**THE BAUPOST GROUP, INC.**
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December 8, 1995

Dear Baupost Fund Shareholder,

We are pleased to report a gain of 7.91% for the year ended October 31, 1995. This result, while ahead of our self-imposed bogey of exceeding the return on U.S. treasury bills, falls considerably short of the performance of various U.S. stock market indices. The primary reason for our underperformance, of course, is that the Fund has relatively little exposure to the U.S. stock market.

The Baupost Fund is managed with the intention of earning good absolute returns regardless of how any particular financial market performs. This philosophy is implemented with a bottom-up value investment strategy whereby we hold only those securities that are significantly undervalued, and hold cash when we cannot find better alternatives. Further, we prefer investments, when we can find them at attractive prices, that involve a catalyst for the realization of underlying value. This serves to reduce the volatility of our results and de-emphasizes market movements as the source of our investment returns. Positions with catalysts tend to lag a rapidly rising stock market (like this past year's) and outperform a lackluster or declining one (like we used to have every few years!).

During fiscal 1995, the Fund profited in most areas of the portfolio. Our largest gains and losses for the fiscal year, both realized and unrealized, are presented in Table 1 on the next page.

This fiscal year was somewhat unusual for the Fund. While we are gratified with the number of important gains, only three positions provided profitability in excess of one million dollars during the year. Maxwell Communications was a large position in the senior debt of a U.K. insolvency. The value rose significantly after the company announced the first of three substantial distributions to creditors. Emcor and MBO both involve securities of post-bankruptcy companies that initially received little attention in the market.

We experienced four significant losing positions this year. The largest was a position in various equity and debt market hedges that mostly expired worthless. Our policy is to continue to protect ourselves from serious market declines through the purchase of out-of-the-money put options. While an expensive proposition in fiscal 1995, the cost was manageable when considered in the context of the entire portfolio. Obviously, in other market environments, our hedges will have a very different impact on overall investment results.

**TABLE 1**

The Baupost Fund
Largest Gains and Losses
For the Twelve Months Ended 10/31/95
($ in millions)

| **Largest Gains** | | **Largest Losses** | |
|---|---|---|---|
| Maxwell Communications debt | $2.2 | Various equity and debt market hedges | $(2.1) |
| Emcor debt and equity | 1.2 | Playmates Toys equity | (1.2) |
| MBO equity | 1.1 | Dep Corporation equity | (0.9) |
| El Paso del Norte debt | 0.8 | Louise's debt | (0.8) |
| Basic Petroleum equity | 0.6 | Semi Tech Global equity | (0.4) |
| Todd Shipyards equity | 0.6 | TLC Beatrice equity | (0.4) |
| Viacom hedged strategy | 0.5 | Esco Electronics equity | (0.3) |
| QCF Bancorp equity | 0.4 | C-3 Inc. equity | (0.3) |
| DuPont equity and options | 0.4 | Carr Gottstein equity | (0.1) |
| Wells Financial equity | 0.4 | Eagle Picher debt | (0.1) |
| RJR Nabisco equity and options (net of hedge) | 0.4 | Fonciere Financiere equity | (0.1) |
| RIT Capital Partners equity | 0.4 | Hills Department Store equity & options | (0.1) |

Our Playmates Toys position declined on the heels of disappointing first half 1995 results. We believe this decline will be more than fully reversed in the future based on improved business performance. At the current level, the shares trade at a price approximately equal to net current assets; the company is involved in a number of projects that could very positively impact results in the second half of 1995 and beyond. Dep Corporation, while statistically cheap, did not perform in accordance with our expectations. The company overpaid for an acquisition and their debt load from the acquisition left little operating flexibility. Louise's was another disappointment; the company failed to take advantage of a window one year ago to come public, and deteriorating results caused us to take a writedown on this position. Other leading declines, such as TLC Beatrice and Semi Tech Global, reflect temporary market fluctuations that have resulted in these undervalued situations becoming even more undervalued. We believe that both these situations have great upside potential with little downside risk. No other investment declines cost us more than 0.5% of our total market value.

Once again in 1995, the U.S. stock market has delivered investment performance appreciably ahead of underlying business results. Over the past thirteen years, the S&P 500 with dividends reinvested has delivered a compound annual return of 15.9%, the best such result ever. For the last five years, the S&P 500 has returned 17.2%, while the NASDAQ Composite Index has returned a staggering 25.7%. Assuming a 10% long term rate of return from equities, the NASDAQ would need to drop a whopping 49% tomorrow to simply return to trendline for the latest five year period.

Bulls will patiently explain that "it is different this time", pointing to low inflation, high corporate profits, increased productivity, world peace (sort of), reductions in government spending, and the like. Of course, any contrarian knows that just as a grim present is usually precursor to a better future, a rosy present may be precursor to a bleaker tomorrow. Without me listing all the things that could go wrong, simply consider that none of these virtuous factors are cast in stone. Just as seeds are sown during the seven lean years that allow the seven fat years to ensue, so does the reverse hold true.

Anecdotally, too, this market is greatly overextended. People with no previous investment experience are starting hedge funds. Everyone seems to know someone who owns stock in a company that has just come public, not to mention the certifiable mania among the general public to own mutual funds and Internet stocks. Just a few days ago, the last remaining bearish Wall Street market strategist turned bullish, arguing that the "valuation paradigm" had changed.

Dangerous lessons are being learned by many investors. Warren Buffett has pointed out that legitimate theories frequently lie at the root of financial excesses; good ideas are simply carried too far. Today, virtually everyone "knows" that over the long-run, stocks will outperform other investment alternatives. Of course, almost no one thought of this as the market made cyclical lows in 1974 and 1982. So after a record-setting thirteen year bull market, proponents of this viewpoint are ignoring the high price they must now pay to purchase equities. Another dangerous notion is that dips in the market always represent buying opportunities. We firmly believe that one of Baupost's biggest risks, and, needless to say, that of other investors, is that we will buy too soon on the way down. Sometimes cheap stocks become a whole lot cheaper; it simply hasn't happened lately. (And when that happens, expensive stocks will fare far worse.)

We have said before and will repeat here that you do not really need Baupost to invest your money in bull markets. An index fund could likely perform better. The true investment challenge is to perform well in difficult times. It is unfortunately not possible to reliably predict when those times might be. The cost of performing well in bad times can be relative underperformance in good times. We have always judged that a worthwhile price to pay.

We remain surprised by the number of attractive opportunities we continue to find despite generally overextended market conditions. We believe that what we own is exceedingly cheap on an absolute basis, and that these holdings will perform well no matter what the broader market does. A number of our largest holdings at year-end have catalysts for the realization of underlying value, and should come to fruition in the relatively near future. Specifically, MBO Properties and Maxwell Communications remain in liquidation. El Paso is expected to emerge from Chapter 11 in the first quarter of 1996; we will receive new equity and debt securities in a reorganized company in exchange for our bonds. Carr-Gottstein Foods common stock and Southland Corp. bonds are both the target of tender offers. RJR Nabisco is under tremendous pressure by two corporate raiders to spin off its food business directly to shareholders, something the company indicated previously that it would likely do anyway. Falcon Cable recently announced that it was pursuing its sale, a year earlier than expected.

A number of our most undervalued holdings have no immediate catalyst for value realization. Allmerica Financial, the subject of a recent conversion from a mutual to stock insurance company, trades at a substantial discount to its peers. Semi-Tech Global sells at a 60% discount from its unleveraged, mostly liquid, asset value. TLC Beatrice's thinly traded shares sell at a large discount to its breakup value, as do the shares of Japan's Kirin Brewery. Recent legislation allowing Japanese companies to buy back their own shares may greatly benefit cash-rich Kirin. RIT Capital Partners continues to trade at a 35% discount from our estimate of net asset value. Several recent thrift conversions, including Trenton Savings Bank, Mississippi View Holding Company and Wells Financial, remain bargain-priced compared to their underlying value. Emcor Group and Envirotest Systems bonds, trading at significant discounts to par, offer high current yields and good asset protection.

We continue to focus our attention on the avoidance and/or reduction of risk. We believe this can be done without sacrificing good, even excellent, returns over time. The return earned by the Fund in fiscal 1995 is well below our long term expectation, and reflects a combination of uncooperative market conditions for our type of securities (the cheap became cheaper) and (with the benefit of perfect hindsight) excessive caution, both in the form of hedging costs and relatively high cash balances.

We remain grateful for your ongoing interest, support and confidence in us. We continue to strive to deserve it. Please let any of us know if there is anything we can do to serve you better.

Very truly yours,

Seth A. Klarman
President



| **Average Annual Total Returns (1)<br>For Periods Ended 10/31/95** | **1<br>Year** | **Life of Fund<br>(since 12/14/90)** |
|---|---|---|
| The Baupost Fund | 7.91% | 14.91% |

Total return is an historical measure of past performance and is not intended to indicate future performance. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

(1) Assumes reinvestment of all dividends.

**GROWTH OF AN ASSUMED $50,000 INVESTMENT
IN THE BAUPOST FUND FROM 12/14/90 THROUGH 10/31/95**

[IN THIS PLACE IS A LINE GRAPH SHOWING THE GROWTH OF AN ASSUMED $50,000 INVESTMENT IN THE BAUPOSTFUND COMPARED TO THE S&P 500 FROM 12/14/90 THROUGH 10/31/95. THE PLOT POINTS ARE AS FOLLOWS]

| | S&P | THE BAUPOST FUND |
|---|---|---|
| 12/14/90 | $ 50,000.00 | $50,000.00 |
| 3/91 | $ 58,024.40 | $55,771.68 |
| 6/91 | $ 57,891.29 | $59,332.96 |
| 9/91 | $ 60,987.08 | $58,998.31 |
| 12/91 | $ 66,100.47 | $61,485.71 |
| 3/92 | $ 64,430.83 | $63,911.75 |
| 6/92 | $ 65,659.40 | $64,203.91 |
| 9/92 | $ 67,729.67 | $65,059.55 |
| 12/92 | $ 71,140.30 | $70,005.54 |
| 3/93 | $ 74,243.41 | $75,227.59 |
| 6/93 | $ 74,604.74 | $77,707.92 |
| 9/93 | $ 76,532.54 | $80,054.79 |
| 10/31/93 | $ 78,116.01 | $82,134.71 |
| 12/93 | $ 78,305.62 | $83,196.92 |
| 3/94 | $ 75,335.75 | $84,533.67 |
| 6/94 | $ 75,653.26 | $89,244.13 |
| 9/94 | $ 79,352.03 | $88,798.55 |
| 10/31/94 | $ 81,134.73 | $91,217.43 |
| 12/94 | $ 79,339.62 | $89,880.68 |
| 3/95 | $ 87,064.74 | $91,488.30 |
| 6/95 | $ 95,375.77 | $93,607.44 |
| 9/95 | $102,955.48 | $99,526.41 |
| 10/31/95 | $102,587.46 | $98,430.31 |

(1) Assumes reinvestment of all dividends.

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June 21, 1996

Dear Baupost Fund Shareholder,

We are pleased to report profitable results for the six months ended April 30, 1996. Specifically, during that period the Fund gained 5.10% in value. This was less than the 6.92% gain posted by the S&P 500 Index during the same time frame.

The Fund ends the first half of its fiscal year 91% invested, with a number of new positions in European holding companies and small capitalization U.S. stocks. The Fund also initiated positions in the U.S.-listed ADR's of three Russian companies (two in the oil and gas business and one electric utility). Baupost has been following the nascent Russian stock market for three years, and we are excited that the Fund now has the ability to participate in this dramatically undervalued part of the world. Of course, because of the higher risk involved, we are limiting our overall exposure in Russia to a level where even a total loss would still be manageable.

The Fund's exposure to the U.S. stock market totaled only 29% of net assets at April 30, a level that reflects our opinion of the frothiness now present in U.S. share prices. Equity mutual funds continue to experience record inflows, and recently a number of highly speculative stocks have seen their prices double or triple within a few weeks as frenzied investors bid up their shares on dubious corporate developments. Even the slightest association with the Internet is cause for an upward thrust in a company's share price.

This is reminiscent of so many similar episodes over the last few decades, where everything from technology stocks to gambling shares to gold mines had their moment in the sun. We know the current mania will end badly; we do not know when.

We will not stray from our rigid value investment discipline. We buy absolute bargains when they become available, and sell when they are no longer bargains. We hold cash when there is nothing better to do, and we hedge against the risk of a dramatic and sustained downturn in the market. Our hedging over the last several years has been expensive and, with perfect hindsight, unnecessary. Yet we are convinced that hedging against catastrophe has been the right thing to do, and it thus remains an integral part of our overall investment posture.

Despite our discomfort with the level of speculative activity in the U.S. market, we remain optimistic regarding our prospects for the future. Because of our fundamental, research-driven, absolute-value orientation, we own undervalued securities that we believe will do well regardless of the overall financial environment. In the event of a major market reversal, we believe our market hedges should cushion any serious decline within the portfolio.

Our employees and their families continue to be major shareholders of the Fund, participating both directly and through our 401(k) plan.

We are grateful for your confidence and support and look forward to continued investment success in the second half of 1996 and beyond.

Very Truly Yours,

/s/ Seth A. Klarman

Seth A. Klarman
President

| **Average Annual Total Returns (1)**<br>**For Periods Ended 04/30/96** | **1**<br>**Year** | **Life of Fund**<br>**(since 12/14/90)** |
|---|---|---|
| The Baupost Fund | 6.74% | 14.81% |

Total return is an historical measure of past performance and is not intended to indicate future performance. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

(1) Assumes reinvestment of all dividends.

## GROWTH OF AN ASSUMED $50,000 INVESTMENT IN THE BAUPOST FUND FROM 12/14/90 THROUGH 04/30/96

| Date | The Baupost Fund | S&P 500 |
|---|---|---|
| 12/14/90 | $50,000.00 | $50,000.00 |
| 3/91 | $55,771.68 | $58,024.40 |
| 6/91 | $59,332.96 | $57,891.29 |
| 9/91 | $58,998.31 | $60,987.08 |
| 12/91 | $61,485.71 | $66,100.47 |
| 3/92 | $63,911.75 | $64,430.83 |
| 6/92 | $64,203.91 | $65,659.40 |
| 9/92 | $65,059.55 | $67,729.67 |
| 12/92 | $70,005.54 | $71,140.30 |
| 3/93 | $75,227.59 | $74,243.41 |
| 6/93 | $77,707.92 | $74,604.74 |
| 9/93 | $80,054.79 | $76,532.54 |
| 10/31/93 | $82,134.71 | $78,116.01 |
| 12/93 | $83,196.92 | $78,305.62 |
| 3/94 | $84,533.67 | $75,335.75 |
| 6/94 | $89,244.13 | $75,653.26 |
| 9/94 | $88,798.55 | $79,352.03 |
| 10/31/94 | $91,217.43 | $81,134.73 |
| 12/94 | $89,880.68 | $79,339.62 |
| 3/95 | $91,488.30 | $87,064.74 |
| 6/95 | $93,607.44 | $95,375.77 |
| 9/95 | $99,526.41 | $102,955.48 |
| 10/31/95 | $98,430.31 | $102,587.46 |
| 12/95 | $99,964.85 | $109,153.62 |
| 3/96 | $103,101.01 | $115,011.78 |
| 4/96 | $105,061.10 | $116,707.47 |

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December 17, 1996

Dear Baupost Fund Shareholder,

We are pleased to report a gain of 22.51% for the year ended October 31, 1996. Due to our significant underinvestment in the U.S. stock market (a topic to which we will return shortly) this gratifying result comes in spite of, rather than as the result of, similarly robust results for the U.S. equity markets. We are chagrined that we could have achieved approximately the same returns had we initiated the Baupost Index Fund a year ago. We are pleased, however, that we managed to do so with a vastly lower risk profile.

As we reflect back at fiscal year end, let us reiterate that Baupost's investment philosophy has remained consistent over time: bottom up, risk averse, absolute value oriented. In making tradeoffs among competing alternatives, we have distinguished ourselves from other professional investors in several ways: our willingness to hold cash balances, sometimes substantial, awaiting opportunities; our preference for investments with a catalyst for the realization of underlying value; our willingness to accept varying degrees of illiquidity in exchange for incremental return; and our flexibility in pursuing opportunities in new areas.

Baupost has long enjoyed a very flexible investment charter, one that has permitted us to depart considerably from our initial conception as US equity and high quality debt investors. This flexibility has been, we believe, at the core of our investment success over the years. Like Baskin Robbins ice cream, opportunities come in dozens of flavors, not all of which are served at the same time. (Like Haagen Dazs, some of these flavors are fantastic.) Investors who find an overly narrow niche to inhabit prosper for a time but then usually stagnate. Those who move on when the world changes at least have the chance to adapt successfully.

Our flexibility has served us very well over the years, allowing us to move into areas of temporary and compelling opportunity (usually characterized by falling prices, distressed or uninformed sellers, and/or decreased liquidity) and away from areas of full or excessive valuation, thereby enhancing return while simultaneously reducing risk. The same flexibility that led us into a heavy concentration in thrift conversions in the mid 1980's and distressed corporate debt in the mid-late 1980's, and a smaller hedging bet on Japanese stock market puts in the late 1980s, has led us into a moderate investment in Russian stocks earlier this year, and an important position in European holding companies in 1995-1996.

The primary risk of entering new investment areas is unfamiliarity itself: the rules of the game might be unfamiliar or changing; others that have been in the area longer might have a significant advantage; and to paraphrase Warren Buffett, if you look around the poker table and cannot identify the patsy, it is probably you. Cognizant of this risk, we have worked diligently to understand new areas as well as existing participants do before we enter, utilizing external resources when necessary. We have entered timidly, probably foregoing some opportunities but ensuring that we had time to gain comfort and any expertise we were lacking.

Risk is also mitigated by both our constant emphasis on investment fundamentals and on knowing why each investment we make is available at a seeming bargain price. We regard investing as an arrogant act; an investor who buys is effectively saying that he or she knows more than the seller and the same or more than other prospective buyers. We counter this necessary arrogance (for indeed, a good investor must pull confidently on the trigger) with an offsetting dose of humility, always asking whether we have an apparent advantage over other market participants in any potential investment. If the answer is negative, we do not invest.

We have always told you that we invest the Fund's assets as if it were our own money (which, of course, a portion of it is). We thus enter a new area only when we gain conviction that our analytical, valuation and risk assessment skills will be useful in that area, and that we understand the potential risks and returns of specific opportunities in that area; then, we manage the size of the investment based upon our degree of conviction, assessment of risk, and opportunity for diversification within the area. Typically, a new area is not a wild leap from anything we have done before, but rather a smaller step from something we already do, with only one variable changing.

One of the consequences of entering new areas has been an increase in the portion of our assets invested in opportunities outside the U.S. This has not been the result of some top down asset allocation strategy, but rather the outcome of a bottom up, investment by investment search for opportunity. Like the underlying businesses, markets, too, have become more global over time. Most companies compete globally, capital flows are global, and many companies now maintain listings in more than one market. Popular US companies like Coca Cola earn well over half their profits overseas, while large European and Asian enterprises often have substantial US subsidiaries. Thus the most important investment criterion for us is not where a company does business, or where it is listed, but an understanding of the factors that might cause a company or security to be particularly undervalued in the market.

Of course, it seems reasonable that at this time we would be finding more opportunities overseas than at home. The U.S. stock market has been in a protracted bull market. With more and more very sophisticated pools of money pursuing opportunities in the U.S., we believe the market has become more efficient than ever (and even when for some reason a stock is not priced efficiently, it is nonetheless considerably more likely to be overvalued than undervalued). The number of sizable, highly sophisticated, professional investors in overseas foreign markets is far fewer, making those markets more fertile fields to till.

The key to increasing our international exposure in recent years was gaining comfort that we understood the potential risks and returns of foreign markets, something we could only achieve over time by immersing ourselves in a flow of information about companies and markets, by meeting directly with managements, and by making some toehold investments and observing their success or failure over time. We did all of this over the past seven years. The increased size and capability of our investment team allowed us to better analyze foreign opportunities; the increase in our assets under management (as compound returns were reinvested over the years) gained the attention of foreign brokers and analysts. We were also able to utilize our existing network of friends on the buy side to gain an ongoing exchange of information. Thus late last year when European holding companies sank to record-wide discounts to underlying asset values, which themselves were quite depressed, we were in a position to act.

Similarly, when we identified the opportunity unfolding in the former Soviet Union, we were able to dispatch three different analysts to cover the area, spending several man-months on the ground there and building relationships with brokers, analysts, and other emerging market investors. Our total assets under management demonstrated that we had the potential to be a very important client to a number of brokerage firms, and we did indeed become among the largest customers of several.

A key component of our investment strategy is sufficient but not excessive diversification. Rather than own a little bit of everything, we have always tended to place our eggs in a few dozen baskets and watch them closely. These bargain-priced opportunities are selected one at a time, bottom up, which provides a margin of safety in case of error, bad luck or disappointing business results. However, we are always conscious of whether these different investments involve essentially the same bet or very different bets. If each of our holdings turned out to involve similar bets (inflation hedges, interest rate sensitive, single market or asset type, etc.), we would be exposed to dramatic and sudden reversals in our entire portfolio were investor perceptions of the macroeconomic environment to change. Since we are not able to predict the future (it is hard enough to understand the present), we cannot risk such concentrated exposures.

The same is true for securities, even of very different companies, trading in a single stock market. Owning a diverse portfolio in one market may greatly reduce the risk associated with a single company hitting a bump in the road but will not at all reduce the risk of being in that market. If that market runs into a pothole, its components could all break down at once. This is particularly true if that market is trading at record levels of valuation, supported more by money flows than by fundamentals, as happens sometimes (read "U.S. equity market"). Exposure to a myriad of markets and asset classes will mitigate certain risks that even broadly diversified exposure in a single market cannot. (Of course, diversification is for us only the starting point for risk reduction. Solid fundamental research, emphasis on catalysts, value discipline, preference for tangible assets, hedged short selling, market put options and other strategies combine to create an overall portfolio safety net for our portfolio that we believe is second to none).

During fiscal 1996, the Fund posted numerous healthy gains and only one substantial loss, that being on stock market put options which we buy as insurance against a steep market decline. Our largest gains and losses for the fiscal year, both realized and unrealized, are presented in Table 1 below.

**Table 1**
The Baupost Fund
Largest Gains and Losses
For the Twelve Months Ended 10/31/96
($ in millions)

**Largest Gains**

| | |
|---|---|
| Maxwell notes | $3.0 |
| Lukoil common | 2.8 |
| Mosenergo common | 2.1 |
| RIT Capital Partners common | 1.4 |
| Allmerica Financial common | 1.3 |
| Semi Tech Global common | 1.2 |
| Emcor common and notes | 1.2 |
| Pullman common | 1.1 |
| Fourteen other investments | 0.8-0.3 each |

**Largest Losses**

| | |
|---|---|
| Market put options | ($1.6) |
| Chargeurs/Pathe/BSkyB (hedged equities) | (0.5) |
| RJR Nabisco common and options | (0.4) |
| Adam & Harvey common | (0.4) |
| Imperial Oil common | (0.3) |
| Northwestern Steel common | (0.2) |
| Dun & Bradstreet common & options | (0.2) |
| Eagle Picher debt | (0.2) |

We believe that we are well positioned as we enter 1997, with attractive, well diversified long positions, a healthy balance in cash and cash equivalents, and a material position in market put options to protect against a serious decline. Many of our positions have either full or partial catalysts for the realization of underlying value. We continue to find attractive opportunities for our portfolio, increasingly outside of the frenzied U.S. stock market.

We are grateful for your ongoing confidence and support, and are working diligently to remain worthy of it.

Very Truly Yours,

/S/Seth A. Klarman

Seth A. Klarman
President

| Average Annual Total Returns (1) For Periods Ended 10/31/96 | 1 Year | Life of Fund (since 12/14/90) |
|---|---|---|
| The Baupost Fund | 22.51% | 16.17% |

Total return is an historical measure of past performance and is not intended to indicate future performance. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

(1) Assumes reinvestment of all dividends.

**GROWTH OF AN ASSUMED $50,000 INVESTMENT**
**IN THE BEAUPOST FUND FROM 12/14/90 THROUGH 10/31/96**

| | FUND | S&P | BF | S&P |
|---|---|---|---|---|
| 12/14/90 | $50,000.00 | $50,000.00 | | |
| 10/31/91 | $59,787.48 | $61,807.01 | 19.57% | 23.61% |
| 10/31/92 | $65,471.71 | $67,963.62 | 30.94% | 35.93% |
| 10/31/93 | $82,134.71 | $78,116.01 | 64.27% | 56.23% |
| 10/31/94 | $91,217.43 | $81,134.73 | 82.44% | 62.27% |
| 10/31/95 | $98,430.31 | $102,587.46 | 96.86% | 105.17% |
| 10/31/96 | $120,585.06 | $127,306.16 | 141.17% | 154.61% |

(1) Assumes reinvestment of all dividends.

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June 20, 1997

Dear Baupost Fund Shareholder,

We are pleased to report profitable results for the six months ended April 30, 1997. Specifically, during that period the Fund gained 8.69% in value.

While this represents an attractive absolute return for a six month period, you should know that our performance has lagged behind the continued strong gains posted by the U.S. equity market. There are several reasons for this relative underperformance: One is our low U.S. stock market exposure (only 31% of net assets at April 30.) Another is our lack of exposure to the expensive large capitalization consumer growth and technology stocks (the new "nifty fifty") which have been among the best performers in the market. A third is our considerable net cash and cash equivalent position (close to 30% of net assets at April 30.) Finally, we have underperformed this roaring bull market for the same reasons we always do: we remain risk averse value investors and will never own what we perceive to be expensive stocks in the hope that they could somehow rise even higher.

Gains in the U.S. stock market, it seems to us, are being fueled by two important factors. First, the U.S. economic situation has been and remains very favorable, with low inflation, relatively low interest rates and steady GDP growth. The world is at peace, the U.S. has emerged as the sole superpower, and capitalism has never been more popular.

Second, investors have come to expect (and depend on?) handsome returns from investing in equities, and money has been relentlessly flowing into U.S. stocks. We believe that this has in the short run become a self-fulfilling prophecy, as funds flows lift share prices to produce the profitable returns that investors have sought. Over time, however, this is very likely to become a self-defeating prophecy, as today's inflows lift share prices to levels from which the long term returns will likely be below the historical average, and even further below today's investors' bloated expectations.

During the past six months, the Fund has enjoyed gains in a number of areas of the portfolio, including several situations that benefited from unexpected takeover activity. This has continued into May with the announcement that Basic Petroleum has agreed to be acquired for $40 per share.

We continue to find attractive investments outside the U.S., and have initiated a number of new positions over the past few months. The French market declined ahead of the recent elections there, and this resulted in an opportunity to add to a few of our established positions. We continue to believe that foreign equity markets are both much cheaper than the U.S. and that they are priced considerably less efficiently than here, creating a compelling long-term opportunity for the Fund, notwithstanding the risks of investing in foreign markets.

We thank you again for your confidence and support and look forward to continued future investment success.

Very truly yours,

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

| **Average Annual Total Returns (1)<br>For Periods Ended 04/30/97** | **1<br>Year** | **Life of Fund<br>(since 12/14/90)** |
|---|---|---|
| The Baupost Fund | 24.75% | 16.32% |

Total return is an historical measure of past performance and is not intended to indicate future performance. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

(1) Assumes reinvestment of all dividends.

**GROWTH OF AN ASSUMED $50,000 INVESTMENT**
**IN THE BAUPOST FUND FROM 12/14/90 THROUGH 4/30/97**

| | FUND | S&P |
|---|---|---|
| 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 |

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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)

| **Largest Gains** | | **Largest Losses** | |
|---|---|---|---|
| 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 Broadcasting 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**

| **ASSET TYPE** | **MARKET VALUE** | **% OF NET ASSETS** |
|---|---|---|
| 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 lockstep 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 because 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 Cuniff 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
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Seth A. Klarman
President

| Average Annual Total Returns (1) For Periods Ended 10/31/97 | 1 Year | 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**

| | FUND | S&P |
|---|---|---|
| 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 |

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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 then 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 protections 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
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Seth A. Klarman
President

| Average Annual Total Returns (1) For Periods Ended 4/30/98 | 1 Year | 5 Year | Life of Fund (since 12/14/90) |
|---|---|---|---|
| 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]

| | THE BAUPOST FUND | S&P 500 |
|---|---|---|
| 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 |
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| 04/30/96 | $105,059.48 | $116,707.47 |
| 04/30/97 | $131,063.27 | $146,040.47 |

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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 | (1.2%) |

| | |
|---|---|
| **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 [redacted] or call me at the office.

Very truly yours,

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

| **Average Annual Total Returns (1)**<br>**For Periods Ended 10/31/98** | **1**<br>**Year** | **5**<br>**Year** | **Life of Fund**<br>**(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**

| | **The Baupost Fund** | **S&P 500** |
|---|---|---|
| 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.

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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% |
| **Total Portfolio** | 100.0% |

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
---------------------
Seth A. Klarman
President

| **Average Annual Total Returns (1) For Periods Ended 4/30/1999** | **1 Year** | **5 Year** | **Life of Fund (since 12/14/90)** |
|---|---|---|---|
| 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**

| | **FUND** | **S&P** |
|---|---|---|
| 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.

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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 undervaluation, 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** | 100.0% |

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. It's 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 Trustor 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)<br>For Periods Ended 10/31/99 | 1<br>Year | 5<br>Year | Life of Fund<br>(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**

| | The Baupost Fund | S&P 500 |
|---|---|---|
| 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.

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June 13, 2000

Dear Fund Shareholder,

We are pleased to report a healthy gain of 10.28% for the six months ended April 28, 2000. This result was achieved amidst a volatile equity market environment where both growth and value managers experienced difficulty. Indeed, two of the most notable investors of the twentieth century effectively ended their investment careers this year after incurring substantial losses. Ironically, Julian Robertson's Tiger Fund closed its doors largely as a result of missing out on technology stocks in recent years, while Stanley Druckenmiller of the Soros organization quit as a result of losses experienced from his technology holdings. This bucking bronco of a market has made it hard for nearly all investors, regardless of approach, to hang on.

The Baupost Fund, as you know, exists to accommodate the family members and friends of Baupost clients. It participates ratably in all of the investment ideas generated at Baupost which are consistent with legal guidelines applicable to the Fund and with the Fund's investment objective. The investment objective of the Fund is capital appreciation, with income as a secondary goal. The Fund seeks to achieve its objective by profiting from market inefficiencies using a value-oriented and, often, an event driven approach. We are not seeking to keep up with any particular market index or benchmark. Rather, we are attempting to achieve good risk-adjusted investment results over time through the successful implementation of our investment philosophy.

We continue to believe strongly in a value investment approach, attempting to buy assets or businesses at a considerable discount to underlying value. Bargains exist because the financial markets are inefficient, yet many investors lack the requisite patience and discipline to take advantage of them. A value approach may outperform or underperform the overall market at various times because of changing investor sentiment, but we believe that a value philosophy never goes out of style. When sentiment towards undervalued sectors of the market is at its nadir, it is the best time to be buying value.

As we sift through the market for opportunities, we come across many stocks that are overvalued and thus of no interest to the Fund. Undervalued stocks are of interest when several or all of the following criteria are met: if the undervaluation is substantial; if there is a catalyst to assist in the realization of that value; if the business value is stable and growing, not eroding; and if the company's management is able and properly incentivized.

Our search for opportunity is conducted on a bottom-up, not top-down basis, seeking to reduce risk situation by situation as a result of in-depth fundamental analysis, a strict assessment of risk versus return, a value philosophy which attempts to create a margin of safety in each of our holdings, an event-driven focus, and ongoing monitoring of our positions to enable us to react to changing market conditions or fundamental developments. We may further attempt to reduce risk for the portfolio through appropriate diversification by asset class, geography and security type, through market hedges such as out-of-the-money put options, and by our willingness to hold cash when we are unable to identify compelling opportunities.

Because investing is a highly competitive activity, we consider for each of our investments not only whether a security is undervalued but why it is undervalued. If the reason is that there are uninformed or emotional sellers, we become more comfortable. Conversely, we do not want to ever be in the situation of having less information than the party selling to us. In effect, we seek an edge in all of our investments, a reason to believe we will have the wind at our backs, not in our faces, as we seek good investment returns over time with limited risk. Situations analytically complex, or where there are forced, mechanical or panicked sellers, nicely fit this criterion.

Since we cannot predict the future level of securities prices, we invest with the goal of performing well regardless of future market conditions. This cautious approach does not guarantee good results (witness 1998) and can cause significant market underperformance for fairly long periods of time. However, we believe that it will deliver strong results with limited risk over the long-run.

Our recent performance and current portfolio positioning illustrate the application of our investment principles. The gain for the first six months of our current fiscal year was achieved throughout the portfolio, net of hedging costs and management fees. We were profitable in four of those months (and were only down 23 and 31 basis points in the other two months), and largely avoided the extreme market volatility experienced by many others over the same period. Table 1 below provides a breakdown of our holdings by geography and asset class.

**Table 1**

Portfolio Breakdown by Geography and Asset Class at April 28, 2000

| | |
|---|---|
| Cash | 4.6% |
| U.S. Public Equities | 61.9% |
| Western Europe Public Equities | 9.5% |
| Arbitrage or Spread Trades | 9.3% |
| Other Public Equities | 3.4% |
| Private Equities and Partnerships | 2.0% |
| Performing and Non-Performing Debt | 5.2% |
| Securities in Liquidation | 2.9% |
| Market Hedges and Other | 1.2% |
| **Total** | 100.0% |

Our current portfolio is broadly diversified with a concentration in undervalued U.S. equities, many with a partial or full catalyst for value realization. In the first four months of 2000, cash balances declined as a result of numerous new commitments. In particular, distressed debt holdings have increased of late. The discount on our equities from underlying or private market value frequently exceeds 50%, an indication of the compelling value opportunities available at this time. A very high percentage of our equity positions trade at single digit p/e multiples, at a healthy discount to tangible book value, or both.

A recent Washington Post article recounted the tremendous core of investor optimism still prevalent in today's financial markets. In an April poll conducted by PaineWebber and the Gallup Organization, investors expected a 16.6% annual rate of return from stocks over the next ten years. The least experienced investors expected 20% returns. By contrast, one prominent investment firm, Grantham, Mayo, Van Otterloo & Co., uses an assessment of market valuation and historic returns to forecast a slightly negative real return from U.S. equities over the next decade. According to Yale economist Robert J. Shiller, today's high investor confidence is not a natural, steady state. It is a sign that the market is vulnerable to decline in coming years.

We don't buy "the market". We invest in discrete situations, each individually compelling. Regardless of what the future brings, we believe we are well-positioned.

Please let us know if you have any questions, comments or suggestions.

Very truly yours,

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

| **Average Annual Total Returns (1)**<br>**For Periods Ended 4/28/2000** | **1**<br>**Year** | **5**<br>**Year** | **Life of Fund**<br>**(since 12/14/90)** |
|---|---|---|---|
| The Baupost Fund | [redacted] | [redacted] | [redacted] |

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 4/28/00**

[LINE GRAPH APPEARS HERE]

| | FUND | S&P |
|---|---|---|
| 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 |
| 04/28/00 | [redacted] | $276,390.70 |

(1) Assumes reinvestment of all dividends.

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December 6, 2000

Dear Fund Shareholder,

We are pleased to report a gain of 22.4% for the fiscal year ended October 31, 2000. This result was achieved amidst a challenging and unusually turbulent market environment.

Profitable results were achieved across the Fund's portfolio, led by gains in U.S. and Western European equities and arbitrage activities. Our returns were reduced by hedging costs of approximately 2.4%. A breakdown of investment results appears in Table 1 below.

**Table 1**
The Baupost Fund
Breakdown of Investment Results for the Year Ended October 31, 2000

| | |
|---|---|
| U.S. Public Equities | 10.8% |
| Western Europe Public Equities | 4.1% |
| Arbitrage or Spread Trades | 4.2% |
| Other Public Equities | 3.7% |
| Private Equities and Partnerships | 0.4% |
| Performing and Non-Performing Debt | 1.0% |
| Securities in Liquidation | 1.0% |
| Market Hedges | -2.4% |
| Interest on Cash Equivalents Less Management Fees and Other | -0.4% |
| **Total Return** | 22.4% |

Clearly, the Internet bubble has burst. Nearly all publicly traded Internet stocks have come up snake-eyes, and there is considerable doubt about whether there is or ever was a "new economy." No longer can you add "dot com" to a word, sell shares to the public, and join the Forbes 400. No longer can entrepreneurs count on investors to fund enormous and protracted operating losses. Although the carnage thus far is extensive, the economic fallout from the end of this speculative mania has yet to be fully felt.

Many financial excesses remain. A bull market mentality has been indelibly etched on the American consciousness over the past eighteen years, and will not be easily erased. The public maintains its lust for equities; the potential of equities to deliver double-digit returns continues to attract buyers who fail to accurately assess the shrinking probability of such an outcome. The prospect of accepting the apparently mediocre, albeit more certain, return from owning high-grade bonds thus far fails to inspire buyers.

The fantasy of a near-term Dow 36000, of holding stocks for the long run regardless of valuation, plays well in classrooms, computer models, and editorials. It fares less well in the real world, where earnings disappointments are met with share price demolition, and where corporate managements massage and manipulate results for gullibly compliant investors until the untidy reality inevitably peeks through. Like a couch potato clicking the remote control, real-world growth investors are continually switching their capital from areas of disappointment to areas of perceived opportunity, oddly unaware that all of the channels are showing reruns. Each alluring new area is the "before" photo, each broken growth stock "the after," but no amount of adversity seems to dissuade growth stock investors from the hunt.

Today's investment herd loves a good story. Last year, the story of rapid growth leading eventually toward profitability topped investors' bestseller lists. Widely portrayed as non-fiction and sometimes masquerading as biography, it turned out to be science fiction. Today, a popular tale involves more elements than growth alone; a good story stock must occupy a compelling and growing business niche, and possess strong market share, an able management, present or foreseeable earnings (or at least cash flow), and results that repeatedly exceed analyst expectations. These factors usually cause a stock to possess a high valuation multiple and an esteemed position in a major market index. Then, in a virtuous circle, this stock market success allows the attraction and retention of able employees through the use of stock options in compensation. Frequently, bookkeeping strings are pulled to manipulate reported results into a steadily rising pattern. The net result is that management and shareholders, for at least a while, become wealthier.

If Paul Harvey's serialized radio program "The Rest of the Story" were applied to Wall Street, it would describe the sad denouement of many such "story" stocks. The unraveling of the virtuous circle of growth is not pretty, with earnings shortfalls, plunging share prices, employees with underwater options jumping ship, overzealous shareholders receiving margin calls, accounting chicanery exposed, lawsuits filed, and, to come full circle, the final insult of deletion from the relevant major market index.

At this time, attractive valuation is not considered a good story. A slow growth or no growth company trading at one half or one third of its underlying value attracts no important constituency of investors. I sometimes joke about the new market valuation rules of thumb: stocks that fail to meet earnings expectations all seem to trade at 10 times reduced earnings, while formerly profitable companies that report losses all seem to trade at five dollars per share. Many investors avoid these stocks precisely because others are staying away. Why would those kind of stocks ever go up, they wonder. Even those of us with value investing in our DNA generally prefer situations with catalysts for the realization of underlying value.

Over time, this will change. At some unknowable future point, the undervaluation of small capitalization stocks lacking exciting growth characteristics will become so gaping that investors will once again be attracted. The point of investing, after all, is not to have a great story to tell; the point of investing is to make money with limited risk. At some point, investors will drop their Pulitzer prize winning story stocks and revisit their attention on the old classics, stocks that make you money because their undervaluation creates a compelling imbalance between risk and return.

***Value Opportunities in Today's Market***

Value investors frequently invoke the explanatory device of Mr. Market, a disembodied character who establishes securities prices in the short run despite knowing nothing about investing. A manic fellow, Mr. Market will sometimes become exuberant, other times depressed. Investors who look to Mr. Market for advice will inevitably do the wrong thing at the wrong time. Investors who attempt to profit from Mr. Market's manic depressive nature will be successful over the long run. These days, Mr. Market has run completely amuck, often manifesting manic and depressive behavior at the same time in different securities.

How should Mr. Market's increasingly volatile behavior influence investors? In our view, investors should, more than ever, act on the assumption that any stock or bond can trade, for a time, at any price. Margin debt (which we do not utilize) should be considered extremely dangerous; investors should never enable Mr. Market's mood swings to result in a margin call which could necessitate forced selling. Investors should prepare themselves for a greater degree of portfolio volatility, because it is impossible to tell how wild Mr. Market's mood swings may become. It is of paramount importance that investors brace themselves for a stern test of their investment will. Avoiding overpriced speculations and maintaining a strict value discipline are more important than ever because the overpricings are so egregious and the bargains so pronounced. Yet the price swings are so severe and swift, and not always in the desired direction, that investors must be braced for mark to market losses. Those sufficiently disciplined and unwavering will be generously rewarded.

A great many value investors suffered terribly during the Internet stock mania of 1999 and early 2000. In a market dominated by money flows, the stocks of mundane companies were abandoned for those that offered growth, the more explosive the better. These value managers experienced poor performance, resulting in investor outflows, which necessitated additional selling. Although value managers have recently outperformed growth managers, they have only started to narrow the performance gap of the last several years.

In today's environment, money flows rule, trumping all other factors in determining security prices. From any starting point, money flowing into one category and away from another can wreak havoc with accustomed levels of valuation and can cause egregious mispricings, both too high and too low. Last March, these valuation disparities reached their apogee, as the Nasdaq Composite Index surged above 5,000 while value stocks plummeted. In recent months, outflows from the corporate debt market have resulted in some egregious mispricings; the equity valuations of a number of companies seem detached from any comprehension of the yields available on the debt instruments of the same companies. Money flows, in effect, can render fundamental analysis futile in the short run, even while creating a compelling longer-term opportunity.

Because Baupost is willing to take a long-term view and to accept, for a portion of our portfolio, the relative illiquidity of small-capitalization stocks, we continue to find significant opportunity in today's equity market. The tremendous undervaluation, extreme volatility and, frequently, limited investor interest in such stocks renders this opportunity particularly compelling.

Distressed debt has long been one of our favorite areas for investment, in that financial distress often serves as its own catalyst for value realization, usually in the form of a debt restructuring inside or outside of bankruptcy court. We also appreciate the margin of safety inherent in owning senior debt securities during a workout process, where equity receives the residual only after debtholder claims are satisfied.

Although the distressed debt arena can present compelling opportunity, Baupost hasn't been significantly involved since the early 1990's, when that era's junk bond collapse and economic downturn created an enormous supply of distressed securities that, for a time, swamped the demand. Economic recovery and the reorganization process reduced the supply of distressed securities over time, even as new funds were being raised to invest in the area. For a number of years, attractive distressed debt opportunities were quite scarce. Today, we are again finding opportunities to buy stable, cash-generating assets of overleveraged companies at very substantial discounts to their underlying value through the purchase of senior debt securities. At October 31, we owned material stakes in the debt of 14 different companies, and are in the process of analyzing numerous others.

As we approach calendar year-end, tax selling and window dressing remain important market forces, exacerbating the price declines of stocks and bonds which have already performed poorly. This mindless selling has created a number of buying opportunities which we are attempting to exploit. Table 2 below depicts our portfolio allocation at fiscal year end.

**Table 2**

The Baupost Fund
Portfolio Allocation at October 31, 2000

| | |
|---|---|
| Cash | 15.7% |
| U.S. Public Equities | 46.7% |
| Western Europe Public Equities | 8.9% |
| Arbitrage or Spread Trades | 6.0% |
| Other Public Equities | 1.1% |
| Private Equities and Partnerships | 2.1% |
| Performing and Non-Performing Debt | 16.2% |
| Securities in Liquidation | 2.8% |
| Market Hedges and Other | 0.5% |
| **Total** | 100.0% |

We believe the values within our current portfolio are extremely compelling and that we are well-positioned for any market environment. We remain grateful for your confidence and support during these challenging and volatile times. Please do not hesitate to contact us if you have any questions or comments.

Very truly yours,

/s/ Seth A. Klarman

Seth A. Klarman
President

| **Average Annual Total Returns (1)<br>For Periods Ended 10/31/2000** | **1<br>Year** | **5<br>Year** | **Life of Fund<br>(since 12/14/90)** |
|---|---|---|---|
| The Baupost Fund | [redacted] | [redacted] | [redacted] |
| S&P 500 | 6.09% | 21.67% | 18.78% |

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 10/31/00**

[LINE GRAPH APPEARS HERE]

| | **THE BAUPOST FUND** | **S&P 500** |
|---|---|---|
| 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 | $138,845.00 | $257,840.00 |
| 10/31/00 | [redacted] | $273,545.00 |

(1) Assumes reinvestment of all dividends.

**THE BAUPOST GROUP, INC.**
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June 15, 2001

Dear Fund Shareholder,

We are pleased to report a healthy gain of 14.44% for the six months ended April 30, 2001. This result was achieved amidst a challenging and unusually turbulent market environment.

Profitable results were achieved across the Fund's portfolio, led by gains in U.S. and Western European equities and distressed debt investments. A breakdown of investment results appears in Table 1 below.

**Table 1**
The Baupost Fund
Breakdown of Investment Results for the Six Months Ended April 30, 2001

| | |
|---|---|
| U.S. Public Equities | 5.34% |
| Western Europe Public Equities | 1.09% |
| Arbitrage or Spread Trades | 0.50% |
| Other Public Equities | -0.12% |
| Performing and Non-Performing Debt | 6.33% |
| Securities in Liquidation | 0.15% |
| Market Hedges | 0.63% |
| Interest on Cash Equivalents Less Management Fees and Other | 0.52% |
| **Total Return** | 14.44% |

The recent period of strong performance for Baupost is a good news/bad news situation. The good news is that the substantial undervaluation of our portfolios has been partially recognized. The bad news is that today's opportunity set, while still attractive, is less compelling than that of six or twelve months ago. Given the suddenly shrinking U.S. economy, we would not be surprised to see a significant correction in many so-called "value" equities and below-investment-grade debt instruments which have appreciated significantly in recent months. We stand ready with ample cash reserves to take advantage of any bargains that may emerge.

The performance of the broad market indices masks significant performance divergence between market sectors. In effect, money has come out of technology stocks, driving them mostly lower, but it has not left the market. Instead, it has moved into "value" stocks, seeking more certain returns and downside protection. This is one manifestation of the "stocks for the long-term" thinking that prevails among most professional and individual investors. Stocks will outperform other asset classes over the long term because they always have, the thinking goes, so the real risk is being out of, and not in, the market. The problem is that many of these so-called value stocks are extraordinarily expensive by historical standards and also face deteriorating fundamentals.

In effect, the lessons of the technology stock bubble have only partly been learned. The correct lessons—price matters, trees don't grow to the sky, high risk does not necessarily correlate with high return, sometimes it is better to be risk-averse—have begun to be applied to technology stocks but not to most of the rest of the market. As we have said before, it appears likely that considerable pain must be incurred over a protracted period for investors to fully absorb these unavoidable lessons.

Our overall posture remains very conservative with cash balances of 48.6% of assets. Table 2 below depicts our portfolio allocation at April 30, 2001.

**Table 2**
The Baupost Fund
Portfolio Allocation at April 30, 2001

| | |
|---|---|
| Cash | 48.6% |
| U.S. Public Equities | 18.4% |
| Western Europe Public Equities | 4.7% |
| Other Public Equities | 1.5% |
| Performing and Non-Performing Debt | 23.4% |
| Private Equities and Partnerships | 1.7% |
| Securities in Liquidation | 1.3% |
| Market Hedges and Other | 0.4% |
| **Total** | 100.0% |

We are pleased to be off to a good start in 2001, and look forward to answering any questions or addressing any comments you may have.

Very truly yours,

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

| **Average Annual Total Returns (1)**<br>**For Periods Ended 4/30/2001** | **1**<br>**Year** | **5**<br>**Year** | **10**<br>**Year** |
|---|---|---|---|
| The Baupost Fund | [redacted] | [redacted] | [redacted] |
| S&P 500 | -12.97% | 15.56% | 15.25% |

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 4/30/1991 THROUGH 4/30/2001**

| | **THE BAUPOST FUND** | **S&P** |
|---|---|---|
| 12/14/90 | $50,000.00 | $50,000.00 |
| 04/30/91 | $50,000.00 | $50,000.00 |
| 04/30/92 | $54,757.07 | $57,018.44 |
| 04/30/93 | $65,132.71 | $62,282.25 |
| 04/30/94 | $73,877.69 | $65,594.76 |
| 04/30/95 | $79,846.02 | $77,050.60 |
| 04/30/96 | $90,320.94 | $100,330.12 |
| 04/30/97 | $112,676.72 | $125,546.87 |
| 04/30/98 | $146,526.23 | $177,105.14 |
| 04/30/99 | $119,738.49 | $215,753.50 |
| 04/30/00 | $131,635.70 | $237,605.28 |
| 04/30/01 | [redacted] | $206,783.48 |

(1) Assumes reinvestment of all dividends.