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June 25, 1998

Dear Fund Shareholder,

Blame it on El Nino or the upcoming Millenium. Call it a new era, if you want. The astonishing reality is that stocks have moved in only one direction (up) for so long that Perma-bull best describes most investors' expectations for the U.S. stock market. From January 1, 1998 through April 30, 1998 the S&P 500 Index has soared 15.1%; it has gained 22.5% since November! While the Fund achieved handsome absolute gains during this period, it has significantly underperformed the U.S. equity market on a relative basis, earning 7.4% and 11.3% for the same four and six month periods, respectively. (Note that market insensitive rate of return investments earning 15 to 20% annual returns are a significant drag on performance amid such a market environment, and cash balances are like cement overshoes. Also note that big cap stocks marched relentlessly ahead of the pack; the Russell 2000 Index gained only 11.0% and 10.2%, respectively, for the same periods.)

"Into Thin Air", the title of a recent bestseller about an ill-fated expedition to climb Mt. Everest, could also aptly describe the U.S. stock market, which has only infrequently reached such rarefied heights. Like the Everest climbers, the problem with reaching the summit is that from there every way you go is down. Not wanting to overuse the metaphor, I won't go on to recount the sudden storm which seemed to come out of nowhere that brought peril to a number of the climbers.

The U.S. stock market has been propelled by investors falling all over themselves to buy large-capitalization growth stocks like Microsoft, Coca Cola, and even General Electric. At least they are, more or less, good companies. Occasionally, periods of unbelievable excess occur, where near-worthless enterprises are propelled into the stratosphere. Such a period is now upon us. It is bad enough that the shares of small growth companies announcing stock splits surge skyward as if something value enhancing has actually taken place. Now, suddenly, the siren song of the internet has become even more irresistible for hordes of growth investors. Consider the case of K-Tel International, the company best known for selling music CDs and tapes on late night television. After hovering in a narrow trading range around \$7 a share (for its 4.1 million outstanding shares) since January, the announcement that K-Tel plans to sell its music on the internet caused its shares to skyrocket from \$7 to \$45 in just one week and to \$80 a week later with daily volume exceeding 100% of the freely tradeable shares outstanding. "You put 'dot com' behind it and they'll buy it", said one analyst commenting on the behavior of internet-obsessed investors. In a similar vein, Market Guide, a provider of financial data, rallied from 3 to 29½ in three trading days after announcing a partnership with

America Online. At 29½, the company had a market capitalization of almost \$150 million yet it boasts current annual revenue of only \$5 million. Watch out below!

Almost no one wants this Goldilocks economic environment (neither too hot nor too cold) to end. Not the public, which is willing to forgive their President almost any indiscretion. Not professional investors, who are shrugging off ominous warning signs (Asian economic and stock market collapse, the steadily rising dollar, numerous U.S. corporate earnings disappointments, their own state of euphoria.) Not even hordes of formerly risk averse investors, who have seemingly adopted the Massachusetts State Lottery's slogan (you gotta play to win) for their new investment guidelines. Clearly, the greater perceived risk is no longer that of being in the market but rather remaining on the sidelines, risk being defined not in terms of yield to maturity but rather yield to termination of the money manager.

The many wonderful benefits of long-term stock ownership, so well hidden in the U.S. from 1973 to 1982, and well camouflaged in Asia at this very moment, are currently apparent to U.S. investors with extraordinary clarity. What is clear to us, and relatively few others, is how disappointing those long-term returns will actually be from today's market levels. Future returns have increasingly been accelerated into the present and recent past. We have entered greater fool territory, and decent market returns from here, while still a distinct possibility, will depend on an even greater sucker showing up. No one should be surprised if one does; however, no one should base their investment program on his or her existence.

You might think that the increasing percentage of investor funds managed by professional ("professional"?) money managers would serve as a check on market excess. If you did, you would be seriously wrong. Very few professional investors are willing to give up the joy ride of a roaring U.S. bull market to stand virtually alone against the crowd, selling overvalued securities without reinvesting the proceeds in something also overvalued. The pressures are to remain fully invested in whatever is working, the comfort of consensus serving as the ultimate life preserver for anyone inclined to worry about the downside. As small comfort as it may be, the fact that almost everyone will get clobbered in a market reversal makes remaining fully invested an easy relative performance decision. Isn't this what always happens at the top of historic bull markets? The answer, of course, is of course.

Investors and the financial media, always eager to grasp at straws, however slim and brittle, jumped on the year-end shareholder letter of legendary investor Warren Buffett as fodder for the bull case. The Dow immediately rallied 200 points. What Buffett, Chairman of Berkshire Hathaway, said is that at today's level of interest rates, and assuming prevailing levels of corporate profitability, in his view U.S. equities as a whole are not overvalued (and, just as assuredly, not undervalued.) Virtually no one explored his real message, equally prominent, suggesting that today's unprecedented level of corporate profitability may well be unsustainable; future profits may fall far short of today's lofty expectations. The U.S. stock market is extremely vulnerable to disappointments; nothing short of perfection is built into today's prices. And Buffett confesses that it has become increasingly difficult for him to find bargains in the current market environment.

It is also interesting to note that while U.S. stocks are historically quite expensive based on reported earnings, they are considerably more expensive when the effects of "extraordinary" write-offs and management stock options are factored in. Over the entire decade of the 1990's, major U.S. companies have recorded extraordinary write-offs averaging over 10% of reported earnings. These "one-

time" write-offs, purported to reflect non-recurring charges related to mergers, plant closings, corporate restructurings and the like, are hardly one-time when they recur year after year. (These write-offs also result in an overstatement of return on equity; high return on equity is another argument used to justify record stock valuations.) Moreover, investors should no more ignore such losses than they should ignore the losing positions in their own investment portfolio.

There has been considerable publicity about the dilutive impact of management stock options on shareholder returns. Reported earnings per share are potentially overstated to the extent that additional shares can be issued to management at fixed prices. The magnitude of this dilution is well known among investment professionals; they simply choose to downplay it as fundamentals increasingly take a back seat to adrenaline.

Gresham's Law says that the bad money (paper) drives the good money (specie) out of circulation; this accurately describes human behavior when people are confronted with a cost-free choice. I now believe it also describes people's choice of investment philosophies, especially late in a bull market, when the sloppy analysis drives out the disciplined assessment, and when the grab for return overwhelms the desire for capital preservation. Persuading budding analysts to postpone the immediate gratification of a momentum or growth stock career for a long-term value investment philosophy is a formidable challenge indeed. Leaving this extraordinary party early, or contemplating not even going, isn't very appealing if all your friends will be there having a great time while it lasts, which appears to be well into the night. To many, the really bad hangover will have been worth it.

At Baupost, we are excited that we continue to identify significant pockets of opportunity. Many of our most promising new ideas are in Western and Eastern European equities. As we started to see in 1996 and 1997, corporate restructuring has accelerated in many Western European countries. We have identified numerous companies in the midst of asset sales, spin-offs, and share repurchases, and others actively exploring such transactions. Because many of these companies are not closely followed by analysts, and because most U.S. event-driven investors have not yet migrated to European situations, we believe this area is compelling and will continue to throw off attractive opportunities for some time to come. Other companies, often of relatively small capitalization and having no immediate catalyst, have fallen through the cracks and trade at single digit price earning multiples where they represent excellent value.

Eastern European markets, including but not limited to Russia, Ukraine, Poland, Czech Republic, Hungary and Romania, have recently become even more attractive. Our main competition for investments are a limited number of dedicated regional funds. Because there is still economic and political uncertainty throughout the region, stock prices remain at very depressed levels despite numerous positive developments and compelling undervaluation.

The composition of our portfolio has shifted in recent months, as a number of more fully valued positions have been sold and the funds redeployed. The portion of our portfolio with a catalyst for the realization of underlying value has increased, hopefully reducing still further our dependence on the level of the equity markets for future results. We intend to persevere in our search for value, and remain confident that our cash balances (17% of Fund assets at April 30) are likely to be most valuable just as fewer and fewer investors choose to hold any. We also have substantially increased our position in disaster insurance (out of the money U.S. equity market put options, as well as various pro-

tections against rising interest rates and fluctuating currencies.) We continue to be willing to give up a portion of our upside to protect against serious downside exposure.

Our investment team continues to work diligently to find the kind of opportunities described in this letter. We are pleased to inform you that Tom Blumenthal, Abner Kurtin, Scott Nathan, and Sam Plimpton have been named Managing Directors of BGLLC (along with Paul Gannon, our CFO). In addition, Diane O'Connell, David Morris, and Carolyn Beckedorff have been named Vice Presidents of Baupost and Barbara O'Connor, Scott Stone and Vickie Alekson are now Assistant Vice Presidents.

We are pleased to have three summer analysts in-between years at Harvard Business School working with our investment team this summer. They each have a strong interest in the investment business, relevant work experience in investment banking and/or private equity, and the intelligence and personality to fit in well at Baupost.

We remain steadfast in our commitment to the risk averse investment of your capital. We are always available to address any questions you may have.

Very truly yours,

/s/ Seth A. Klarman

Seth A. Klarman
President

Average Annual Total Returns (1) For Periods Ended 4/30/98	<u>1</u> <u>Year</u>	<u>5</u> <u>Year</u>	<u>Life of Fund</u> <u>(since 12/14/90)</u>
The Baupost Fund	30.04%	17.60%	18.55%

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.

(1) Assumes reinvestment of all dividends.

[CHART OMITTED - PLOT POINTS AS FOLLOWS]

	<u>THE BAU- POST FUND</u>	<u>S&P 500</u>
12/14/90	\$50,000.00	\$50,000.00
04/30/91	\$58,158.98	\$58,161.73
04/30/92	\$63,692.31	\$66,325.82
04/30/93	\$75,761.04	\$72,448.88
04/30/94	\$85,933.03	\$76,302.11
04/30/95	\$92,875.27	\$89,627.93
04/30/96	\$105,059.48	\$116,707.47
04/30/97	\$131,063.27	\$146,040.47