in millions)

<u>Largest Gains</u>		<u>Largest Losses</u>	
TLC Beatrice equity	\$ 7.3	Semi-Tech Global equity	\$ (2.3)
MBO Properties equity	5.2	Various equity and debt market hedges	(2.1)
Assurances Generales de France equity	4.2	SK Telecom equity and swaps	(1.6)
Lukoil Oil Co. equity	3.0	Playmates Toys equity	(.8)
Chargeurs / Pathe / British Sky Broad- casting equity and options	2.3	Philip Morris calls	(.7)
Yield on Cash and Cash Equivalents	2.2	NCR Corporation equity	(.6)
C-Tec / RCN / Cable Michigan equity	2.2	Kookmin Bank equity and swaps	(.5)
Heritage Media equity	2.0	Vareganneftegaz equity	(.5)
Ralcorp Holdings / General Mills equity	1.7	Northwestern Steel & Wire Co. equity	(.4)
Allmerica Financial equity	1.6	Wang Laboratories equity	(.3)

IFIL equity	1.4
Unified Energy Systems equity	1.2
Surgutneftegaz Sponsored equity	1.0
Thomson CSF equity	.8

Table 2

<u>ASSET TYPE</u>	<u>MARKET VALUE</u>	<u>% OF NET ASSETS</u>
European Equities*	\$ 47,035,855	30.5%
Cash & Cash Equivalents*	39,280,619	25.5%
U.S. Equities	31,322,113	20.3%
Emerging European Equities	12,685,930	8.2%
Liquidations	10,470,017	6.8%
Bankruptcies & Distressed Debt	8,079,115	5.2%
Asian Equities*	3,143,531	2.0%
Market Hedges	2,091,836	1.4%
Total:	154,109,016	100.0%

*Net of currency hedges

For most of the Fund's fiscal year, the U.S. equity market raced ahead, followed closely by other world markets. Despite high valuations, investors poured money into U.S. equity mutual funds at a record pace. The main trouble spot in the world was in Southeast Asia, which experienced a growing currency crisis as the year progressed. Stock markets in Thailand, Malaysia, and Indonesia were decimated over the summer, followed in October by Hong Kong and Korea. This, in turn, led to sharp selloffs in Japan, as well as Russia, Brazil, and other emerging markets.

After dramatic nightly Asian losses in late October, the U.S. stock market plunged 550 points on Monday, October 27. For the first time in quite a while, fear overtook greed at the forefront of investors' minds. The world's stock markets were dropping, no one knew how low, and nobody, for a day, wanted to buy. By the next morning, the U.S. market stabilized and partially recovered, while emerging markets remained in turmoil.

Value Investing in a Turbulent Environment

The most favorable position going into a sudden downdraft (if you could correctly anticipate one) is to hold market hedges and/or cash (or better still, short positions, but short sellers have been aging in dog years for a long time). We hold both, although never enough in a downturn, because both are costly. Hedges, like any insurance, involve paying a premium. Premiums have skyrocketed in lock-step with the market's surge over the past two years, and have risen even more in the current volatile environment. Cash provides protection in a storm and ammunition to take advantage of newly created opportunities, but holding cash involves the considerable opportunity cost of foregoing presently attractive investments. Given the choice between holding mostly cash awaiting the periodic market tumble or finding compelling investments which earn good returns over time but fluctuate to a certain extent with the market amidst turbulence, we choose the latter. Obviously, we could not have earned the returns we have from investing, without investing.

The upside of the recent market episode is that many good bargains have become even better ones, and numerous attractive new situations have surfaced. We are selectively deploying cash into what we believe are wonderful, long-term values, and are also repositioning ourselves, adding to some positions while reducing or deleting others, to take advantage of the lay of the present landscape. The opportunity to invest more money at lower prices will certainly be to our long-term financial benefit.

If the financial markets remain turbulent and retrace some of their decade-long gains, I believe we will be in a strong position. Despite delivering good investment performance over the Fund's first seven years of operations, I must remind you that value investing is not designed to outperform in a bull market. In a bull market, anyone, with any investment strategy or none at all, can do well, often better than value investors. It is only in a bear market that the value investing discipline becomes especially important because value investing, virtually alone among strategies, gives you exposure to the upside with limited downside risk. In a stormy market, the value investing discipline becomes crucial, because it helps you find your bearings when reassuring landmarks are no longer visible. In a market downturn, momentum investors cannot find momentum, growth investors worry about a slowdown, and technical analysts don't like their charts. But the value investing discipline tells you exactly what to analyze, price versus value, and then what to do, buy at a considerable discount and sell near full value. And, because you cannot tell what the market is going to do, a value investment discipline is important because it is the only approach that produces consistently good investment results over a complete market cycle.

Increased International Focus

The most important investment decision we have made over the past several years is the one to increase our international efforts. This decision resulted in part from a realization that opportunities in the U.S. were considerably less attractive than they had been, and that the situation would not necessarily improve. Our assessment was in part due to much higher valuations as well as to a perception of increased market efficiency over time, as more and larger investors have come into existence. It is still possible to find opportunities in the U.S. equity market, but we believe it will continue to be more difficult and less profitable than a few decades ago.

Another key component of our decision to look overseas was the identification of compelling bargains in numerous European markets, one at a time, bottom up. We believe that we are at the beginning of a period of value realization in a number of these markets, and Baupost now has the capability to identify and rigorously analyze and monitor opportunities in foreign countries.

Some prominent U.S. investors have argued rather vociferously against international investing. The risks and uncertainties are greater, they insist, the work far more demanding, and the track record perhaps spottier. So I thought it might be interesting to reflect on the basic underlying principles of value investing and evaluate possible reasons why they wouldn't work overseas.

The main underlying principle of value investing is that you should invest in undervalued securities because they alone offer a margin of safety. Over time, by again and again avoiding loss, you have taken the first step toward achieving healthy gains. Value investors should buy assets at a discount, not because a business trading below its obvious liquidation value will actually be liquidated, but be-

cause if you have limited downside risk from your purchase price, you have what is effectively a free option on the recovery of that business and/or the restoration of that stock to investor favor. If an undervalued stock drops after you buy it and you are confident in your analysis, you simply buy more. All of these points apply equally well regardless of the market on which a stock trades or where a company does business.

Value investing in the U.S. is driven by fundamental analysis, a rigorous assessment of underlying value based on an understanding of a particular business or asset. The same principles that apply here, such as not paying up for growth, or buying businesses you can understand that are not subject to rapid technological change or obsolescence, apply internationally as well.

One vocal objection I have heard to applying value investing principles overseas is that foreign companies are not particularly shareholder-value oriented. Of course, Ben Graham invented value investing when the U.S. was effectively a foreign country to value investing principles. Certainly, in the 1920's and 1930's, the idea of management running a company for the purpose of maximizing shareholder value was a totally "foreign" concept, one which didn't really come into the mainstream until the past decade and, even now, is certainly not an operative principle at all U.S. firms. Even a few decades ago, U.S. managements were hardly shareholder value oriented. No one was arguing that you shouldn't be a value investor then, when Warren Buffett, Max Heine, Tweedy Browne, and Ruane Cunniff were building their brilliant track records.

I frequently hear the argument that the rules are different overseas: the accounting murky, the annual reports unreadable, the currencies sometimes unhedgable. All of these points are fair, but, rather than being arguments to avoid foreign markets, they are instead arguments to embrace them. After all, as an investor you never have perfect information, and the biggest profits are always available (just as they have been in the U.S.) when competition and information are scarce. The payoff to fundamental analysis rises proportionately with the difficulty of performing it.

Through this general line of thinking, you might conclude that future returns will be lowest in expensive markets and greatest in cheap ones; lowest where information is plentiful and straightforward, and greatest where it is scarce and hard to interpret; and lowest when markets are priced to reflect shareholder-oriented management and greatest where managements are currently indifferent. All of this, I believe, is the case, and the next decade should prove it.

Conclusion

I would be remiss if I did not mention the exemplary performance of Baupost's analysts and traders in recent months. While they have worked tirelessly and skillfully all year to produce the strong annual returns the Fund achieved, they have risen to new heights during the recent market turmoil. To a person (and like myself), they hate to lose money, even temporarily, for any reason and at any time. But it is their cool headedness during an emotional period that deserves special commendation. They have calmly reacted to rapidly changing conditions, worked as a cohesive team, and challenged their own previous assumptions to see if they still made sense in a potentially different market environment.

Baupost's recent recruiting activities continue to bear fruit. Aaron Cowen, a 1994 Wharton graduate, joined Baupost's investment team in October after three years at Lehman Brothers. Reuben Munger, a 1995 honors graduate of Washington and Lee, joined Baupost after a two year stint at BT Wolfensohn, an investment banking firm. We are excited to have these bright and capable analysts on board.

Baupost's administrative staff has performed exceptionally well all year long. Baupost has benefited from increased depth in each of our departments, and has been working on a number of valuable projects including the reclaim of foreign tax credits for the Fund's tax-exempt investors, the change of the Fund's custodian to State Street Bank, and continuing upgrades to Baupost's accounting and financial reporting software.

In investing, nothing is certain. The best investments we have ever made, that in retrospect seem like free money, seemed not at all that way when we made them. When the markets are dropping hard (as they are right now in Asia) and an investment you believe is attractive, even compelling, keeps falling in price, you aren't human if you aren't scared that you have made a gigantic mistake. The challenge is to perform the fundamental analysis, understand the downside as well as the upside, remain rational when others become emotional, and don't take advice from Mr. Market, who again and again is a wonderful creator of opportunities but whose advice should never, ever be followed.

The markets have remained volatile into November and December, presenting both challenges and opportunities. We remain focused on risk aversion, seeking to hold only compelling bargains. Positions that have risen toward full value have been sold and catalysts have also recently turned a number of the Fund's holdings into cash. We continue to believe the Fund is positioned to fare well in any future environment. We remain grateful for your confidence and support, and are always available for any comments or questions you may have.

Very truly yours,

/s/ Seth A. Klarman

Seth A. Klarman
President

Average Annual Total Returns (1) For Periods Ended 10/31/97	<u>1</u> <u>Year</u>	Life of Fund (since 12/14/90)
The Baupost Fund	27.04%	17.69%

Total return is an historical measure of past performance and is not intended to indicate future performance. Because investment return and principal value will fluctuate, the Fund's shares may become worth more or less than their original cost. During the periods reported above, an expense cap was in place which had the effect of lowering the Fund's management fee and therefore enhanced the total return of the Fund.

(1) Assumes reinvestment of all dividends.

**GROWTH OF AN ASSUMED \$50,000 INVESTMENT
IN THE BAUPOST FUND FROM 12/14/90 THROUGH 10/31/97**

	<u>FUND</u>	<u>S&P</u>
12/14/90	\$50,000.00	\$50,000.00
10/31/91	\$59,787.28	\$61,807.01
10/31/92	\$65,471.39	\$67,963.62
10/31/93	\$82,134.71	\$78,116.01
10/31/94	\$91,217.43	\$81,134.73
10/31/95	\$98,430.31	\$102,587.46
10/31/96	\$120,583.20	\$127,306.16
10/31/97	\$153,193.22	\$168,186.49