

THE BAUPOST GROUP, INC.
44 BRATTLE STREET, 5th FLOOR
P.O. BOX 389125
CAMBRIDGE, MASSACHUSETTS 02238-9125
TEL. (617) 497-6680
FAX: (617) 876-0930

December 21, 1998

Dear Fund Shareholder,

We will not soon forget the volatility and financial market mania that characterized the year ended October 31, our first loss year. In this letter, I will attempt to identify the reasons for our 1998 result, describe what we have done to reduce the possibility that the same thing could happen again, and attempt to assess our prospects for 1999 and beyond.

First the facts. For the year, the Fund posted a market value decline of 16.3%. To add insult to injury, the large cap U.S. stock market indices posted substantial gains over the same period. In a year characterized by extreme divergence in a number of markets and asset classes, market indices of small cap stocks posted material declines.

Review of 1998

To better understand our loss year, we are providing you a closer look at our investment results. Table 1 below breaks down our investment performance for the year by asset class. It is apparent from this breakdown that we posted losses in U.S. equities, and that we lost further in trying to hedge the portfolio from market risk. The area of greatest loss, however, was emerging markets and, most significantly within that area, our exposure to Russian equities, which could not escape that market's severe collapse during 1998.

Table 1
Baupost Fund Investment Results by Asset Class
For the Year Ended October 31, 1998
(expressed as contribution to total return)

Cash and Cash Equivalents	1.0%
U.S. Equities	(2.8%)
Western European Equities	0.0%
Emerging Market Investments	(10.5%)
Liquidations	0.0%
Market Hedges	(2.8%)
Other	<u>(1.2%)</u>

Total Return

(16.3%)

Although there are many ways to think about our investment performance in 1998, we believe there were three main contributors to the negative result. While these exposures might not have been problematic in a more normal market environment, it is our objective to protect on the downside. In a highly unusual year where the cheapest market sectors and asset classes became considerably cheaper while the most expensive areas went to the stratosphere, we did a poor job protecting capital.

First, it is clear that we took on too much emerging market exposure in 1998. While we were able to identify many outstanding bargains in this area, emerging markets involve both political risk and macroeconomic risk, and have a potentially high degree of correlation with one another. These risks make emerging market investments difficult to hedge. We were simply overexposed to emerging markets this year.

Second, we had too much of our money in equities and too little cash during the year. Given our recurrent fear of a severe market correction and spreading economic weakness, this required us to maintain expensive and imperfect hedges. A substantial portion of our equity exposure was in small cap stocks (this is where the bargains were), and our results suffered when that part of the market became considerably more illiquid than usual.

Third, while we do not believe we were wrong to attempt to hedge our market exposure (we have been doing this in various ways for years), the mismatch between our long positions (mostly small cap) and our hedges (mostly large cap) caused us to lose money on both. It makes logical sense to hedge inexpensive small cap stocks against very expensive large cap stocks. However, we might have been better served finding more closely correlated hedges which acknowledged both the continuing trend toward indexation and the possibility that investor preference for a small number of very large cap growth stocks could continue for a protracted period.

Going forward, we will seek to focus on low risk investments while emphasizing capital preservation. Although emerging markets are bargain priced by historical standards, we will maintain a much more limited exposure to them in the future, including, as much as possible, an emphasis on situations with catalysts for the realization of underlying value. Until the developed stock markets retreat from record levels of valuation, we expect to have less portfolio exposure to equities going forward and more exposure to event driven situations such as liquidations and reorganizations that are not so dependent on the vicissitudes of the stock market for their investment return. Also, we will demand more compelling undervaluation than before to incur market risk. In the absence of appropriate opportunities, we will hold increased levels of cash. Finally, while we still expect to hedge against extreme conditions, the aforementioned combination of greater undervaluation, catalysts, potentially higher cash balances, and hopefully better aligned hedges should result in much improved performance.

To increase your understanding of our current positioning, Table 2 on the next page provides a chart showing our October 31 asset allocation. As of mid-December cash balances have increased further to approximately 35%. The portion of assets invested in U.S. equities has also increased in recent months while foreign holdings have been reduced.

Table 2

Baupost Fund Asset Allocation at October 31, 1998

Cash and Cash Equivalents	30.3%
U.S. Equities	18.1%
Western European Equities	32.5%
Emerging Market Investments	9.8%
Liquidations	6.7%
Market Hedges	1.5%
Other	1.1%
Total Net Assets	100.0%

The Current Frothy Environment

It is evident that we are in the midst of a stock market mania, with the usual accoutrements: hot IPO's, a market sector attracting enormous speculative activity (internet stocks), rising margin debt, and the late 1990's innovation: at home trading via the internet. Most significantly, the prevailing bullish arguments focus on momentum, money flows, and inevitability; valuation underpinnings are not mentioned as part of the bull case.

Just as in the early 1970's, but perhaps even more pronounced, there has been a stampede to own a "nifty-fifty", several dozen widely admired companies seeming to promise an investment utopia of safety, stability, steady growth, and liquidity. Once again, no price is regarded as too high to pay for these characteristics. An illusion is created that owning these stocks is prudent, that not owning them is imprudent, and, lately, that owning anything else is downright irresponsible. Investors are strangely willing to ignore the moral hazard of their own behavior, rewarding managements which successfully manipulate quarterly earnings into a steady and predictable uptrend. Valuations of these large cap stocks are at record levels, even ignoring the beneficial effect of big bath accounting writeoffs and the unrecorded compensation expense implied by dilutive management stock option programs.

As of mid-December 1998, nearly all of the S&P's return for the year can be attributed to its largest 20 constituents. The market-cap-weighted Nasdaq 100 Index (dominated by Microsoft, Intel, Cisco Systems, Dell Computer and MCI WorldCom) has gained 80% since January 1 even as the Russell 2000 Index (the 2000 stocks below the 1000 largest cap stocks) is down almost 8% year-to-date! We recently read one analyst's calculation that the current p/e multiples of the top 20 U.S. growth stocks required those companies to achieve 60% of ALL future U.S. corporate profit growth, a virtual impossibility. Over the past 30 years, this group provided only 15% of total profit growth. The author points out, however, that valuations can become even more absurd before they drop to reasonable levels.

Part of the reason for the return to a nifty-fifty era has been the increasing use of indexing by large institutional investors. Pointing to the difficulty of any one manager outperforming the market and the impossibility of the entire investment community doing so, many large institutions and pension funds have focused on cutting the costs of investment management to enhance net returns.

This has fueled more and more money going into the largest stocks, which have continued to surge while other parts of the market have slumped. While we sympathize with the difficulty the largest institutional investors face in achieving superior results, we believe the concentration of funds in a handful of stocks is in the process of creating a staggering opportunity amidst the neglected (or even totally ignored) thousands of smaller stocks.

Shorter-term investors will be skeptical that anything could cause this phenomenon to change, allowing the abandoned small stocks to outperform. Investing in a stock is really the purchase of a fractional ownership in a business, and the value of that business is determined by its fundamentals, not by the stock market (which, in the words of Ben Graham, is a voting machine, not a weighing machine.) Ultimately, undervalued stocks appreciate toward their underlying value; the market eventually recognizes the business fundamentals, or a catalyst, such as a takeover, forces the valuation gap to close.

Finally, we do not believe the current market mania will end without the ending of its twin, the mutual fund mania. U.S. equity mutual fund assets have surged tenfold since 1990, helping to fuel the market boom. Overconfident individual investors, projecting the stock market's recent performance indefinitely into the future, have developed a blind faith in the merits of equity investing, the fundamentals notwithstanding. They have also developed supreme confidence in their own willingness to remain invested in the face of unfavorable developments, a confidence reinforced by their successful buying of the market's dips for the past 16 years. When the tide goes out, as it has in Japan for the past eight years, money will flow out of the market and out of mutual funds (as it has in Japan); buying the dips will significantly exacerbate the pain.

Potential Areas of Future Opportunity

As you know, Baupost has benefited historically from migrating to new asset classes in order to find the areas of greatest opportunity. At the moment, we are faced with difficult conditions for bargain hunting, yet we are also excited by the promise of what we own and the opportunities we expect to develop in the months and years ahead. It is obvious that the U.S. and Western European equity markets are extremely expensive in general. Yet below the top few hundred equities around the world, there are tens of thousands of mid cap and small cap stocks which have underperformed the large stocks for years, which lost considerable ground in 1998, and which are increasingly overlooked, ignored or even hated. While many of them represent good relative value but are not inexpensive enough for us to like them on an absolute basis, we are continuing to uncover a number of situations that are absolutely cheap. Further, we expect that when the current large cap mania comes to an end and reverses, there will be a staggering opportunity in the small to mid cap area. This market sector is already under-analyzed by both the buy side and the sell side of Wall Street. There is little money coming into the sector as mutual fund inflows are mostly directed toward large cap exposure (the self-fulfilling prophecy still at work.) We intend to be well prepared for the period when big cap stocks return to earth and small cap stocks are offered at almost any price to anyone able to supply fresh capital to the sector.

We believe that another area of future opportunity will be bankrupt and distressed credits. This area provided us with enormous opportunity a decade ago, and has been remarkably unattractive in recent years, a combination of too much capital chasing too few bankruptcies (and most of those that

do exist are of poor quality businesses). Given the record junk bond issuance and leveraged buyout activity in recent years (there are over \$500 billion of junk bonds outstanding), there is almost certain to be a renewal of opportunity in this area in the years ahead.

Conclusion

We remain grateful for your support, and are working hard to continue to merit your confidence. While I am obviously busy, I am never too busy to take the time to respond to any questions, comments or concerns you may have. Communicating with you is one of the most important aspects of my job, so please feel free to e-mail me at sklarman@baupost.com or call me at the office.

Very truly yours,

/s/ Seth A. Klarman

Seth A. Klarman
President

Average Annual Total Returns (1) For Periods Ended 10/31/98	1 Year	5 Year	Life of Fund (since 12/14/90)
The Baupost Fund	-16.30%	9.32%	12.70%

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 be worth more or less than their original cost when redeemed. During some of 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.

**GROWTH OF AN ASSUMED \$50,000 INVESTMENT(1)
IN THE BAUPOST FUND FROM 12/14/90 THROUGH 10/31/98**

	<u>The Baupost Fund</u>	<u>S&P 500</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
10/31/98	\$ 128,220.00	\$ 205,175.00

(1) Assumes reinvestment of all dividends.