

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

June 24, 1999

Dear Fund Shareholder,

We are pleased to report a gain of 8.62% for the six months ended April 30, 1999. While less than the gains recorded by the broad market indices, the profit for the latest six months meets our ongoing objective of positive returns delivered with limited downside risk.

The broad market indices remain extremely expensive and have, despite a brief retreat by some of the highest multiple stocks, charged ahead to repeated record highs. The Dow Jones Industrial Average, for example, recently rose from under 9,200 to over 11,100 in less than three months. The U.S. economy remains robust (for now), and long term U.S. Treasury bond yields have climbed to over 6.0 % from 5.1% at the end of January. Most asset allocation models contrast bond yields to stock price-earnings multiples. At 6.0% bond yields, the S&P 500 Index is calculated by these models to be more than 30% overvalued. It would be far more overvalued were earnings to fall or interest rates to rise from current levels.

Unprecedented gains in large capitalization growth stocks continue to generate a mistaken faith among individual investors in the safety of owning stocks, as well as an erroneous impression of the potential future returns from equity ownership. Success begets additional success as investors project future results from the rear view mirror. One particularly irksome development is that fundamental research is today a significant impediment to good short-term results, as the most overvalued securities have steadily been the best performers and the most undervalued the worst. More and more, stocks are seen as apart from the businesses underlying them, with capital gains a product of investor money flows rather than corporate profit growth.

The Internet stock market bubble has been expanding at an accelerating rate. The shares of Internet companies have been rising 10%, 20% or more in a single day, splitting every month or two, and then quickly returning to their pre-split share prices. Dozens of nascent Internet companies are prominent on the IPO calendar and Internet stocks increasingly dominate cocktail party conversations as well as the daily stock market roundup. The \$200 billion market capitalization of America Online recently exceeded that of IBM. Charles Schwab was recently valued 50% more highly than Merrill Lynch. Priceline, the Internet company that sells airline tickets, was valued more highly than the three largest airlines, combined! eToys came public and immediately jumped to a valuation well above that of the well established Toys "R" Us. The prevailing casino atmosphere must certainly put

a damper on trips to Las Vegas or Atlantic City, where there are more losers than winners. In Internet-land, there have been no real losers as of yet; the illusion of a positive-sum casino is an attractive lure for the gambler. Recent exuberance notwithstanding, at today's valuations it is clear that Wall Street is certain to continue issuing shares of new Internet companies until the supply of shares overwhelms the resources of the buyers.

Simply put, we continue to face an unprecedented market environment with extreme volatility. In the face of very high prices, affordable and appropriate hedging is next to impossible. In our assessment, significant caution is called for at this time, and this is how we are positioned. While everyone else on Wall Street motors ahead at a frenetic pace, we are intentionally going slowly, unafraid of missing out on speculative gains and intent on protecting capital. This is an extremely challenging and dangerous environment, and we would rather be overly cautious and forego some profit than overly optimistic and potentially much poorer.

### *The Current Market Environment*

A recent Wall Street Journal article was headlined: For Some Stocks, Price Doesn't Matter. Within the article, the co-manager of the billion dollar Stein Roe Young Investor Fund described how he had revised his investment strategy to cope with today's environment: "To own a company like AOL (America Online), you had to throw out traditional measures of valuing companies. We had to say we have to own what we think is the dominant franchise in the Internet. It was a space that as a money manager you simply have to be in." Another manager similarly said, "It's almost like you have to own it." AOL recently sold for 388 times 1998 earnings and 238 times projected 1999 earnings.

This bubble is spilling over into the rest of the stock market, again at an increasing rate. Internet valuations make those on real companies, however overextended, seem reasonable, propelling those stocks even further into uncharted valuation territory. We believe there has been an extraordinary (and unknowing and probably temporary) increase in the risk tolerance of average investors. Specifically, what may happen in the future is today valued with unprecedented enthusiasm while what has already come into being (buildings, stores, traditional businesses) trades at subdued, even depressed prices.

Many of today's leading technology and telecommunications companies trade at 50 to 100 times earnings, or higher. While most of these companies are growing rapidly and possess extraordinary technology, these businesses remain highly competitive. Very low costs of capital and high returns attract enormous competition, and companies have to innovate faster and faster to stay ahead of the pack. Product life cycles are shorter and shorter, and unit prices continue to decline. We understand that the technology content of these companies is fabulous. Whether they are good businesses, deserving of astronomical multiples of current earnings, is an entirely different matter.

Students of financial history can point to historic levels of valuation to suggest that we are in a bubble. But students of psychology may be needed to complete the picture. For one thing, the financial markets have been so strong for so long that fear of market risk has mostly evaporated. People who used to hold bank certificates of deposit now maintain a portfolio of growth stocks. It is not really within human nature to comprehend that you may not know everything you think you know,

and, further, that what you believe in could change on a dime. When your investments are backstopped by reasonably-priced tangible assets, the prospect of a change in sentiment is not very costly. If a building is no longer needed as a furniture retailer, maybe it would make a good warehouse. If you can't make money as a distributor, you can recover most of your capital by reselling your inventory.

Not so for dreams. With more and more of the market value of U.S. equities represented by lofty (in some cases infinite) multiples of current results, a change in sentiment could wipe out a large percentage of investor net worth. Sentiment, existing only in the minds of investors, is subject to change quickly and without notice. Perhaps today's dreams will become realities for some of the current Internet and technology favorites; and perhaps not. For many, the dream will be replaced by a nightmare. Then, the escalating bill for betting on dreams rather than on realities will have to be paid up.

Real value, of bricks and mortar, finished goods inventories, accounts receivable, operating factories and businesses, and even brand names, is hard, although far from impossible, to destroy. If you don't overpay for it, your downside is protected. If you purchase it at a discount, you have a real margin of safety.

### *Our Current Positioning*

While the major stock market indices have never been so expensive, the range of valuation in today's markets is also extraordinarily wide. As a result, there are numerous undervalued small to medium capitalization stocks even as there are dozens of astonishingly overvalued large capitalization companies. Indeed, a vicious circle has been working against these smaller stocks (even as a virtuous circle propels the high flyers) in that their recent period of protracted underperformance causes disappointed holders to sell. This produces illiquidity and further declines, resulting in even greater underperformance which then triggers new waves of selling. Many small-cap value managers have been facing investor redemptions, further fueling the selloff.

We prefer to invest with a catalyst present to facilitate the partial or complete realization of underlying value. There is, however, significant competition for these sorts of opportunities from other investors, rendering many of them unattractive for investment; by contrast, uncatalyzed value situations today attract few buyers. Seemingly, it would make sense to increase our commitment to the deeply depressed uncatalyzed investments that are much more undervalued and where there is considerably less competition. Our concern is that we cannot know when the current love affair with large capitalization growth stocks will end, and what sort of havoc this will wreak on smaller stocks, however inexpensive. As we have explained before, the only logical way to hedge against this risk is to protect an investment in these undervalued smaller stocks with a put option on or short sale of more expensive stocks. We have ruled out short selling for a number of reasons, including the unlimited downside risk that short selling poses. With puts, at least, your cost is limited to the up-front premium. Such a hedge, however, is historically quite expensive and, as we learned last year, far from perfect.

Our resolution to this dilemma is to position the Fund's portfolio in three parts. A major component is cash (held in U.S. Treasury bills and/or in a U.S. Government securities money market fund), at

around 42% of the Fund's portfolio at April 30. This asset is available to take advantage of bargains, but represents important dry powder until some of today's market extremes resolve themselves.

Another segment, about 25% of the Fund's portfolio, involves numerous public and private investments with catalysts for the partial or complete realization of underlying value. This includes corporate bankruptcies, restructurings and workouts, liquidations, breakups, asset sales and the like. These situations are generally purchased at expected annual returns of 15% to 20% or more. The success of these investments depends primarily on the outcome of each situation rather than on the level of the stock market. There can, however, be month by month fluctuations in the market prices of these positions.

At April 30, we held about 32% of the portfolio in deeply undervalued securities with no strong catalyst for value realization. Values in this portion of the portfolio are particularly compelling, with prices at discounts of 30% to 50% or more from our estimate of underlying asset values. A number of these positions are former spinoffs, ignored and abandoned in a market not oriented toward smaller companies. Most of these situations involve partial catalysts for value realization such as ongoing share repurchase programs and/or insider buying, but these limited catalysts offer only modest protection from the short-term volatility of the financial markets. This category represents the lion's share of our market exposure; this is generally the portion of the portfolio that we attempt to hedge. Frequently, but unpredictably, investments in this category develop a stronger catalyst and move to the previous category; indeed, the undervaluation itself often attracts such a catalyst. Less often, an investment from the previous category loses its catalyst and either moves into this category or is sold.

The balance of about 1% of the portfolio was held in market hedges and various other option exposures, which may or may not serve as hedges.

In recent weeks, we have been extremely active in a number of areas. The market-driven shift of our public equity portfolio back to the U.S. continues; we have taken advantage of several selling opportunities in Western European equities, while buying into several depressed U.S. stocks. We are actively researching dozens of others. We have also added to our position in the undervalued bonds of Loewen Corporation, which recently filed for bankruptcy. Table 1 below depicts the geographic or asset class breakdown of the Fund's portfolio at April 30.

**Table 1**  
Baupost Fund  
Breakdown of Portfolio at 4/30/1999

Cash and Cash Equivalents	42.1%
U.S. Equities	31.0%
Western European Equities	7.7%
Emerging Market Investments	8.0%
Liquidations	5.8%
Distressed Debt Investments	4.9%
Market Hedges	0.2%
Other	0.3%
<b>Total Portfolio</b>	<b>100.0%</b>

We are continuing to balance on the tightrope between investment opportunity and risk aversion, taking advantage of the most compelling opportunities while maintaining a very cautious posture in an environment where most securities are priced for perfection and then some. The preservation of your capital remains our foremost goal, and we are confident that our current portfolio will both protect and reliably enhance Fund capital.

Please contact us with any questions, comments or suggestions you may have.

Very truly yours,

/s/ Seth A. Klarman

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Seth A. Klarman  
President

<b>Average Annual Total Returns (1) For Periods Ended 4/30/1999</b>	<b>1 Year</b>	<b>5 Year</b>	<b>Life of Fund (since 12/14/90)</b>
The Baupost Fund	-18.28%	10.14%	13.01%

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 4/30/1999**

	<b>FUND</b>	<b>S&amp;P</b>
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
04/30/98	\$170,436.34	\$206,014.84
04/30/99	\$139,277.38	\$250,971.95

(1) Assumes reinvestment of all dividends.