

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 17, 1999

Dear Baupost Fund Shareholder,

The Baupost Fund completed its year ended October 31, 1999 with a gain of 8.29%. This result, while profitable, is disappointing to us, especially coming on the heels of last year's decline. We remain determined in our pursuit of good absolute returns with limited downside risk. The valuation extremes of today's market have resulted in opportunities as attractive as any we have come across in the past decade. We believe the extremely compelling valuation of our current portfolio holdings augurs well for strong investment results with limited risk in the months and years ahead. The next several pages will describe the factors underlying our recent performance and provide more detailed information regarding our current portfolio holdings.

Simply put, we are navigating through an unprecedented market environment, where fundamental analysis is thrown out the window and logic is turned on its head. We underperformed in 1999 not because we abandoned our strict investment criteria but because we adhered to them, not because we ignored fundamental analysis but because we practiced it, not because we shunned value but because we sought it, and not because we speculated but because we refused to do so. In sum, and very ironically, we got hurt not speculating in the U.S. stock market.

Occasionally we are asked whether it would make sense to modify our investment strategy to perform better in today's financial climate. Our answer, as you might guess, is: No! It would be easy for us to capitulate to the runaway bull market in growth and technology stocks. And foolhardy. And irresponsible. And unconscionable. It is always easiest to run with the herd; at times, it can take a deep reservoir of courage and conviction to stand apart from it. Yet distancing yourself from the crowd is an essential component of long-term investment success.

Baupost has employed a value approach to investing because it is, above all, risk averse, and focused on preserving capital over the long run. This approach demands both discipline and patience. Discipline is required to buy only bargains and sell fully-priced holdings, never becoming swept up in the enthusiasm of the herd. Patience is required to wait for just the right opportunities, avoiding the pressure to make investments that don't meet the most stringent criteria of quality and under-valuation, and then to hold on, allowing an investment sufficient time to come to fruition.

The stalwart performers of today's stock market trade at higher valuations than any of the bull market favorites of yesteryear. The major stock market indices are, by virtually all measures, extremely overvalued. Never before have companies that have strung together a few years (or quarters) of earnings (or sales) growth been valued at such high multiples. And never before has the gap between the in-favor few and the out-of-favor many been so great. A few hundred in-favor growth stocks lift the market averages, while thousands of out-of-favor companies trade at bear market valuations. The disparity between the market favorites and everything else has never been greater.

It is not just our portfolio which has lagged. A recent article in the Wall Street Journal explained that although the Nasdaq 100 Index is up over 74% year to date, the average Nasdaq stock is actually down on the year. Just about every day on the New York Stock Exchange, there are more stocks making new lows for the year than new highs, usually many times more, even though the major market indices are all at or near record high levels. Indeed, on Friday, December 3, by no means an unrepresentative day, the Dow Jones Industrial Average surged 247 points, the S&P 500 Index jumped 1.7% (to a record level), and the Nasdaq 100 Index rallied 2% (also to a new high); on that day on the New York Stock Exchange, 99 stocks made new highs for the year while 200 posted new yearly lows! On December 10, all three indices again rose sharply; on the New York Stock Exchange, however, only 85 stocks made new highs while 339 hit new lows. On December 15, the Dow, S&P and Nasdaq Indices all rose sharply; that same day, 49 NYSE stocks made new highs while a whopping 455 posted new lows. It is hard to imagine a worse environment to assess the merits of a value investing approach (nor, ironically, a more favorable environment in which to practice it).

The gravitational force of the Internet and technology stock bubble is exerting a strong pull on the assets of investors. Money is draining from other sectors of the market into these strongly performing ones, causing share prices of more mundane companies not merely to underperform but actually to decline. Like a gambler withdrawing his or her savings for a trip to Las Vegas, investors are literally dumping their conservative shareholdings at giveaway prices to try their luck at the technology stock casino. The effect is a wild skewing of investment performance. From January 1 through December 13, 1999, the technology-heavy Nasdaq 100 Index rose 74.8%, versus 15.2% for the more balanced S&P 500 Index.

Several Forces Contribute to Today's Lofty Growth Stock Valuations

There are several unusual forces at work in the U.S. stock market and in major stock markets worldwide which are important to understand. First, there has been a decade-long increase in indexing activity, where more and more money is either overtly or tacitly invested to mirror the performance of market indices, especially the S&P 500 Index. The view is that investors on average cannot beat the market (a tautology, since they are the market) so you shouldn't bother to try. Moreover, trying will certainly result in transaction costs and management fees and could result in market underperformance. Many investors have found these arguments persuasive, especially in combination with the steady stream of academic arguments trumpeting the merits of stock ownership over the long-term compared to other asset classes. Finally, there has been a protracted self-fulfilling prophecy at work, as inflows into the indices lift their components at a faster rate than most other stocks, leaving the impression that an indexing strategy could actually outperform over time. The recent inclusion of Yahoo, Inc. into the S&P 500 Index caused a 67 point (24%) one-day gain and a one-week \$19.1 billion valuation enhancement to Yahoo's already generous market capitalization. Later,

we describe how the popularity of indexing will almost certainly be a source of significant opportunity creation for Baupost.

A second factor contributing to today's lofty market valuation is the cult of growth and momentum investment strategies, a bizarre emphasis on the trend of a company's results rather than on the absolute level of its performance. To this way of thinking, no price is too high to pay for a company that is rapidly growing and there is no price worth paying for a company that is not. I heard about a recent business school discussion where an entire class of students expressed a preference to own Microsoft (60 times earnings, 20 times revenues) rather than General Motors (under 10 times earnings). One student indicated that he would not choose General Motors at one half or even one fourth of its current price. The professor asked if there were any price at which the student might prefer General Motors. The student started to reply in the negative, hesitated, and then allowed how he might take it were it offered for free. This so perfectly captures today's investment mentality.

Investors are particularly enamored with companies which are able to post long records of unflagging earnings growth. Companies which do so achieve very high stock prices which, in turn, generously reward stock-option-laden management teams. As a result, there is no shortage of companies which always "make their numbers". The stakes are enormous, providing tens or even hundreds of millions of dollars to corporate executives who achieve consistent growth in reported results, little or nothing to those who do not (whose stocks consequently plummet and generally fail to recover).

Since businesses simply are not as steady or consistent as Wall Street number crunchers demand, there is enormous pressure on managements to smooth their results and pull the occasional rabbit out of a hat to deliver the desired quarterly outcomes. There are elements of a conspiracy to all this, as managements and shareholders both benefit from good reported results. A great many companies meet or exceed estimates only with a great deal of accounting legerdemain: write-ups and write-downs, changes in accounting procedures, modifications to actuarial assumptions, one time charges or gains and other forms of chicanery. There is little incentive for the market cheerleaders on the sell side of Wall Street to bring the goings-on to light. Such practices render the stock market even more overvalued than commonly recognized, because many of today's dubious accounting practices would almost certainly be reversed in an adverse market environment, with much lower multiples applied to the resultant lower reported earnings.

The third factor impacting today's stock market is the Internet. While we have no doubt that this extraordinary technology is changing and will continue to change our lives in important and unimaginable ways, it has spawned a gigantic stock market bubble among investors who wish to connect their investment fortunes to their excitement about this technology. At the root of all financial bubbles is a good idea carried to excess. The Internet is an extraordinary idea; how fitting, then, is the magnitude of the excess. Hundreds upon hundreds of Internet-related companies have come public and achieved valuations well into the billions of dollars, a great many possessing little more than a business plan. Very few of these companies are currently profitable, and it is our belief that most of them never will be.

The excitement of the Internet, the well publicized successes of investors who jumped in early on the Internet stock bandwagon, and the greed element in human nature have combined to create a market culture of day-trading, a low cost, convenient alternative to casino gambling that has to date, unlike Las Vegas, delivered a positive sum experience. The level of speculative activity is at a fevered

pitch, and people are changing their lives around to participate. Some have quit their jobs to day-trade. Venture capitalists are fighting to throw money at each successive hot deal; many have raised their fees and taken in gigantic sums of new capital. Business school and college students are rushing to write business plans that routinely get funded for millions of dollars. Traditional businesses are being raided for managerial talent by Internet companies with the lure of vast quantities of stock options as bait. Stories are everywhere of mere mortals who became multimillionaires overnight either working at or investing minor sums in Internet companies.

The explosive performance of Internet stocks has infected many professional investors who are typically judged by their investment performance relative to their industry peers. Relative performance is a slippery slope, and when a few investors holding Internet stocks outperform their peers, it becomes increasingly difficult for everyone else to avoid them. This sustains and even fuels the bubble despite the absence of investment fundamentals. Performance-driven hedge funds, relative-performance-oriented mutual funds, and even some "value investors" have capitulated. One prominent "value investor" owns among his ten largest holdings big stakes in Microsoft, IBM, Cisco Systems, America Online and Amazon.com. The first three trade at an average p/e ratio of over 69. America Online trades at 378 times earnings, while Amazon.com "suffers" large operating losses which the stock market values highly. Needless to say, this "value investor" has significantly outperformed his less imaginative peers.

The tendency of investors to follow the market's momentum and bet on whatever has worked recently is accompanied by antipathy to whatever hasn't. Underperforming market sectors and asset classes are generally experiencing fund outflows, exacerbating the downward trend. Historically, out-of-favor investments have typically performed best in the periods immediately following their underperformance, while those that have done well almost always follow their success by lagging badly. Human nature makes it unlikely for most investors to benefit from these predictive factors; the memory of most investors only incorporates what recently has been successful. Small and mid-capitalization stocks, and especially those at the lower end of the valuation range, have underperformed dreadfully for years, as money has gone into larger capitalization stocks. Some of this has been due to indexing; some is explained by momentum. Many institutional investors manage sums so vast that only the few hundred largest capitalization stocks could possibly absorb a meaningful portion of their capital. The underperformance of small and mid-capitalization money managers has caused investors to withdraw funds from them in search of better relative performance. Client redemptions force these managers to sell shares to raise cash, regardless of the valuation of what they are forced to sell. Thus it is that the undervalued become even more so, even as the overvalued do the same.

The Opportunity

We are actually cheered by the current environment (although not by its impact on our results) because we believe it represents an enormous opportunity in the making, an opportunity which we are currently in the process of exploiting. Right now, we are able to purchase high-quality assets and businesses in the form of small to medium capitalization stocks at their cheapest valuations in a decade or more. Many are selling at or below fifty cents on the dollar of underlying value, an extraordinary level of discount. Significantly, we believe these bargains are upon us precisely because of the

speculative activity surrounding the Internet, which has siphoned enormous sums of money out of more mundane investments.

It is important to emphasize that we are not describing a portfolio of cats and dogs, highly competitive or declining businesses, poor quality assets, or the likely losers in the Internet economy. Rather, our portfolio has been assembled through rigorous fundamental analysis, one investment at a time, bottom up. We typically pass on dozens of prospective investments for every one we make. Most companies in our portfolio, in addition to compelling undervaluation, have strong market positions, significant barriers to entry, substantial free cash flow, and catalysts in place to assist in the realization of underlying value. Almost all have managements who own significant amounts of stock personally. Even if these smaller stocks never return to investor favor, we expect to earn good returns from our fractional ownership in the underlying businesses. Over time, we are confident that the market for these stocks will recover as overstimulated investors refocus on risk as well as on return. This should result in a period of strong absolute performance and even better relative results. As we emphasized in our Semi-Annual Letter to Shareholders, our goal is to generate good absolute returns with limited downside risk over time. A portfolio of deeply undervalued, carefully chosen securities, many with catalysts in place for the realization of underlying value, is the most reliable way we know of to achieve this goal.

Our search for investment opportunity is always guided by fundamental analysis and valuation. We employ no rigid formulas, believing that the flexible pursuit of opportunity improves one's prospects for good returns with limited risk. We strive to be intellectually honest at all times, maintaining a willingness to change our minds when we are wrong. Given the competitiveness of the investment business, we believe it is important in every investment to have an edge, an advantage over the herd. This edge could be a willingness to take a long-term perspective in a short-term-oriented market, a tolerance of complexity when others crave simplicity, or the absence of constraints which either impede the ability of others to act or force them to act in uneconomic ways. For many of our holdings today, we believe the market has become increasingly inefficient, as investors have simply decided not even to look at small capitalization stocks outside of high technology industries.

Frequently, we attempt to profit by providing liquidity to urgent sellers. Financial markets act as allocators of capital, but they function much more efficiently when things are going well than when they are not. When an industry, asset class, security type, or geographical region is out of favor, profitable opportunities can be available to those who have cash and the expertise and willingness to deploy it. These opportunities superficially appear to be risky, since investing where capital is exiting is by definition unpopular. Since most investors derive comfort from consensus, many would not even identify such areas as rich with opportunity.

The investment challenge of providing liquidity to out-of-favor asset classes is more complex than simply identifying areas that others are avoiding. First, it is important to never be blindly contrarian, betting that whatever is out of favor will be restored. Often, investments are disfavored for good reason, and investors must consider the possibility that recovery may not occur. Second, it is important to gauge the psychology of other investors. How far along is the current trend, what are the forces driving it, and how much further may it have to go? Being extremely early is tantamount to being wrong, so contrarians are well advised to develop an understanding of the psychology of the sellers. Finally, valuation is extremely important in reducing risk. Investors must never mistake an

investment that is down in price for one that is bargain-priced; undervaluation is determined only by a security's price compared to its underlying value.

Despite two consecutive disappointing years, we remain enthusiastic about our prospects going forward and continue to invest virtually all of our liquid net worths in various Baupost portfolios. We choose to eat home cooking not only out of habit, not only because we should, and not so we can tell you that we do, but because we have a great deal of confidence in our strategy. Our portfolio contains greater undervaluation and higher quality investments than we have owned in years. We are continuing to scoop up extraordinary bargains amidst this crazy market, and we look forward to an upcoming period of profitable value realization.

We have no mandate other than the risk averse investment of the capital under our direction. We need not be fully invested, and frequently hold significant cash balances, waiting for truly great opportunities to come along. As part of our risk management, we have never leveraged our portfolios. We do not bet the ranch on any single investment; few positions have exceeded 5% of assets in recent years. We do not generally engage in the short sale of overvalued securities, believing that short-selling could effectively increase, not decrease, portfolio risk in certain kinds of markets.

With so many investors choosing not to think about their investing (indexing), failing to analyze the fundamentals of their holdings (momentum investors), and having an extremely short-term time horizon (almost everyone else), this is a wonderful time to be a long-term value investor. It is important to keep in mind that stocks are perpetuities, with no maturity date. While we frequently invest in stocks with a catalyst for value realization in order to create a portfolio of limited duration, we nevertheless buy only when we are prepared to hold for the long-term. Very few investors would choose to hold their current portfolios if they thought the stock market might be closed for trading for the next five years; since we are investing and not speculating, we would be comfortable with our portfolio under such conditions.

Our Current Portfolio

To help you understand how we are positioned at this time, we have broken down our current portfolio into categories as shown in Table 1 on the next page. As you can see, we continue to hold substantial cash balances. Most of our common stock investments are in the U.S., where we continue to see a strong flow of opportunities. A significant percentage of our investments have either partial or full catalysts in place for the realization of underlying value. The next several paragraphs will describe some of our major current holdings.

Table 1
The Baupost Fund
Breakdown of Portfolio at 10/31/99

Cash and Cash Equivalents	32.2%
U.S. Equities	41.9%
Western European Equities	11.5%
Emerging Market Investments	5.0%
Liquidations	6.5%

Distressed Debt Investments	2.3%
Market Hedges	0.2%
Other	0.4%
Total Portfolio	<u>100.0%</u>

Among today's most attractive pockets of opportunity are corporate spinoffs, which initially come under selling pressure in even the best of markets. Currently, a number of spinoffs are truly orphaned securities trading at giveaway prices. For example, we have recently purchased shares of both of the recently separated subsidiaries of Tenneco, Inc. The larger company, Pactiv Corporation, manufactures Baggies brand food storage bags and Hefty brand trash bags, and has leading market shares in a myriad of other plastic packaging products. Due to indiscriminate post-spinoff selling pressure, the shares have slumped to around 10 times currently depressed after-tax earnings and about 5.5 times pretax cash flow. The earnings should grow from a combination of cost reductions, asset redeployments, bolt-on acquisitions, volume growth, and expected lower raw materials prices. Management recently received significant stock options as part of a new incentive plan to better align their interests with those of shareholders. They have also been buying stock personally. It has been many years since a branded consumer products business fell through the cracks to trade at such a compelling valuation.

We are also buying shares of the Tenneco Automotive spinoff; this company manufactures Monroe shock absorbers and Walker mufflers, and is the market share leader in nearly all of its products and markets. It currently trades at approximately four times after-tax earnings. Its shares have been particularly brutalized as a result of its deletion from the S&P 500 Index. Tenneco pre-spinoff traded at a market capitalization of several billion dollars; the highly leveraged Tenneco Automotive spinoff, still under extreme selling pressure, trades at a market capitalization barely above \$200 million. Selling pressure has turned this market leader into a micro-capitalization stock, forcing many holders to exit because it no longer meets their size criteria. In effect, there is now a class of shareholders who must sell a stock simply because it trades at a depressed market valuation.

Harcourt General recently spun off most of its interest in Neiman Marcus, allowing it to become a pure play in the publishing and computer-based learning and training businesses. In the current turbulent market, we believe investors have failed to focus on the low valuation and high-quality, strongly growing businesses within Harcourt. Currently, trading at a several year low, the shares trade for under 12 times cash earnings (earnings plus goodwill amortization) and for roughly half of our estimate of the company's asset value. The company is expected to grow earnings 12 - 15% annually, and recently reported strong quarterly results. Harcourt's management has most of their net worths invested in the company (which they control) and has committed to take additional actions as warranted to cause the company's share price to more fully reflect underlying business value.

Chemfirst, a specialty chemical company, came public several years ago as a spinoff. Despite the company's strong position in the fast growing electronics chemicals market, the shares trade at around five times estimated cash flow. Business results are strong, and the company's management owns a substantial interest in the company. In addition, the company is actively repurchasing its shares. We believe the company will eventually be acquired in the chemical industry's consolidation.

We own several investments in the real estate area including shares in LNR Corporation, a spinoff a few years ago from a respected homebuilding company. This company is essentially an opportunistic investor in a variety of real estate assets, with a bias toward purchasing underperforming or out of favor properties, turning them around and selling them. They have achieved consistently strong returns over time, and the underlying value of the company's assets is close to twice the current market price of the shares. We expect underlying value to grow at a healthy rate for the foreseeable future. Management owns approximately 30% of the company's shares, and the company has been repurchasing substantial amounts of its own stock at the current price.

Octel was spun-off from Great Lakes Chemical Corporation in 1998 and has not succeeded in attracting investor interest. It is the world's dominant producer and marketer of worldwide TEL, a fuel additive that makes gasoline "leaded." This has been called a "sunset industry" because leaded gasoline is being phased out all over the world. In the meantime, however, it is a high margin business that requires almost no ongoing investment. Octel has recently consolidated its position and now controls in excess of 90% of the worldwide TEL market. The company is currently buying back around 10% of its stock per year. There are two primary risks - that the phase-out goes much more quickly than the 15-20% annual decline that management anticipates or that the company's abundant cash flow is squandered on foolish acquisitions rather than being used to pay down debt and buy back stock. At three times current after-tax earnings, valuation more than compensates for these risks.

We have recently become more active investors in thrift conversions. Thrifts at one time had a large dedicated community of investors, but after a period of overvaluation and poor stock performance, this is no longer true. While there are generally no short-term catalysts for value realization in this area, stock repurchases are accretive to shareholder value and industry consolidation seems likely to continue at a healthy pace. In short, the opportunity to buy significantly overcapitalized, conservatively managed thrifts between 50% and 75% of book value and at reasonable earnings multiples offer a low-risk investment with significant return potential.

We own shares in Stewart Enterprises, a funeral home and cemetery company which currently trades at approximately six times after-tax earnings per share. The death care industry has come under pressure as a result of overpriced acquisitions, excessive levels of debt, a recent, temporary decline in the death rate, and increased competition in some regional markets. All of the public companies in this industry are trading at extremely depressed levels. Stewart has some of the best properties in the industry; the company has recently repurchased its stock around current levels, and insiders have added to their holdings. A new management team is expected to reorient the company to maximize free cash flow generation.

Ucar is the world's leading manufacturer of graphite electrodes which are used in steel production. The company came under a cloud a few years ago when the industry admitted to price fixing. Results were then adversely affected by the Asian crisis last year. Management announced a sweeping cost cutting plan, which has been implemented faster than expected. Earnings are expected to grow strongly over the next few years as a result of lower expense levels, stronger demand, and possible price increases from currently depressed levels. The company also has announced a potentially lucrative product development and supply agreement with Ballard Power Systems, developers of a new fuel cell technology. Despite the company's excellent prospects and strong market position, the shares trade at roughly eight times estimated 2000 earnings.

Chargeurs is a French company which processes and trades in wool and produces fabrics, interlinings, and protective films. It is the market leader in virtually every segment in which it operates, generating substantial free cash flow from operations. Management is proactive in taking measures to maximize shareholder value including a securitization program to reduce volatility and risk in the trading business and the repurchase of a large number of shares. Some segments of the business have suffered as a result of the Asian crisis and are only now beginning to recover. Even on depressed results, however, the market values the company at approximately seven times earnings. Small capitalization companies in mundane businesses are out of favor in France, too.

Lambert Fenchurch is a publicly traded insurance broker in the U.K. Small in scale and in an industry that was out of favor amongst British investors, the company was unable to get a reasonable valuation from the stock market. Trading around 80 pence, the shares languished at six times earnings. Last month, after a long strategic review, the company accepted a takeover offer at 145 pence per share. The deal went unconditional on December 16.

Saab is a Swedish defense company primarily focused on aircraft, space and training systems which is valued at about seven times earnings. This valuation does not take into account growth opportunities available from the expansion of Saab's fighter aircraft program into the export market; the company recently received its first export order, validating our investment thesis. Management is also pursuing value creation through the monetization of the company's civilian aircraft lease portfolio. Last month, Saab agreed to purchase Celsius, another Swedish defense contractor, in a deal that enhances value by about 20% after cost-saving and revenue synergies. Although the European defense market is undergoing rapid consolidation, Saab, as one of the smallest remaining independent players, is below the radar screen of most investors.

We continue to have exposure to several investments whose outcome is totally independent of the level of the stock market. One such holding is Truster Corporation, which is in liquidation. The company's assets are cash and legal claims against a former executive who committed embezzlement. Cash on hand exceeds the share price and a substantial liquidating distribution is expected shortly. Another such investment is in the debt of Maxwell Communications, which is also in liquidation. This company continues to make good progress selling off its assets and resolving legal claims at better-than-expected levels. Another liquidating distribution from Maxwell is expected in late December.

The last two years have been difficult ones for The Baupost Fund. We are disappointed but not disillusioned, and remain confident that a fundamentally-driven, disciplined value investment approach will deliver good results with limited risk over time. We appreciate your patience and support and look forward to a period of improved performance.

As always, we are eager to address any questions, comments or suggestions you may have.

Very truly yours,

/s/ Seth A. Klarman
Seth A. Klarman
President

Average Annual Total Returns (1) For Periods Ended 10/31/99	<u>1</u> <u>Year</u>	<u>5</u> <u>Year</u>	Life of Fund (since 12/14/90)
The Baupost Fund	8.29%	8.77%	12.20%

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 10/31/99**

	<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
10/31/99	\$138,847.18	\$257,839.45

(1) Assumes reinvestment of all dividends.