2000

Scion Value Fund – A Series of Scion Funds, LLC

Annual Letter

Scion Capital, LLC
Private Investment Management

www.scioncapital.com

To the Members of the Scion Value Fund:

For the fiscal year ended December 31, 2000, encompassing the entire two months of the Fund's existence to that date, the Fund's net asset value increased 6.63% after expenses and contingent fee allocations. The gross performance of the Fund was 8.24%.

It is my opinion that the most stable, cost-effective, and eternal alternative to the Fund is the S&P 500 Index, and hence this index should be used as a benchmark. I propose the S&P 500 as a benchmark not because the character of its securities closely matches the character of the Fund's investments – I have yet to find an index that can do this - but rather because one may invest in the S&P 500 with great ease and tax efficiency. Moreover, the S&P 500 has shown an incredible resiliency by outperforming the great majority of money managers as well as most other indices over a great number of years.

During the two months ended December 31, 2000, the Fund's net performance bested that of the S&P 500 by 14.08%. Let me be the first to tell you that this is no small anomaly – it is a quite large anomaly. Over periods greater than 5 years you should rightfully expect the Fund to beat the S&P 500 handily, but in these first two months the Fund certainly overreached. I trust that you will not hold me to this standard every two months henceforth.

During the period just ended, the Fund acquired neither short positions nor options contracts. As well, the Fund neither wrote calls on its positions nor borrowed exorbitant sums of money to enhance returns. The Fund instead has remained quite simply long stocks and on balance has held a small cash position.

No member need write a check as a result of this year's activities. Scion Capital will fold its bill for these last two months into its bill for the 2001 fiscal year. As you are aware, Scion Capital does not charge a quarterly asset-based fee and instead relies entirely on its performance as your manager. Finally, no member will owe taxes on this year's profits, as a small tax-loss is built into the aforementioned gain. You should expect your K-1 tax forms to arrive separately and in timely fashion.

The Portfolio

In order that this Fund's performance escape the randomness of return that defines much of the investment management industry, it is imperative that I as manager respond only to the value of an individual investment when making capital allocation decisions.

Value is far from the only potential input in the typical portfolio manager's investment process, however. Throughout the universe of public and private funds, managers are measured quarterly against one index or another, defined by statistics, and corralled into this category or that category so that fund of funds, pensions, and other institutions can make comforting – if not necessarily prudent – asset allocation decisions. Such forces restrict and otherwise harm the manager's ability to invest intelligently and are entirely deleterious to performance. Managers who respond to such inputs fight an uphill battle.

The Fund is structured to allow its manager to ignore these secondary inputs. The less definition offered, the less positions revealed, the less statistics applied – all the better for the portfolio that aims for these supra-normal returns. Hence, the Fund's individual portfolio positions may not be revealed except at the discretion of the manager.

Hedge Fund Defined?

Private investment funds such as the Fund are nearly always lumped into the category of "hedge fund." Common hedging techniques include shorting stocks, buying put options, writing call options, and various types of leverage and paired transactions. While I do reserve the right to use these tools if and when appropriate, my firm opinion is that the best hedge is buying an appropriately safe and cheap stock. This is not the prevailing opinion, however. Hence, according to a common interpretation of this Fund's activities, the charter investors in the Fund – myself included – entered November invested in a hedge fund that was, by all convention, completely un-hedged.

What happened? The stock market promptly morphed into a minefield. During the single month of November, the technology-laden Nasdaq Composite Index – the best performing market measure of the last several years – experienced a 22.9% loss of value. The Russell 2000 – a measure of small companies with market values averaging just under $600 million – stumbled 10.40%. The S&P 500 fell 8.01%, and the Dow Jones Industrial Average finished off 5.07%.

While striking, these statistics likely do little justice to the potential risk for those investors holding concentrated portfolios. Indices are not about stock picking. Concentrated portfolios – those holding less than 25 stocks or so – are entirely about stock picking. And there were tremendous devaluations in widely held issues over the course of November as well as December.

During this time, the Fund was comfortably positive. The main accomplishment of the Fund, in my opinion, was not grossing 8.24% in two months but rather avoiding such debilitating devaluations as affected the indices and many widely held stocks during that month. While I cannot proclaim that my stock-picking ability is responsible for the gain – the size and most probably the direction of that gain is almost surely a random short-term fluctuation in our favor – I can with some confidence assert that my strategy is entirely designed to avoid and otherwise minimize the price risk in individual securities. As a result, I would argue that it is the lack of a loss in a month like November that represents the most reproducible and the most potent characteristic of the Fund. It is a tenet of my investment style that, on the subject of common stock investment, maximizing the upside means first and foremost minimizing the downside. The deleterious effect of permanent capital loss on portfolio returns cannot be overstated.

Some basic math elucidates this point. When planning for a double, every dollar in excess cost amounts to two dollars in excess gain required. Every dollar saved amounts to the same two dollars in excess gain already realized. And it goes without saying that a 33.3% loss requires a 50% gain just to attain breakeven. On the flip side, 33.3% saved on the buy price makes a 50% gain back to the price of first consideration. On a percentage basis – and it is on this basis that we must evaluate each and every decision – lost dollars are simply harder to replace than gained dollars are to lose.

This focus on a margin of safety in each and every investment is what should make the Fund special. But for the unwieldy nature of such a term, "fund of well-conceived investments" might make an apt handle. Whether or not the Fund ought to be called a hedge fund is an individual decision grounded only in semantics.

Fund Expenses

The most significant potential weakness of the Fund is its expense ratio. You do not earn a return unless the annual return exceeds expenses. I do not earn an income unless your annual return exceeds 6% net of expenses. Hence, aside from my fiduciary duty to maximize your return, both my very nature as something of a cheapskate and my financial incentive to have an income give me every reason to rationalize expenses in favor of return.

There are two main drivers of the Fund's expense ratio, which is expressed as a percentage of assets under management. One is the absolute level of expenses, which should remain relatively fixed. The other is assets under management (AUM) – as AUM increase, the expense ratio will decrease.

Not surprisingly, the vast majority of potential members of the Fund backed out for one reason or another as the deadline for committing funds approached. This has had the effect of increasing the expense ratio for the rest of us. Many of these individuals and institutions are now "sitting on the fence" waiting to see how the Fund and/or the market do. I fully expect the expense ratio to which you are exposed to decrease quite significantly in response to increased assets under management as these and other potential investors become members of the Fund.

Affiliated Parties

Just prior to the opening of the Fund, I was approached by two interested parties – neither of whom I solicited – who separately expressed an interest in owning a part of Scion Capital, LLC. The first party, Gotham Capital V, LLC, is run by Joel Greenblatt, who has been involved in money management for the better part of two decades. An author, professor and portfolio manager, Mr. Greenblatt is an extraordinary special situations investor with whom any professional value investor should be proud to be associated.

The second party is White Mountains Management Company, a subsidiary of White Mountains Insurance Group, Ltd (symbol WTM on the New York Stock Exchange). Led by Warren Buffett associate and insurance guru Jack Byrne, White Mountains is an extraordinary company managed in a manner to warm a shareholder's heart. Once called the "Babe Ruth of insurance" by Mr. Buffett, Mr. Byrne himself is legendary among value investors as the man who turned around GEICO for Mr. Buffett and subsequently turned around Fireman's Fund. White Mountains is his latest venture, and Mr. Buffett himself recently stepped in to acquire nearly 20% of White Mountains.

After some discussion, separate agreements were made with both parties whereby a family trust and I would option portions of our interests in the management company to these parties. The option agreements, now consummated by premiums paid, give Gotham Capital V, LLC the 5-year option to acquire 22.50% of the management company and give White Mountains the option to acquire up to 15.44% of the management company. The agreement with White Mountains is structured such that 5% of the interest would be acquired upon investment of a substantial amount of capital in the Fund for a little over three years. In this manner, I have given up a portion of my own future profits in an effort to jump-start assets under management and hence reduce the expense ratio experienced by investors in the Fund.

Needless to say, I very much appreciate having these parties on the Scion Capital team. I do expect that the options will be exercised within the next year or so, and that both White Mountains and Gotham Capital V will become full non-managing members of Scion Capital, LLC. I alone will retain the majority economic interest in Scion Capital as well as the entire managing member interest.

Since nearly the entire interest allocated to these parties will come from my personal stake in Scion Capital, it is natural to wonder why I would enter into these agreements at all. To be clear, were it not for the quality and integrity of the individuals associated with both parties, I would never have entered into such agreements. The net of it is that, as a result of these agreements, the financial incentive for me to manage the fund for the benefit of the shareholders is significantly increased. At the same time, Scion Capital has acquired potent partners in terms of raising additional assets under management and thereby driving the expense ratio lower.

As part of these transactions, Scion Capital re-organized from a subchapter S corporation to a limited liability company. The firm's Form ADV was re-filed with the state of California, and you will be receiving an updated Part II of the Form ADV, as required, once the Form ADV becomes effective.

Outlook

I have no view on whether the market, broadly defined, will fall or rise during the coming year. At year-end, the situation certainly appeared dire. But it is well known that Wall Street climbs a wall of worry, making appearances, like past performance, no guarantee as to future results. The prudent view, in my opinion, is no view.

Rather, I prefer to look at specific investments within the inefficient parts of the market. I seek individual investments that will allow me to target total portfolio returns of at least 20% annually after fees and expenses on an annual basis over a period of years, not months. Such opportunities are more prevalent now than they have been in recent years, and I do not feel the current climate is particularly adverse with regard to the attainment of this goal.

The Fund maintains a high degree of concentration – typically 15-25 stocks, or even less. Some or all of these stocks may be relatively illiquid. As a result, apparent short-term returns may be adversely or positively affected by otherwise normal fluctuations in portfolio holdings. While it has not been my observation that the Fund experiences undue volatility on a daily basis, there can be no certainty of this trend continuing. I do not view volatility as being in any manner a measure of risk, and hence the Fund is not managed to minimize volatility.

As I write this, I personally have over $1 million invested in the Fund. You should understand that this amount represents the vast majority of my net worth, and the entire amount of my net worth aside from that required for daily living expenses. I maintain no personal securities account aside from the investment in the Fund, and my entire professional focus is this one Fund. Scion Capital does not manage separate accounts or participate in wrap-free programs. I will most certainly notify you at once if any of these circumstances should change – though you can be quite confident that you will not hear from me on this matter.

Michael J. Burry, M.D.
Managing Member
Scion Capital, LLC

January 8, 2001

Scion Value Fund, A Series of Scion Funds, LLC

April 3, 2001

Dear Fellow Members:

During the first quarter of 2001, the Scion Value Fund ("Fund") appreciated 7.81% after deducting accrued and actual expenses and fees. The S&P 500 Index experienced a net loss of 12.21% during the period. Since its inception, the Fund has appreciated 14.96% net of fees and expenses, while the S&P 500 Index has recorded a loss of 18.82% during the same time period. As a result, since inception five months ago, the Fund has outperformed the S&P 500 by 3,379 basis points, or 33.79 percentage points.

This performance was not without volatility. However, allow me to be quite stern on this subject: volatility does not determine risk. I guide the Fund to a net long position by investing in a concentrated manner and by frequently taking relatively illiquid positions in undervalued situations. The goal here is long-term capital appreciation, with the emphasis on long-term. Therefore, while the Fund may yield surprising results over short time frames, this phenomenon neither concerns me when the results seem cause for lament nor lifts me when the results seem cause for celebration. I urge the same reactions in you.

Thus, I will advise that whatever numbers you see before you on your capital account statements, they should not be compounded into the future indefinitely. I fully expect and recommend that members of this investment vehicle judge my performance over a period of five years or greater, not five months or less. This will prove to be the most fruitful and enjoyable manner in which to participate in the Fund.

Tax Policy

One facet of my style and my investment manner is extremely well suited to finding and profiting from tax-loss losers during November and December and riding them through January. In the past, this has been a successful activity, and I have occasionally found some longer-term holds within the group. Never have I had the success I had this past January, however, and I did not react well to it in context.

Here's the context. Tax loss selling takes many poorly performing stocks to even more extreme lows nearly every year during the late fall. Mutual funds must realize such losses by October 31st and others have until December 31st. However, in many cases these stocks represent businesses under significant duress. Aside from a moderate January bump as selling pressure is alleviated and as stockholders once again buy into these stocks, one would not expect such despised stocks to truly reflect, in short-run, any realization of longer-term or hidden value. With the clarity of hindsight, I see now that my stocks bought amidst the vicious sell-off of mid-December were no match for the vicious sell-off of mid-March. While nearly all remained above the purchase price, the amount of short-term profits given back to the market this quarter remains wholly unsatisfactory.

Most unsatisfactory results are not without reason, and this one is no exception. I failed to clearly re-establish the tax policy of the Fund after it was subtly suggested that paying taxes was something to avoid. Although this thought was far from startling, I allowed it to persuade me to hold on to a few extremely profitable positions too long. This feeling is not uncommon in the market today, but I did know better, and I did break with a long-standing tax policy that has contributed significantly to my success as a portfolio manager.

In order to ensure we do not have a repeat, allow me to clarify the Fund's position on taxes. I am a tax-paying US citizen, and hence I am in the same boat as many, but not all, of you. I also have more of my net worth in the Fund than any other member, and in dollar terms it is the largest as well. However, I will not let the prospect of taxes on gains prevent the achievement of those gains.

To recap, January saw a rapid run-up in the value of your investment in the Fund. One competitive advantage of mine has been taking advantage of the fast times to raise cash for the next slow time, to rotate into less-appreciated securities, and occasionally to short into speculative excess. This can result in my investment strategy producing higher profit, higher turnover, and, yes, higher taxes. In the past, it has done so. In the future, I expect it to do so. For now, I must simply point to one opportunity sorely missed, to one achievement not yet accomplished on your behalf, and to taxes, unfortunately, drastically reduced.

Market Overview 1Q 2001

When I stand on my special-issue "Intelligent Investor" ladder and peer out over the frenzied crowd, I see very few others doing the same. Many stocks remain overvalued, and speculative excess – both on the upside and on the downside – is embedded in the frenzy around stocks of all stripes. And yes, I am talking about March 2001, not March 2000.

In essence, the stock market represents three separate categories of business. They are, adjusted for inflation, those with shrinking intrinsic value, those with approximately stable intrinsic value, and those with steadily growing intrinsic value. The preference, always, would be to buy a long-term franchise at a substantial discount from growing intrinsic value. However, if one has been playing the buy-and-hold game with quality securities, one has been exposed to a substantial amount of market risk because the valuations placed on these securities have implied overly rosy scenarios prone to popular revision in times of more realistic expectation. This is one of those times, but it is my feeling that the revisions have not been severe enough, the expectations not yet realistic enough. Hence, the world's best companies largely remain overpriced in the marketplace.

The bulk of the opportunities remain in undervalued, smaller, more illiquid situations that often represent average or slightly above-average businesses – these stocks, having largely missed out on the speculative ride up, have nevertheless frequently been pushed down to absurd levels owing to their illiquidity during a general market panic. I will not label this Fund a "small cap" fund, for this may not be where the best opportunities are next month or next year. For now, though, the Fund is biased toward smaller capitalization stocks. As for the future, I can only say the Fund will always be biased to where the value is. If recent trends continue, it would not be surprising to find the stocks of several larger capitalization stocks with significant long-term franchises meet value criteria and hence become eligible for potential addition to the Fund.

Where the Value Isn't

With many large cap technology sector stocks falling out of favor, one might be tempted to jump into the fray and find a bottom. This is all well and good, but there is a flaw at the first assumption here. All stocks, including technology stocks, must find a floor in terms of fundamental value and expected return to the stockholder before they find an era-defining floor in price. In most all cases, the floor will be much lower than popular opinion might indicate – and much lower than "fair" value. Investors ought to take care to be coldly realistic in their appraisals.

Following is an outline of a problem that a lot of technology-related companies face – and that makes their stocks in general overvalued. Unlike nearly every other industry, technology companies, as they are generally grouped these days, compensate their employees in a manner that hides much of the expense of the compensation from the income statement. Of course, the subject here is options compensation.

With the most prevalent type of option - called "nonqualified stock options" – the difference between the price of the stock and the price of the options when exercised accrues to the employee as income that must be taxed because it is considered compensation. Not according to GAAP ("Generally Accepted Accounting Principles"), but according to the Internal Revenue Service (IRS). So the IRS gives companies a break and allows them, for tax purposes, to deduct this options expense that employees receive as income. The net result is an income tax benefit to the company of roughly 35% of the sum total difference between the exercise price of the company's nonqualified options during a given year and the market price of the stock at the time of exercise.

Since GAAP does not recognize this in the income statement, the cash flow statements record this "Tax benefit from exercise of stock options" as a positive adjustment to net income. After all, the company included neither the cost of the options nor the income tax benefit on the profit/loss statement. Hence, the correction to cash flow.

So cash income is understated by net income, right? Wrong. When evaluating US companies, conservative investors ought to assume that if the IRS can tax something, then it is a real profit. And if they allow one to deduct something, then it is a real cost.

In a rising market, the net income tax benefit can be quite large – but it only reflects roughly 35% of the actual cost of paying employees with options. How does it cost the company? Because the company must either issue new stock at a severe discount to prevailing market prices or buy back stock at prevailing market prices in order to provide stock at a discount for employees exercising their options. The cost is borne by shareholders, who suffer from significant dilution. The per share numbers worsen, while the absolute numbers improve. After all, issuing stock at any price is a positive event for cash flow if not for shareholders.

Adobe Systems, for instance, is widely regarded as a good company with a decent franchise. A bit cyclical maybe, but a member of the Nasdaq 100 and the S&P 500. It is widely held by institutions.

Looking at its annual report for 2000, one sees that the income tax benefit for options supplied $125 million, or roughly 28% of operating cash flow. Fair enough. Let's move to the income statement. Divide that $125 million by a corporate tax rate of around 35%, and one gets an amount of $357 million. That's the amount of employee compensation that the IRS recognizes Adobe paid in the form of options, but that does not appear on the income statement.

Plugging it into the income statement as an expense drops the operating income – less investment gains and interest – from $408 million to $51 million. Tax that and you get net income somewhere around $33 million – and an abnormally small tax payment to the IRS. That $33 million is a good proxy for the amount of net income that public shareholders get after the company's senior management and employees feed at the trough. For this $33 million – roughly 1/10 of the reported earnings – shareholders were paying $8.7 billion around the time of this writing. Shareholders of such firms as Seibel Systems, Oracle and Xilinx were paying near infinite multiples on last year's earnings, as a similar exercise shows that these firms paid employees more money in options compensation than their entire net income last year.

Many, and probably most, technology companies are therefore private companies in the public domain – existing for themselves, not for their shareholder owners. Of course, it is a shell game. A prolonged depressed stock price – for whatever reason, including a bear market – would cause a lot of options to become worthless, and would likely require the company to either start paying more in salary or, often worse, to start re-pricing options at lower prices. Even if neither action is taken, operating cash flow takes a hit.

In truth, this type of activity might be expected from companies that were often created with the help of venture capitalists who viewed public shareholders as an exit strategy, not as a group that deserves to benefit from improving company results and prospects. The significant implication here is that shareholders cannot count on these sorts of companies for proper corporate governance. They have demonstrated that they will ask shareholders to bear the burden during good times and that they will re-price options during bad times, thereby taking from shareholders both on the way up and on the way down.

Such an argument has very significant implications for the valuation of many popular stocks. In a coldly calculating market rather than a speculative one, the stocks of companies governed with so little respect for shareholders will suffer. It is not limited to Adobe, Seibel, or Xilinx. Cisco, Intel, Microsoft and many of the greatest technology-related "wealth creators" of the last decade are in the same boat. Now that the bubble is burst, it is not my expectation that we will see any lasting rebound in the stocks of companies in the hands of such reckless management teams. Indeed, it is quite certain that public expectations regarding these companies' stocks will not be met.

Volatility Revisited

Because expenses are relatively fixed, higher amounts of assets dilute the expense ratio. Therefore, in keeping with the goal to lower the expense ratio, efforts must be made on occasion to raise new capital. While attempting to raise new capital recently, your manager has recently had a colorful experience that is fairly illuminating with regards to the hallowed ground on which most investors consider volatility.

I delivered a short talk at the Banc of America Alternative Investment Strategies Symposium in Los Angeles last month. I had a good slot – immediately after the keynote speaker and at about 9 o'clock in the a.m. A room of about 200 wealthy potential clients heard me state unequivocally that risk is not defined by volatility, but rather by ill-conceived investment. The corollaries, as I pointed out, were that portfolio concentration and illiquidity do not define risk. That simple statement, I am told, had not just a few of those in the room shaking their heads.

The very pleasant gentleman who spoke after me then proceeded to delineate how frequently his portfolio moved with a magnitude greater than 1% on a *daily* basis. I think the number was quite impressive for an institution that measures itself by such things – somewhere around 25 days in the past two years or so. And this, he proclaimed, minimized volatility and thus risk. He seemed a decent fellow, and if you wish me to provide his name and number, I would be happy to do so.

Not that he necessarily needs the business. Perhaps it is not so surprising that your portfolio manager sat relatively alone at his lunch table, while the second fellow was quite popular. By and large, the wealthiest of the wealthy and their representatives have accepted that most managers are average, and the better ones are able to achieve average returns while exhibiting below-average volatility.

By this logic, however, a dollar selling for 50 cents one day, 60 cents the next day, and 40 cents the next somehow becomes worth less than a dollar selling for 50 cents all three days. I would argue that the ability to buy at 40 cents presents opportunity, not risk, and that the dollar is still worth a dollar.

The stock market is full of dollars selling for much more than a dollar. A dollar that consistently sells at 1.1X face value may even be respected for the consistency of this quality, earning it the "right" to have that premium.

These are not the investments your portfolio manager chooses for the Fund. A wildly fluctuating dollar selling for 40 or 50 or 60 cents will always remain more attractive – and far less risky. As for my loneliness at the lunch table, it has always been a maxim of mine that while capital raising may be a popularity contest, intelligent investment is quite the opposite. One must therefore take some pride in such a universal lack of appeal.

Policy Matters

While I will continue to attempt to raise new capital, it will not be my policy to compromise the Fund's current policies to do so. You have all accepted the Fund on its own terms, and first and foremost it is my intention to protect your capital and enhance your returns. Be assured that I eat my own cooking. The vast majority of my net worth, aside from money set aside for modest living expenses, is in the Fund. If I compound my own investment in the Fund at a rate of 20% annually, excluding fees, for 30 years, I will have over $250 million. If I can do 25%, I will have nearly $1 billion. This is how I think about your investment. It is also why I do not think in terms of monthly or quarterly snapshots of performance, although I do understand that after five years or so you would expect to see a favorable trend. I intend to provide it.

To this end, I will change the schedule of new investment to a quarterly basis. May 1st will be the last start date on which new investment in the Fund may be initiated on the monthly schedule. From then on, the Fund will accept new investors on the first of July, the first of October, the first of

January, the first of April, and so forth. I will retain the right to allow investments at other times, but only as a rare exception in the face of overwhelming justification. Members may continue to add to their holdings on a monthly basis.

Also, the minimum initial investment in the Fund for future investors will be raised to $250,000 as of the July 1, 2001 investment date. Current members and those with planned investment during April for a May 1 start are exempt from this new minimum.

Please feel free to call me if I have not been clear, or if you need further clarification on a matter discussed above.

Sincerely,

Michael J. Burry
Scion Capital, LLC

Scion Value Fund, A Series of Scion Funds, LLC

July 3, 2001

Dear Fellow Members:

During the first half of 2001, the Fund appreciated 22.00% net of all actual and accrued expenses and performance allocations. Year-to-date, the S&P 500 has experienced a net loss of 6.68%. Since its inception on November 1, 2000, the Fund has appreciated 30.06% net of allocations and expenses, while the S&P 500 Index has recorded a loss of 13.63% during the same time period.

	1H 2001	Since Inception[1]
Scion Gross[2]	+26.98%	+37.44%
Scion Net[3]	+22.00%	+30.06%
S&P 500	-6.68%	-13.63%

[1]Inception November 1, 2000
[2]Return before 20% performance allocation
[3]Return after 20% performance allocation and expenses

It would be disingenuous of me to state that the Fund's performance relative to the S&P 500 Index does not appear startling. On the surface, it certainly is. However, you should realize that the Fund in no manner attempts to mimic an index, much less the S&P 500 Index. Securities attract an investment from the Fund when they stand alone as tremendous values – there are simply no other criteria.

Therefore, I must reiterate that I present the S&P 500 Index as a long-term benchmark only because it has proven a mighty foe for most portfolio managers over the decades. Many managers of average talent have recorded outperformance as well as underperformance relative to the S&P 500 Index over short time periods. Hence, during these early years of the Fund, I will present the S&P 500 Index only to set proper precedent for the distant future years when it actually means something. In truth, for now, please ignore the S&P 500 Index with respect to the relative performance of the Fund.

It would be similarly disingenuous of me to state that the short-term returns since inception do not appear strong in an absolute sense. They certainly *appear* strong. Yet I must emphasize once again that while the Fund may yield surprising results over short time frames, this phenomenon neither concerns me when the results seem cause for lament nor lifts me when the results seem cause for celebration. I urge the same reactions in you.

Thus, I will continue to advise that whatever numbers you see before you on your capital account statements, they should not be compounded into the future indefinitely. I fully expect and recommend that members of this investment vehicle judge my performance over a period of five years or greater. This will prove to be the most fruitful and enjoyable manner in which to participate in the Fund.

Performance Revisited

For some reason the "quarter" has been set upon as an ideal unit of time in the investment world. Yet in terms of measuring investments prowess, a quarterly compartmentalization of returns is no better than a monthly, weekly, or daily division of returns. Indeed, one of the most harmful aspects of human nature in terms of the investment process is the tendency to extrapolate to any extent into the future a manager's performance in the most recent period. Enclosed is a 1985 U.S. Trust memo that, with striking data, addresses this notion. I urge you to take the time to read it. I trust you will find its conclusions as timeless and as powerful as I find them; they are indeed relevant to your investment in this Fund.

Strategy

I have previously written that I strive to discover the proverbial dollar bill selling for 50 cents, preferably with enough volatility such that I have the opportunity to buy at 40 cents or less. I certainly view volatility as my friend – and hence your friend. This works out well because most in the market treasure the dollar bill that consistently sells for $1.10 or more – as long as it consistently does so. In short, volatility is on sale because 99+% of the institutions out there are doing their best to avoid it – under the mistaken but Nobel Prize-winning impression that volatility and risk have some relation. Those of us that feel affection for volatility therefore hold title to the most disabused yet undervalued quality that the markets have to offer.

As much as the Fund is a value fund, it is an opportunistic fund. And as much as I enthusiastically explore the value of each business behind every stock, I seek the pockets of the market that are the most inefficient, the most temporarily imbalanced in terms of price. Whatever extra return this Fund will earn will be borne of buying absurdly cheap rather than selling dearly smitten. I certainly have proven no ability to pick tops, and I do not anticipate attempting such a feat in the future. Rather, fully aware that wonderful businesses make wonderful investments only at wonderful prices, I will continue to seek out the bargains amid the refuse.

Current economic conditions present a recurring opportunity that occasionally offers dollar bills for at most 55 cents on the dollar. Importantly, this opportunity allows the accumulation of large positions in illiquid securities with relative rapidity, although liquid securities are also occasionally affected. This is yet another opportunity that presents for our benefit because institutional investors are exceptionally good at crowding the exits. In most cases, I expect many of these securities to move back to par within a reasonable time frame. Already, the Fund has benefited significantly as one such opportunity worked out as expected. As June came to a close, another opportunity of this sort presented itself. While I am not certain of the time frame, I am very certain of the value.

While the Fund may hold securities short, this is not generally the case. In fact, since inception the Fund's minimal short-selling activities have yielded a mere one percentage point addition to the year-to-date performance numbers listed above. Similarly, the Fund may take advantage of leverage. However, again, this is not generally the case. My preference is to hold a portfolio of 15-25 securities long while holding a small cash position in order that I may take advantage of particularly valuable opportunities without leveraging the Fund or rashly selling another position. Since inception, the Fund has generally operated in this manner – that is, holding a portfolio of 20 or so securities long together with a decent cash position.

Many would consider such a portfolio to lack any hedging feature. One hedges when one is unsure. I do not seek out investments of which I am unsure. Hence, except to the extent that buying a security very cheaply may be considered a hedge, I do not hedge.

Despite the Fund's unhedged portfolio, I expect bear markets to be most favorable for the Fund in terms of relative performance. Generally speaking, this means that I expect the Fund will fall less than the market in a bear market. Similarly, I expect that in the event of a general bull market in stocks, the Fund will not shine so brightly in terms of relative performance. The math of investing would favor the Fund, however, over several bull and bear market cycles because, on a percentage basis, lost dollars are simply harder to replace than gained dollars are to lose. The emphasis will always be placed first on preventing the permanent loss of capital, and good results should follow.

Risk

Although an outsider might think the goal of prevailing modern investment practice to be one of mediocrity, there in fact remains much more competition to achieve gains in the market than there is competition to record losses. Laissez-faire security analysis paired to an entirely misdirected view of risk management nevertheless dooms most institutional portfolios to mediocre performance. In fact, traditional risk management – centered on minimizing volatility in various forms – relies on theories that assume security analysis is a rather fruitless effort, courtesy of efficient markets. There is a great paradox in this line of thinking that should warn investors away from all portfolio managers that employ it. The correct view remains that risk is minimized not through the alchemy of volatility calculus but rather through respectful business evaluation.

Respectful business evaluation in turn requires respect for the boundaries of one's fund of knowledge, however dynamic the boundaries may be. Venturing cash-first into unfamiliar territory nearly always results in either losses appropriate for the bonehead move or successes borne of dumb luck. Be assured that neither do I employ dumb luck as an input into my investment process nor do I count on its sudden appearance by my side. Risk management need not be more complicated than this.

Options Revisited

I do realize that in addition to your investment here, some of you invest for your own accounts. The Fund does not generally offer portfolio transparency. Hence, for those of you that do manage portfolios of individual securities, being a member of the Fund provides no specific insight into what I believe you ought to be doing. It is with this knowledge that I share with you my thoughts on some of the more baffling aspects of the stock market in these letters. Be aware, however, that how I think of these things may be more instructive than what I think of them.

One area that is particularly perplexing is the accounting for options compensation. In the last letter I outlined one particularly Draconian manner with which to examine options compensation. In that manner, I take the tax benefit that the company receives from the IRS for its employees' exercise of non-qualified stock options and divide by the company's tax rate. This calculation yields the amount of money that the IRS – but not GAAP – recognizes the company paid its employees in options compensation during that period. After all, if companies get to deduct this options expense from their tax statements, is it not a real expense?

Well, yes, shareholders should think so. But there is much more to options compensation accounting than I outlined previously. Maybe I hear a groan or two from the gallery. Put in the words of not one or two but three investors, "But, Mike, what if you are the only one that thinks of options this way? If everyone else thinks another way, doesn't that make how you think of it irrelevant?" I would argue that if I am the only one that thinks in this manner, and if I am correct, then my understanding becomes a competitive advantage that makes the subject even more relevant. I would also argue that a policy of minimizing risk requires that these complex issues be investigated and understood rather than ignored. Granted, this is my job, not yours. For those of you interested in the subject, a discussion follows. Others feel free to skip to the next section.

As I mentioned, the subject of options compensation is quite complex, and what I previously outlined is only one particularly strict interpretation. The pitfall with the tax rate divisor methodology is that it assumes that this compensation is some sort of precise ongoing expense infinitely into the future. It also ignores the impact of share repurchases and share issuances relative to intrinsic value.

That is, to the extent the company is issuing stock at prices in excess of intrinsic value and in numbers and dollar volume in excess of any buyback, the company is creating incremental intrinsic value per share. To illustrate, when an employee exercises an option to buy stock at $15, the company issues stock at that $15 price and hence receives $15 cash. At the same time, assume intrinsic value is $10 per share. Intrinsic value is thus created at a rate of $5 per share issued.

Note that it does not matter if the market is currently valuing the stock at $20 per share. Intrinsic value is created whenever shares are issued at a price per share in excess of intrinsic value per share. Indeed, one could argue that for companies that issued and had exercised many options with high strike prices, value was created on a per share basis even though the shares were being issued to employees at seemingly low prices at the time and even though the even greater value creation that could be realized by issuing stock at much higher prevailing market prices is ignored. Here, "high" and "low" are defined relative to intrinsic value per share, not relative to prevailing share price.

Of course, if the company simultaneously buys back stock at those high prices, then it is to an extent offsetting any benefit. In many cases, one finds that the issuance of stock far outpaces the repurchase of stock, resulting in the seemingly paradoxical circumstance of shares outstanding rising in the face of an ostensibly strong share buyback. The gut reaction is that this is very wrong – that is, that the share buybacks are helpful while the share issuances are deleterious. The gut reaction is imprecise and possibly in error, however.

When evaluating an options compensation program, one must weigh the net value creation from (a) the issuance of excess options-related stock at prices higher than intrinsic value and (b) the tax benefit associated with the program against the net value destruction from (a) buying stock back at market prices higher than intrinsic value and (b) issuing options-related stock at prices lower than intrinsic value. Such an evaluation is most illustrative when it encompasses several bull and bear cycles in the company's history. Also, note that this methodology does leave open the potential for tremendous value destruction if option-related stock is consistently issued at a discount to intrinsic value while an ongoing buyback consumes stock at a significant premium to intrinsic value.

To be clear, there is no easy rule of thumb, and digging through ten or more years of SEC filings to find the relevant numbers and trends is not generally a task most investors like to pursue. Certainly it is easier to listen to someone else's opinion regarding the company's growth rate or some other easily understood metric. It is likely, however, that the investors in the habit of overturning the most stones will find the most success.

Following are two general conclusions that I found while investigating options compensation over the last decade. One, it takes tremendous growth in the underlying business as well as a significantly inflated share price to justify options compensation. Such characteristics may result in share price issuances at prices above intrinsic value at the same time the value creation of early share buybacks is magnified and the value destruction of recent buybacks is minimized. So, to the extent that companies used options compensation to attract the key workers that helped drive earnings and share prices upward at dizzying rates, the options program may be less dilutive to shareholder value than a skeptic might initially believe. On the other hand, low stock prices relative to intrinsic value may increase shareholders' susceptibility to options re-pricing or re-issuance, both of which tend to destroy value.

Two, many of the leading growth companies benefited tremendously from the substantial share buybacks that took place in the early part of the last decade. These buybacks were performed at prices that subsequently proved to be substantially less than intrinsic value, and were not accompanied by significant options-related share issuances. It is not clear that, given current corporate governance abuses, such a circumstance would repeat in the future. Indeed, in the first half of the 1990s, many of today's leading technology companies saw their shares outstanding shrink significantly. Without these early buybacks, growth would have had much less impact on per share value creation over the decade.

Several corollaries arise from these conclusions. One line of thought holds that the approved 10K-ready method of using Black-Scholes methodology to evaluate the cost of an options program ought to be thrown out a window. Black-Scholes relies on volatility for pricing. In the case of 5-10 year options that are subject to re-issuance and re-pricing in tougher times, volatility means little to the value of an option. To clarify, to reject Black-Scholes and to accept my line of reasoning above, one has to reject both the idea that the stock market is efficient and the idea that risk is derived from volatility. I find it relatively easy to reject these ideas.

Fees & Expenses

Allow me to clarify the difference between this Fund and the typical private fund with respect to expenses. The typical fund charges a 1% asset management fee and does not necessarily include within that fee the costs of accountants, lawyers, and several other additional expenses borne directly by the fund. In addition, in some cases, "soft dollars" allow office space, back office help, software, and other items to be bought with excess commission dollars. Hence, the expense ratio for most funds is generally doomed to be higher than 1%.

The Fund takes a different approach. With no automatic 1% asset management fee, the expense ratio is generally doomed to be no greater than 1%. While the Fund bears all expenses taken on its behalf directly rather than through indirect means such as asset management fees and soft dollars, managing the Fund simply does not require a lot of overhead. Moreover, every dollar of expense subtracts from the performance that is the basis for the whole of Scion Capital's income. In short, these factors conspire to minimize the expense ratio.

Equity in the Fund now exceeds $14.7 million. As has been the experience thus far, the expense ratio will continue to fall as this number grows.

Policy Matters

The minimum initial investment for new members is now $250,000. Current members may contribute a minimum additional investment of $50,000 as frequently as monthly. Word of mouth remains the primary method for marketing the Fund's existence, and introductions are welcome.

You will not often find me highlighting one time or another as a particularly good time to invest. However, with the Fund in a cash-rich position, the current risk of buying into the Fund at a near-term portfolio high is minimized to a degree that is not generally predictable under more normal circumstances.

I continue to maintain the vast majority of my net worth in the Fund. As long as the Fund exists, it will be my only investment.

Please feel free to contact me if you require further clarification on a matter discussed above.

Sincerely,

Michael J. Burry, M.D.
Scion Capital, LLC

Scion Value Fund, A Series of Scion Funds, LLC

October 2, 2001

Dear Fellow Members:

During the first nine months of 2001, the Fund appreciated 10.98% net of all actual and accrued expenses and performance allocations. Since its inception on November 1, 2000, the Fund has appreciated 18.31% net of allocations and expenses.

	2001 YTD	Since Inception[1]
Scion Gross[2]	+13.49%	+22.84%
Scion Net[3]	+10.98%	+18.31%
S&P 500	-20.39%	-26.33%

[1]Inception November 1, 2000
[2]Return before 20% performance allocation and expenses
[3]Return after 20% performance allocation and expenses

Again, I will continue to advise that whatever numbers you see before you on your capital account statements, they should not be compounded into the future indefinitely. The portfolio is a fairly concentrated one, and significant volatility is to be expected. I fully expect and recommend that members of this investment vehicle judge my performance over a period of five years or greater. This will prove to be the most fruitful and enjoyable manner in which to participate in the Fund.

The Third Quarter

In the second quarter letter, I made light of the investment industry's fascination with the quarter as a unit of time. Indeed, Scion Capital, as a California registered investment advisor, is required to provide you a report on a quarterly basis at minimum. Therefore, the quarter has become the fabric of our lives regardless of my opinion on the matter. Normally, I write these letters with the standard disclaimer, as in the paragraph above, that the timing of report is rather arbitrary – and that very little predictive value can be conveyed in simple quarterly performance numbers.

It is fair to say, however, that September proved a unique month in stock market history – overshadowed only by its unique place in human history. The tragic events of September 11th have caused performance during this third quarter of 2001 to be particularly irrelevant to the task of measuring investment skill.

That is, the ability to take such a quarter's performance and extrapolate it into a general summation of the investment manager's ability is fraught with even greater difficulty than usual. To this end, however, my position has been that the narrative of the quarterly report ought provide some aid to such an evaluation, and my efforts on this front follow.

The Portfolio

All major stock market indices saw significant declines during the third quarter. The Dow Jones Industrial Average, the most venerable of the group, lost 16%, its worst quarterly performance since 1987. The Nasdaq Composite, a recent favorite, lost 31%. The S&P 500 Index, the modern standard, fell 15%. And the Russell 2000, a small cap benchmark, lost 21%.

The Fund fared comparatively well, but I have to say such comparisons are not necessarily valid. The general market decline was not the reason for downward fluctuation in the Fund. Indeed, the results of the third quarter have no more reason for correlation with the market than the results of the first half of 2001. Rather, the Fund fell because I simply chose several key stocks that declined in price during the quarter. Any correlation with the indices in terms of direction and magnitude is largely coincidental. Certainly, in large part, the price declines of portfolio holdings do not reflect any similar deterioration in intrinsic value. And because the Fund has added to several of these decliners, the Fund is more valuable now than one quarter ago.

So, with this preface, I will review several specific reasons for the third quarter performance that you see on you account statement. For this was one quarter in which run-of-the-mill market volatility was not the culprit.

First and most important, the Fund has been averaging down in a stock, purchased during the quarter, which has fallen tremendously out of favor over the past couple of months. In a steep decline throughout July and August, the stock found the week after the markets re-opened particularly brutal as panicked sellers found relatively few buyers. Very few investment funds would want this stock on their books at the end of the quarter. Indeed, as the quarter came to a close, the stock came under renewed selling pressure, presumably as other investment funds worked to "window dress" their portfolios for public viewing. Some element of early tax-loss selling may have played a role. As well, it appears a very large institutional investor, having used the stock as collateral for a loan, has disclosed that it is dumping several weeks' worth of volume -with apparent disregard for price. All of these factors were detrimental to reported third quarter performance, and quite beneficial for the Fund. This position now ranks as among the largest in the Fund.

The future performance of this position will have absolutely no correlation with either the performance of the general market or further terrorist attacks. At quarter end, however, the position sat at a low point, trading at a valuation of just 3/4 the free cash flow of the trailing twelve months. And unlike many businesses that have faded rapidly during 2001, this business achieved record free cash flow yet again during the first half of 2001.

I will note that the prospects for a recovery in this position during the fourth quarter are wholly in question. However, over the next year or two, and especially over the next five years, there is a very high probability of substantial gains as a result of this investment. Such gains would be largely irrespective of the status of any economic recovery, or lack thereof.

This one position, while a very significant drag on the third quarter performance numbers, did not account for the entire decline. The events of September 11th affected the portfolio as well. Unlike one fund manager who found himself holding a fortuitous top four – a defense electronics manufacturer, a videoconferencing company, a medical company involved in the treatment of depression, and a bible publisher – I cannot claim that the Fund was particularly well-positioned, in terms of short-term price performance, for incomprehensible human tragedy involving commercial jumbo jets as weapons of mass destruction.

Specifically, you should understand that the largest holding in the Fund on September 11th was an airline stock. Breaking with tradition, I feel I should explain this position in a bit of detail. For no matter how strenuously I emphasize that this was a rational decision, buying an airline stock rarely looks like a good idea – especially in retrospect, after the seemingly inevitable monstrous loss has been realized. The rationale for buying this airline stock, and for patiently growing it into a very large position, is provided in the Appendix, attached.

The effect of our national tragedy on the market value of the portfolio was not limited to this one airline holding however. The Fund held two hotel stocks on September 11th – one of which was, and is, among its top five holdings. I will not reveal the name of this company here, as I do hope it continues to fall – thereby providing the Fund an opportunity to add to the position. Hotel stocks ranked with other travel-related industries and airlines as among the worst performers in the wake of the September 11th tragedies. In several cases, the short-term reaction was entirely unjustified, as long-term intrinsic value was not significantly impaired. The Fund's largest hotel holding is one such business, and I expect the Fund to receive full value for the shares in the future. Such recognition had simply not arrived by quarter's end.

As well, another hotel stock held in the Fund's portfolio, though not among the top 5 holdings, fell over 30% in the aftermath of September 11th. It now trades at the value of the free cash on its books, meaning an international hotel franchise lacking any recourse debt now goes for free on the stock exchange. Publicly traded real estate has always been neglected, but this is ridiculous. I fully expect it will recover and ultimately head much higher over time. The stock rarely trades, but if I am successful in my efforts to acquire more of this stock at these prices, the Fund will participate to a much greater degree on the way up than it did on the way down.

Finally, the portfolio has generally held relatively illiquid stocks for the balance of the year. The logical reason for this is that the more liquid, larger capitalization stocks had remained stubbornly overvalued since inception of the Fund. The logical consequence, however, is that the portfolio is susceptible to short-term downside volatility in times of rampant market fear. With all seriousness, a 2500 share sell when no one is looking could torpedo the apparent market value of several of the Fund's holdings. Such volatility in no way impacts the intrinsic value of the portfolio, and rather provides opportunity. In one case, this volatility has allowed the Fund to build a smaller stock position into significant size at a free cash flow yield approximating 20% – and at a price that is only half its private market value. Just ask the three separate financial buyers who bid to buy the company outright earlier this year. A tight financing market stymied these efforts. The value remains – and will be realized by the markets in good time.

Towards the very end of September, I allocated capital to several larger capitalization stocks as they fell to levels that implied extraordinarily high long-term returns. Indeed, I have been very happy to pick up several consumer franchises, with ever-widening competitive advantage, at discounts that imply virtually no growth going forward. Given the quality of these companies – and the natural ability of these companies to raise prices at a rate greater than inflation – such discounts imply an unrealistically low valuation.

Terrorism, External Shocks, and Risk

A portfolio manager must understand that safeguarding against loss does not end with finding the perfect security at the perfect price. If it did, then the perfect portfolio would likely consist of one security. Rather, to the extent possible, I have the responsibility to structure the portfolio such that if any of a number of unforeseen events occur, that I do not lose the whole, or even a significant portion, of the clients' money. To do this, I seek to minimize the correlation between the intrinsic values of the various securities held in the portfolio.

Minimizing this correlation involves a bit of diversification among industries. Minimizing this correlation does <u>not</u> involve straying from sound principles of securities analysis. Including speculative or overpriced stocks in the portfolio simply to diversify against the impact of an array of possible external shocks is simply irrational given the relative odds involved. Moreover, minimizing this correlation does not require a portfolio of more than fifteen or so stocks. Therefore, a relatively concentrated portfolio may still offer decent protection against unforeseen adverse future circumstance.

Although it so happened that on September 11th the Fund's largest position was an airline, and that another large position was a hotel stock, the impact of this tragedy should not, in the long-term, prove significant to the Fund's performance. The principles by which I invest served the Fund well during the recent turbulent time, and I expect that these principles, applied consistently, will continue to serve the Fund well – whatever additional shocks the future may hold.

On Portfolio Upgrades

One reason that several of the Fund's illiquid common stocks fell during the quarter is that many value managers, who might hold similar stocks, saw the opportunity to "upgrade" their portfolios during mid-late September. That is, acting on the fact that larger, well-known companies were recently trading at steep discounts to historical prices, portfolio managers dumped their illiquid, ignominious stocks and rushed into these more popular but depressed stocks. The phrase "I am upgrading my portfolio" became one I heard frequently among fellow portfolio managers as September came to a close.

In order to apply this technique to the Fund's portfolio, the existing securities and the securities to which one might upgrade, would have to come to some sort of equilibrium in terms of value offered. This most certainly has not been the case, at least not on any widespread basis. Indeed, the very fact so many investors acted rather eagerly to upgrade has recently pushed the value differential that much further in favor of current portfolio holdings. As a result, the time to exit such positions is certainly not the present.

Another issue I have with this sort of thinking is probably best summarized by the word "Ick." Ick investing means taking a special analytical interest in stocks that inspire a first reaction of "ick." I tend to become interested in stocks that by their very names or circumstances inspire an unwillingness – and an "ick" accompanied by a wrinkle of the nose - on the part of most investors to delve any further. In all probability, such stocks will prove fertile ground for the rare neglected deep value situations that could provide significant returns with minimal risk, and minimal correlation with the broad market. Occasionally, well-known stocks fall into the "ick" category, and it is at those times that I become interested.

Finally, I suspect that many who are actively upgrading their portfolios are doing so because they fear missing either a major market rally or the next bull market. With stocks in general having come down fairly far, the feeling a bottom is near may be fairly pervasive. The optimal way to participate in a market rally, by definition, is to buy the better-known stocks that either are in the major indices or are comparable to those that make up the indices. However, doing so exposes one to the risk that one is wrong on the direction of the market. To my knowledge, such a hazard has proven notoriously difficult to avoid. In any case, the goal, always, of intelligent investing is not to mimic the market but rather to outmaneuver the market.

This is not to say that I am not a fan of larger, well-run businesses with fantastic economic characteristics and durable competitive advantage. I have a list of about eighty or so stocks that represent businesses with very decent and predictable long-term business characteristics. At the right price, I would like to include any one or more of these stocks in the Fund. Of course, what I consider the right price seems ridiculously low given where most of these stocks have been priced in recent years. When these stocks come to my prices, then I will consider adding them to the Fund. But only because they represent absolute value, and not because of any desire to "upgrade the portfolio" into either more palatable or more market-responsive stocks.

Also on this subject, I should note that recently, as many well-known companies saw their stocks fall drastically, a select few made it to my buy prices. Those that did were added to the portfolio on the sole criterion of absolute value. The vast majority of popular stocks continue to be valued as popular stocks rather than as real businesses. Certainly, in the broader market, many stock prices overestimate the permanence of the underlying businesses.

Summary

As I have noted in previous letters, I will always choose the dollar bill carrying a wildly fluctuating discount rather than the dollar bill selling for a quite stable premium. This will often result in surprising quarterly results. To the extent prudent, I will attempt to explain surprising results when they occur. During the third quarter we saw an attempt to buy a cheap security become a process of averaging down into what is now, apparently, the most undervalued security available on any exchange. We saw investors start to dump illiquid small capitalization stocks using an order process that may be summarized as "Just get me out of this stock!" And to top it off, we saw a human tragedy of rare proportion directly and negatively impact the market values of several of the largest portfolio holdings of the Fund – with surprisingly little offset.

Thus, a confluence of happenings seems to have knocked the Fund for a decent price decline in just three months time. However, my entire net worth resides alongside your investment in the Fund, and I neither bemoan these recent short-run declines nor fear long-term impairment of my net worth. On the contrary, I am enthused that the market is offering up values on a scale not seen previously during the Fund's existence. Moreover, the Fund holds significant cash and sources of cash to put to work in such an environment.

Policy Matters

The minimum initial investment for new members is $250,000, and the next investment period starts January 1, 2002. Current members may contribute a minimum additional investment of $50,000 as frequently as monthly. For regular accounts, no additional paperwork is necessary to make an additional investment. Simply let me know your plans, and I will ensure you have the correct wiring instructions, or the correct address if mailing a check.

For IRA accounts, additional investments entail similar paperwork as for the initial investment. To start the process, please call me first.

Attorneys have updated the offering memorandum and operating agreement of the Fund in order to adjust the minimum investment from $100,000 to $250,000. As well, the documents were amended to provide more clarity on expenses. While certain powers and expenses were clarified, no additional expenses or powers were awarded to Scion Capital. Updated versions of these documents are enclosed with this quarterly report. Please file them for future reference.

I continue to maintain the vast majority of my net worth, and the whole of my family's investment account, in the Fund. And I continue to earn a paycheck only if I achieve a return on your capital in excess of the hurdle rate. My interests remain very much aligned with yours.

Please feel free to contact me if I have not been clear on a matter discussed above.

Sincerely,

Michael J. Burry, M.D.
Scion Capital, LLC

Scion Value Fund, A Series of Scion Funds, LLC

January 6, 2002

Dear Fellow Investors:

During 2001, the Scion Value Fund appreciated 44.60% net of all actual and accrued expenses and of performance allocations to the managing member. Since its inception on November 1, 2000, the Fund has appreciated 54.16% net of allocations and expenses. The 2001 audit is pending.

	2001	Since Inception[1]
Scion Gross[2]	+55.44%	+68.24%
Scion Net[3]	+44.60%	+54.16%
S&P 500[4]	-11.88%	-18.45%

[1]Inception November 1, 2000
[2]Return before 20% performance allocation and expenses
[3]Return after 20% performance allocation and expenses
[4]Including dividends

Your individual results to date will vary depending on the timing of your investment. Neither leverage nor short selling was a significant factor in the returns displayed above.

As I do not gear the Fund's buying and selling of securities to general market views but rather to available values in individual securities, it is likely that I will allocate capital to simple cash when I have difficulty finding reasonable investment opportunities. This tendency, along with the intent that the individual investments held in the Fund's portfolio ought ultimately perform regardless of general market movements, should result in longer-term returns that do not correlate very well with any of the standard benchmarks. Even so, recent history mandates further discussion.

During 2001, the Fund – before allocation of the performance incentive to the manager – outperformed the S&P 500 Index, adjusted for dividends, by 6,732 basis points. Since inception, covering a 14-month span, the outperformance amounted to 8,669 basis points. This degree of outperformance over short time periods will be an extremely poor guide as to future relative performance. In fact, should common stocks again bask in the speculative fervor that defined much of the last decade, I will welcome <u>any</u> degree of outperformance during such a period.

Over the longer term, however – I continue to recommend evaluation periods in excess of five years, and in no circumstance less than three years – I expect the Fund will show decent outperformance relative to most widely used benchmarks. Such relative performance will occur largely as a byproduct of my focus on achieving respectable absolute returns, and will occur most significantly from the position of being long common stocks that offer supranormal appreciation potential over reasonable time frames.

An Illustrative Situation

The repercussions of the late 1990's asset bubble continued to resonate through the markets during 2001, creating tremendous volatility as well as tremendous opportunity. Those with a clear idea as to valuation likely did not find their portfolios terribly troubled this past year. Those stock market players who respond to other inputs likely had some difficulty finding their bearings. As for the Fund portfolio, one situation in particular provides insight into the character of your investment here.

Within the 3rd quarter letter, I explained that the "Fund has been averaging down in a stock, purchased during the quarter, which has fallen tremendously out of favor over the past couple of months." I further explained:

> The future performance of this position will have absolutely no correlation with either the performance of the general market or further terrorist attacks. At quarter end, however, the position sat at a low point, trading at a valuation of just 3/4 the free cash flow of the trailing twelve months. And unlike many businesses that have faded rapidly during 2001, this business achieved record free cash flow yet again during the first half of 2001…I will note that the prospects for a recovery in this position during the fourth quarter are wholly in question. However, over the next year or two, and especially over the next five years, there is a very high probability of substantial gains as a result of this investment. Such gains would be largely irrespective of the status of any economic recovery, or lack thereof.

The Fund continued to purchase this security during the first days of October, while the security remained downtrodden. As it turns out, we did not have to wait five years, or even a year or two. The stock tripled off its quarter-end lows by late October. Moreover, during early December, a competitor agreed to buy all of the stock of the company at a price that amounts to nearly seven times its price as of September 30th, 2001.

Indeed, while this stock traded down and around its lows, allowing the Fund to take advantage of a truly tremendous sale on free cash flow, a secret bidding process was in the works. Two strategic buyers and one financial buyer submitted three separate bids for the company at valuations six to seven times the then-current market price. This extraordinary example of market inefficiency surely increased the reported volatility of your investment in the Fund – but without added risk, and ultimately much to your benefit. There are many in the investment world that believe the sentence you just read describes an impossibility.

Not so coincidentally, both the CEO of the winning bidder and your portfolio manager independently responded to the same July event when finalizing our rather bullish investment theses – even as the market proceeded to punish the stock on news of the very same event. Owing to our different professions, we went about our investments in different ways. I committed the Fund to a substantial investment in the common stock. He called the target and began to bid for the entire company. You should recognize, however, that this is not such a coincidence precisely because I buy common stocks for the portfolio as if I were buying pieces of businesses.

In fact, at all times I strive to buy stock at prices per share that no acquirer could ever pay for the whole company – not because the prices are too high, but because the prices are so low that a potential acquirer proposing them would be laughed out of the boardroom. Such is the opportunity afforded by the very human market for common stocks.

The Current Market

Several investors have asked me to specifically outline my view on the market. I have generally responded that it is neither my policy nor my interest to attempt to predict broad stock market levels to any degree of precision over any useful time frame. Rather, I will respond to the opportunities that the stock market provides, no matter the prospects for or level of the general market. That said, certain current market characteristics are worthy of comment in light of the history of our financial markets.

It is my belief that one constant in the stock market is human nature. For this reason, while I do not believe history provides a precise blueprint for the future, I also do not believe that those who blithely ignore history will have much success understanding the present. Below is text from an article that Benjamin Graham wrote for Forbes in 1932, a few years after the bursting of a speculative asset bubble most like our late-1990's bubble.

> A study made at Columbia University School of Business under the writer's direction, covering some 600 industrial companies listed on the New York Stock Exchange, disclosed that over 200 of them – or nearly one out of three – have been selling at less than their net quick assets. Over fifty of them have sold for less than their cash and marketable securities alone...Businesses have come to be valued in Wall Street on an entirely different basis from that applied to private enterprise. In good times the prices paid on the Stock Exchange were fantastically high, judged by ordinary business standards; and now, by the law of compensation, the assets of these same companies are suffering an equally fantastic undervaluation.

While I do not necessarily expect the after-effects of our more recent bubble to approach in any general manner the absolute valuation levels that Graham describes, I do believe that his extrapolation remains quite valid today. That is, by some law of compensation that would derive its permanence from the constancy of human nature, fantastic undervaluation ought to be expected as a reaction to fantastic overvaluation. It is my opinion that we have yet to find fantastic undervaluation on any scale of depth or breadth comparable to the overvaluation previously, and quite recently, wrought.

In fact, common stocks of nearly every persuasion and category have found themselves today at price levels that can only be described as optimistic. To some extent, the events of September 11th may have created the feeling among investors that nothing short of another large scale terrorist attack or other national disaster could force stocks back down below the September lows. This is clearly not the case. Emotion may produce short-term market bottoms just as it may produce short-term market tops, yet logic that attempts to peg valuation levels of any gravity without first and foremost considering valuation is flawed logic at best.

During a brief period of time this past September, I concluded – based on my evaluation of many individual issues rather than on aggregate statistics – that a number of stocks did find valuation levels that were too low. However, by and large most remained at somewhat high valuations despite significant price declines. Therefore, in the absence of a new asset bubble, the current level of common stock valuations – and the eagerness with which the public grew to accept such valuations – appears to promise future returns well below those still expected by the investing public.

To return to the original point, I provide this opinion on general valuations only as a response to the natural question that I have been asked so frequently of late. However, I am not at all convinced that the opinions above bear significantly on the investment process that I employ on behalf of the Fund. That is, I will respond to the value of individual securities, regardless of current or expected market levels.

I should add that those investors who must own a diversified basket of stocks fated to more or less match the market are precisely those who should be most concerned with the state of the economy and, more importantly, interest rate trends. As the Fund owns a more concentrated portfolio of deeply undervalued stocks affected by a variety of special situations, macro trends should naturally be much less of a concern.

The Current Portfolio

Friday, September 21st marked the most recent market low, as measured by the various indices. The prices of that Friday spurred the Fund to invest in a limited manner in a handful of large capitalization common stocks, as I indicated in the last letter. All of these stocks have been now sold as a result of the ensuing broad market rally, which no doubt helped carry these investments to higher valuations. Quite literally, 2-3-year performance goals for these positions were met within two months. The net effect on the portfolio was only moderately significant, however, as these positions were never taken to appropriate size. In retrospect, one might argue I ought to have rushed to take larger positions at the time.

As the broad market rally gained steam over the ensuing months, I continued to hold a sizable cash position while patiently buying a few securities that remained undervalued. I remained wary of the fear so prevalent during the last quarter – that is, the fear of missing either a tremendous rally or the beginning of the next great bull market. Such fear carries the dangerous potential to obscure and even to obliterate any efforts at rigorous and rational valuation of individual common stocks. As I have noted before, whatever excess return the Fund earns will be the result of my natural inclination to buy cheaper rather than any inclination to sell dearer.

As a result, the Fund's cash position – hovering around 40% or so for most of the fourth quarter – prevented the Fund from participating to the fullest extent possible in the recent general price appreciation across most categories of stocks. If this market rally were to continue from this point at this rate, surely the Fund would have little luck in keeping up over the short-term. On the other hand, those placing new or additional investment into the Fund on January 1 – a group that includes me – should know that the Fund is appropriately positioned given current opportunities in the market.

Short Selling

Short selling is of course the investment technique most readily identified with hedge funds. As you know, I do not and will not simply seek to hedge the long portion of the Fund's portfolio with a basket of short positions, or for that matter with index put options. It will never be my purpose to sell stocks short as part of a risk management program, contemporaneously defined. Rather, I approach the shorting of common stocks in an opportunistic manner that is in many ways the mirror image of my approach to going long stocks. I short a stock for the Fund when there is some temporary, manipulated, or misunderstood phenomenon that has caused the stock to rise to an egregious valuation.

Vanguard Group founder John C. Bogle specifically ridiculed my strategy in a Forbes magazine article during the year.

> His technique to manage risk is to buy on the cheap and, if he takes a short position--I hope you're all sitting down for this--it is because he believes the stock will decline.

In all respects, he describes my strategy exactly right – even inserting an "if" to reflect that I only occasionally take short positions. I contacted Mr. Bogle after reading this characterization, and not surprisingly we are of a different mind on this matter. He is, after all, a strong efficient markets proponent. What I propose just does not seem terribly plausible in his view. Nevertheless, this is what I do. I occasionally short a common stock in the Fund because I believe the stock will decline, resulting in a profit. I trust, forewarned, you were sitting down.

I will note that short selling has become extremely competitive. Much as the opportunity to find merger arbitrage opportunities at decent prices shriveled as capital flooded investment funds devoted to this activity, the short selling field has become awfully crowded as a result of recent broad market declines. In my opinion, it is possible that managers in aggregate have done poor research on many of the companies that they are short. This would be a different situation from the past, when short sellers in aggregate were generally correct in their assessment, if not always in their timing. Whether relying on a checklist or on a service that supplies potential short-selling ideas, managers new to the practice have potentially allowed the process to become too mechanical. As with most investment activities, the crowding and automating of the short selling field affects the practice and the profitability of more thoughtful short selling, in good part due to the mechanics of creating and maintaining a short position.

I consider all these issues in deciding whether to commit the Fund to short positions, and to what degree. As a result, my version of short selling at the portfolio level might be considered special-situation short selling. It will happen on occasion in stocks that are not generally heavily shorted, and only in cases where I have developed or can independently confirm an original investment thesis that recommends such action. During the vast majority of 2001, the Fund held no short positions at all, and the primary driver of the Fund's performance will continue to be its long positions.

Reiteration

I intend for this Fund to be populated primarily by investors with a longer view, rather than by speculators attempting to catch a brief period of performance. In fact, the policies of the Fund are structured specifically to attract an investor base of special and somewhat uniform caliber. It may not be clear, on first consideration, why I place so much importance on the composition of the investor base. I do so to help maximize the returns earned by the Fund.

An important reason that well-chosen investors actually help good investment managers to maximize returns is that dissonance within the investment vehicle is minimized. For instance, it has been widely reported that substantial cash is now sitting on the sidelines in the form of large cash positions at investment managers, especially hedge funds. To the extent this is true, it reveals that investment managers have become wary even as their investors have remained confident regarding the potential for substantial future returns. The real opportunities in any market of common stocks will occur when it is the investors who carry the pessimism. Of course, when this occurs, average investors – those doomed to mediocre investment returns over their lifetimes – will tend to withdraw their capital from the hands of the investment managers, and the buying power of investment managers will be minimized. As a result, when opportunity is most extreme, it is probable that cash balances at the various investment managers will not be of sufficient size to take advantage of the opportunity. When such a situation arises, the investment manager with the stable, more sophisticated investor base will retain buying power amid turmoil and opportunity. As a result, the entire investment operation will benefit.

My fundamental, personal investment goal is to earn reasonable returns on my invested capital, such that these returns, compounded over a decade or more, will yield significant absolute sums of capital. For aesthetic purposes, it may be ideal that the string of returns over such a span will never once see a losing year, but I am much more concerned with maximizing long-term compounded returns than maximizing the return in any given period, whether the period be a month, a quarter, or a year.

With your investment here, you have not invested in a stock or even necessarily in the stock market broadly defined. Rather, you own a portion of a private investment vehicle, a limited liability company, that gives you the annual right to require repurchase of your investment at then-current book value. My job, as manager and fellow owner, is to allocate the vehicle's capital to produce the highest absolute return on invested capital possible while minimizing the risk of permanent loss of capital. The available options for capital allocation are generally publicly traded securities, which by their frequent outlandish pricing serve as fertile ground for opportunistic capital allocation and re-allocation.

The goal here should be neither to take profits when the Fund is up significantly nor to cut losses when the Fund is down significantly. Your belief in this statement ought stem from a belief that I actively manage the Fund for intelligent capital allocation as well as re-allocation, and that I expect to do this for a sufficient amount of time. Certainly this is my belief, as I have invested the majority of my 2001 income back into the Fund for a January 1 start. The vast majority of my family's net worth continues to reside in the Fund. Our expectations and motivations should be very similar. To the extent they are, we will all benefit.

Policy Matters

The Fund now has about $27 million in capital, and the minimum initial investment for new investors has been raised to $500,000. The next investment period starts April 1, 2002. Current members may contribute a minimum additional investment of $50,000 as frequently as monthly. For regular accounts, no additional paperwork is necessary to make an additional investment. Simply let me know your plans, and I will ensure you have the correct wiring instructions, or the correct address if mailing a check. For IRA accounts, additional investments entail similar paperwork as for the initial investment. To start the process, please contact me first.

Since shortly after the Fund's inception, I have outsourced administration and bookkeeping tasks to Hedgeworks, LLC. Hedgeworks provides expert administrative abilities for much less cost than hiring a full-time, on-site assistant. I have increasingly made use of the services offered by Hedgeworks, and going forward you should expect most paper correspondence to arrive in the mail from Hedgeworks. Please be sure to open any package or envelope from Hedgeworks, as such mail will be certain to contain important information.

Frank, Rimerman & Co, LLP of Menlo Park, California is the certified public accountant and auditor for the Fund. United States investors should receive tax documents sometime during February, shortly after the audit is completed. We have arranged for preliminary audit work to be completed prior to year-end, and therefore it is my hope and expectation that these matters will proceed in timely fashion.

All other aspects of the Fund remain unchanged. Please feel free to contact me if I have not been clear on a matter discussed above.

Sincerely,

Michael J. Burry, M.D.
Scion Capital, LLC

2006

Third Quarter Letter

Scion Value Fund – A Series of Scion Funds, LLC

Scion Qualified Value Fund – A Series of Scion Qualified Funds, LLC

SCM Qualified Value Fund LTD.

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October 5, 2006

Dear Fellow Investors:

The loss for an investment in the Scion Value Fund during 2006 thus far amounted to 17.36%, net of all expenses. An initial investment in the Scion Value Fund at its inception on November 1, 2000 and held through September 30th, 2006 shows a gain of 135.30%, net of performance allocations and expenses.

	S&P 500 Index Return[2]	SVF Gross Return[3]	SVF Net Return[4]
2000[1]	-7.45%	+8.20%	+6.61%
2001	-11.88%	+55.44%	+44.67%
2002	-22.10%	+16.08%	+13.10%
2003	+28.69%	+50.71%	+40.81%
2004	+10.88%	+10.77%	+8.86%
2005	+4.91%	+7.81%	+6.49%
2006 9M	+8.53%	-17.36%	-17.36%
Since Inception	+3.21%	+208.00%	+135.30%

[1]Inception Nov 1 2000; data for 2000 covers Nov-Dec only
[2]Includes re-invested dividends
[3]Return before 20% performance allocation and after expenses
[4]Return after 20% performance allocation and expenses

An investment in the Scion Value Fund at inception on November 1, 2000 that was subsequently transferred to the Scion Qualified Value Fund at its inception March 1, 2003 would have a net gain of 140.17%. The loss for such an investment during the first three quarters of 2006 amounted to 15.96% net.

	S&P 500 Index Return[2]	SVF-SQVF Gross Return[3]	SVF-SQVF Net Return[4]
2000[1]	-7.45%	+8.20%	+6.61%
2001	-11.88%	+55.44%	+44.67%
2002	-22.10%	+16.08%	+13.10%
2003	+28.69%	+51.58%	+41.50%
2004	+10.88%	+10.20%	+8.40%
2005	+4.91%	+8.21%	+6.81%
2006 9M	+8.53%	-15.96%	-15.96%
Since Inception	+3.21%	+211.53%	+140.17%

[1]Inception Mar 1 2003; data for 2000-2002 covers the SVF only
[2]Includes re-invested dividends
[3]Return before 20% performance allocation and after expenses
[4]Return after 20% performance allocation and expenses

The SCM Qualified Value Fund is a Cayman Islands investment vehicle that feeds into the domestic Scion Qualified Value Fund. The portfolios of these two funds are therefore identical. The returns may vary slightly due to different expense ratios.

Within reason, I attempt to keep the Scion Value Fund and the Scion Qualified Value Fund *pari passu* in terms of portfolio composition. This cannot be an exact process, and as a practical matter I expect there will be minor variability between the two portfolios.

Last year, Scion Capital launched new investment funds with a dedicated pan-Asian investment strategy. These funds are open to all investors. Please direct initial inquiries to either our CFO Dan Nero or myself.

2006 Performance Attribution

	Stocks, Bonds and Bank Debt	Credit Derivatives	Equity Index Puts	SVF-SQVF Gross Return
2006 9M	-0.01%	-15.42%	-1.69%	-16.42%

Our Unique Position

Never before have I been so optimistic about the portfolio for a reason that has nothing to do with stocks. This year the portfolio is down, but our performance so far is solely due to our credit default swap positions. It all comes back to the market's tolerance for risk, which this year has risen to unprecedented heights while mine has remained constant. As a result, credit spreads, also known as risk premiums, have fallen across nearly every asset class. Most ironically, this has been true for securities backed by subprime residential mortgages, despite fundamental deterioration in the performance of these mortgages. Were Long-Term Capital executing its strategy the last three years, its managers would be the toast of Wall Street.

Of course it is no surprise to you that the Funds are on the other side of that strategy. So today, as homebuilders turn to discounts and promotions, and as for sale signs multiply across the United States, the Funds are in a unique position.

Yes, other funds have begun to attempt to execute this strategy. The Financial Times recently ran an article describing the inverse-LTCM trade that hedge fund managers are starting to employ. But man oh man are they the overconfident big boys diving head first into the shallow end of the pool. Despite our mark-to-market losses, we're short the mortgage portfolio everyone would want if they knew what they were doing.

After all, it is not possible to short mortgages themselves. It is only possible to derivatively short mortgage tranches which are part of large mortgage pools. These pools are professionally managed, and not all that run these portfolios are idiots. Even the idiots may have heard by now that the housing market, and in particular the subprime borrower, is in trouble. These managers can make use of tools such as interest rate swaps, mortgage insurance, and more substantial overcollateralization, and they have certainly done so.

This is a point worth emphasizing. Even during March 2005-September 2005, when the housing and mortgage industry was most complacent and home prices were peaking, I found most mortgage pools and their subordinate tranches to be totally unworthy as short candidates. Good luck to all those hedge funds finding the right stuff in 2006. The story has been out for some time, and the structurers of mortgage backed securities as well as the ratings agencies are not exactly clueless regarding the risk. Sooner or later, one of the big boys should really read a prospectus – probably not something they've done in a very long time.

The Perfect Strategy?

So I launch a hedge fund that will only short mortgages via credit default swaps. Milton's Opus II is the name. I explode upon the scene and pick up shorts with drive-by inaccuracy. I buy protection on every BBB-rated tranche under the sun and on the run during a very short period of time- say, the last two weeks of the month. Thanks to the pressure my spree put on the market and thanks to how supportive my own buying has been of my positions, I post a 3% month for that first month. The perfect hedge fund number, don't you think? That number will surely be of benefit as I seek out more capital. Actually, no, I did no such thing. Never would I do such a thing. I leave such behavior to others. I have left such behavior to others.

Counterparties

Counterparty relations are no picnic. There does not exist on Wall Street such a creature that will forgo an opportunity to act in its self-interest. For nearly all, it is not a question of ethics but rather one of fiduciary duty or job preservation. My eyes were wide open to this back when we first entered the credit derivatives market. Using no small amount of strategy and patience, Scion Capital negotiated very favorable ISDAs with all eight of our counterparties. At the time, however, in the interest of investor comfort, we allowed the appointment of the counterparty as the marking agent for valuation and collateral call purposes. Of course, this is a bit like buying stock from a short seller and allowing the short-seller to decide how my position is marked.

Perhaps we were too worried about appearances, and we should have done differently. This is a situation that has deteriorated as our counterparties – the global dealers that are household names – have refused to invest in the technology and the human capital required to manage their back offices properly in the face of exponential growth of the credit derivatives market. These dealers may not recognize the terminology in my accusation, as "cost center" is apparently the proper dealer term for back office infrastructure. Our tireless CFO Dan Nero continues to battle for our rights. And thanks to the ISDAs we negotiated, we long ago captured the key hill in this battle. Our rights to have our positions collateralized by the counterparty are our single most significant protection against counterparty failure. Our diversification among counterparties is also a significant protection. We have taken other measures as well, and so ultimately the problems with pricing do not impair our contractual rights in the event of default.

But short of deciding to mark our own book, the marks used will continue to come from the counterparties, as no third party agent offers the comprehensive coverage necessary to mark our credit derivatives portfolio.

Where Our Housing Short Stands

I never expected our mortgage short to work within one year. Mortgages by their nature tend to be good for at least the first year. Even in the event of missed payments from the start, it may take a year for these to appear in the form of a write-off. I knew full well we would be subject to the vagaries of a liquidity-drunk and overconfident market in the meantime. At the end of the day, we have the contractual right to receive cash when these tranches deteriorate to the requisite level, and that is a right that grows more valuable every single day.

The deterioration is in fact already substantial. For example, the vast majority of our portfolio is short Moody's Baa2-rated and Baa3-rated subordinated tranches of subprime mortgage pools issued during 2005. The credit support under these tranches is that portion of the pool that must be written off before we can start collecting cash. A key data point that we use to monitor the pools for deterioration is the sum of those portions of the pool that are either at least 60 days delinquent, bankrupt, in foreclosure, or now fully repossessed by the lender, also known as real estate owned (REO). We further make this data useful by calculating a ratio of these problem mortgages divided by the amount of the credit support. At quarter end, these ratios on our portfolio are as follows.

	(Total Delinquent + Bankrupt + Foreclose + REO) / Total Credit Support	(60+ Days Delinquent + Bankrupt + Foreclose + REO) / Total Credit Support	(Bankrupt + Foreclosed + REO) / Total Credit Support
2005 Baa2	1.58	1.15	0.79
2005 Baa3	1.99	1.47	1.01

Such ratios greater than one are significant, and in fact these ratios have risen rapidly in the last couple of months. The positions we are short are now effectively undercollateralized by performing mortgages. I expect that rising delinquencies and defaults will continue to drive these ratios higher. As most of the mortgages underlying the tranches we are short face interest rate resets six to twelve months from now – along with a reported $1 trillion in other mortgages during 2007 - these mortgages have not yet entered their highest risk period.

Still, this leaves open the question of the loss severity that the lenders face when they go to sell these foreclosed properties. Again, in our favor, these loss severities have been rising at a rapid rate this year, from 10-15% at the beginning of the year to 30-45% recently. We can measure this severity by looking directly within the monthly servicer reports for those pools which the Funds are short.

For example, let's take PPSI 2005-WLL1, an early 2005 mortgage pool.

	Current Month Loss Severity	Three Month Average Severity	Twelve Month Average Severity
September 2006	63.53%	42.03%	34.29%
August 2006	29.75%	28.48%	29.00%

This PPSI deal is a particularly nasty example, but yes, nasty examples exist among our shorts. The market in subprime mortgages is melting down right now. Shorts on 2005 tranches are both more likely to pay off and closer to paying off than 2006 deals. Home prices did not appreciate during the last year, so home price appreciation is no reason to shun 2005 vintage mortgages. Yet many rushing into the market now favor 2006 vintage shorts, driving recent prices higher. Why? Well, whatever such players say, the real reason is protection on 2006 vintage tranches is on the run and readily available. The good shorts from 2005 vintages – those in our portfolio - are not being offered.

I should reiterate that we are not betting on housing Armageddon. Yes, national housing prices fell nearly 3% in August, and this year will mark the first year since the Great Depression that national housing prices fall. And I do not believe this will be a one year blip. Yet our investment in these mortgage shorts was and is a rational investment shorting the absolute worst quality among borrowers and their mortgages during the most extreme credit bubble ever seen in the housing industry. The Funds have paid more for the right to do this. Much more than we would have paid were we betting on housing Armageddon.

I would caution against reading too much into what is widely reported. Most news stories on housing and mortgage issues are not specific to the worst 5% or so of loans made during 2005 - the slice that is most relevant to the Funds. Too, I should note that equity markets need not fall for these securities to work to our advantage. Recently the Dow Jones Industrials have scaled all-time highs. But the fundamentals on those positions we are short are rapidly deteriorating, and during 2007, the reward for our patience should be made clear in the Funds' performance.

<u>The Rest of the Portfolio</u>

I nearly forgot to write this section. Actually, that's a bit of a joke. I know a few investors have wondered whether I spend too much time on the derivatives book. Not hardly. The fact is, I spend nearly all my time on stocks and other long-oriented analysis. The Funds are blessed with a very capable back office that maintains the derivatives book, as well as analyst David Chu, whose time is now dedicated to monitoring the mortgage pools and other credits that we are short. My biggest burden with respect to this portfolio is in selecting and transacting in these derivatives, and I last purchased credit derivatives in May. By and large, the bulk of my purchase activity tailed off in late 2005. Long stock investments are my focus, as they have always been.

Given this, I cannot claim to be devoid of frustration. In a way, we are like the boy in the toy store who wishes the objects of his affection were just a tad cheaper. The difference is, we can afford nearly anything but just know better. The Funds hold quite a bit of cash. This last occurred back in the 2001-2002 era. Back then, the wait was not too long before notable opportunities presented themselves. Today, we're staring at a couple years of rising futility. I am fully aware that this is not true at many other hedge funds, many of which are doing just fine this year, even beating the indices. Simply put, they're invested. It's a good year to be long. Such facts have no bearing on my analytical conclusions with respect to individual company valuations.

Take Nordstrom, a higher-end retailer benefiting from most every macro trend today. Its 11.5% pre-tax margin in 2005 surpassed 10% for the first time since the company went public in 1971, and its net margins rose from 1.5% to greater than 7% in the last four years. Net income is five times what it was in 2001, and return on equity rose nearly fourfold. Similar stories abound, though not necessarily all to this degree.

If this is not a peak in a dramatic debt-fueled economic boom, well, it certainly looks like one. Over half the S&P's earnings are derived from financial businesses benefiting directly from global liquidity being as it is. Another huge chunk of S&P earnings come from retailers, and yet another huge chunk from commodity-related and heavy industrial companies. With remarkable synchronicity, nearly every such group is experiencing historically high margins.

Too, competitive threats are both manifest and underappreciated. Analyzing a Cisco in a world with a Huawei, a Whirlpool in a world with a Haier, a Microsoft in a world with a Google – well, this is a special challenge. It would be the definition of bad analysis to inadequately account for all competitive threats, yet at current prices, the market has done so. Of course, public securities are further supported by the prices that leveraged investors such as private equity firms and hedge funds can and must pay, rather than what is rational for a cash account long investor to pay.

A Scion portfolio will be a concentrated portfolio, though, and I have generally thought that in any market environment I should be able to spot the handful of investments that will make all the difference. Such a belief guides me and the Scion analysts as we scrub the markets in search of true value. By true value, I mean those rewards independent of the risk and leverage that binds so much of today's market together.

I would emphasize that our long portfolio has been conservatively managed from the get go. Like any portfolio manager, I do make mistakes now and then, but the long performance of the portfolio, stripped of all derivatives losses, since the inception of the derivative short portfolio has been satisfactory, especially in light of the minimal risks taken.

While the incentive for any hedge fund manager is to get invested, even overinvested, in the wake of a substantial decline in performance, this I will not do. I would rather await the proper opportunities, and continue to practice the conservative investing that has served me well for years. The high water mark and the other realities of this business do not tempt me to take on additional risk, nor will I ever be tempted. Conservatism rules the day here at Scion.

Asia

The Funds have roughly a 12% allocation in Asia, lower than in the past. I expect this will grow in the near term.

Energy

The Funds rode the boom in commodity prices primarily by being invested in unique energy-related securities before they were widely discovered. Earlier this year, the Funds' exposure to energy was reduced, and today energy-related positions are less than 10% of assets and largely concentrated in one position. It has recently become popular to bail on energy themes as oil prices retrace some of their gains. It does appear to me that this is creating opportunities.

Why not Short?

I have been asked whether our difficulty finding acceptable longs means we should adapt and focus more on shorting. We have shorted just a couple handfuls of times in the history of the funds. As I have described previously, I do not like the math of shorting stocks, nor the risks. It is simply a better use of time, over the long run, to focus on finding great longs. Certainly during the last year there is an industry or two that we could have profitably shorted. Moreover, we were right on top of the fundamentals, and we perhaps should have shorted but for some stubbornness on my part.

At this point, nearly all of the situations where our insight may have led to a successful short have passed us by. Few such situations are on the radar today, unless I assume significant disruptions of the consumer and residential real estate. The credit default swap portfolio has that covered in spades.

Too, while our long portfolio is putting up a goose egg this year, this was bound to happen at some point and therefore does not disturb me. The results are a reflection of my conservative nature with longs, and my patience. This has served me and the Funds well in the past, and I would still put our risk-adjusted long-term stock-picking record up against most anybody in most any environment. I see little reason to change strategy with respect to equities.

Index Puts

Our experience with equity index puts has not been a good one, especially now that indices are surpassing or approaching all-time highs. Given how close we are to fruition in our housing short, and by extension our corporate credit shorts, I do not feel much need to own a further removed short on the same thesis.   Presently, the Funds hold roughly $2 million in puts, and they are focused on the Russell 2000 Index.

Side Pockets

The Funds contain three investments that have been side pocketed.

Livedoor

Livedoor is a Japanese financial services and internet company that has been in the headlines due to allegedly fraudulent efforts to inflate earnings back a couple years back. This sort of thing passes smell tests in the United States all the time. Fannie Mae, for instance, still cannot file its financials. In Japan, Livedoor is a national scandal. The Funds took this position in the wake of the scandal, and when the stock was delisted, we side pocketed the investment. At our purchase price, the company appeared undervalued by at least 50%. Other hedge funds are involved here, and there is an activist effort underway to maximize the value of this investment. I remain optimistic that the outcome will be satisfactory.

Symetra

Symetra is the former Safeco Life & Investments that was taken private by a consortium led by Berkshire Hathaway and White Mountains Insurance at slightly above one times book value and less than six times earnings. The business is doing well, right in line with expectations. The time horizon for liquidity is finite, but unknown. Other co-investors in the deal have limited time horizons as well. For now, I am confident the value accretion will reward our patience.

Blue Ocean Re

Blue Ocean Re was founded in the wake of last year's devastating hurricane season. As capacity in the retrocessional insurance space dried up, Blue Ocean Re stepped in with supply at market-clearing prices that bore no resemblance to those of the prior year. To help guide and protect this investment, I took a position on the board of directors of Blue Ocean Re. Results during this first year of existence have certainly not been troubling.

Administrative Matters

Scion Capital continues to employ Spectrum Global Fund Administration as the third party administrator for the Funds. For capital account balances, please contact Laura Gillen at lgillen@sgfallc.com or at (312) 602-5636.

Of course, Dan Nero and I both stand ready to accept any questions you may have regarding your investment.

Sincerely,

Michael J. Burry, M.D.

Scion Capital Analysts at September 30, 2006

David Chu - Analyst
David Chu serves as a security analyst for Scion Capital, LLC. Prior to joining Scion Capital in September 2004, he consulted for various hedge funds in the San Francisco Bay Area and worked as a research associate at Abacus Capital Investments, LLC, analyzing public equity investment opportunities. David began his career at Goldman, Sachs & Co., in the Leveraged Structured Finance Group, where he executed high yield financings, leveraged recapitalizations and project finance transactions. He then moved to Equinox Capital Pte Ltd., a private equity firm in Singapore, where he focused on direct investments in Southeast Asia. At Equinox, he conducted extensive field-level due diligence and financial analysis on acquisitions in the manufacturing, food, and banking sectors, specializing in distressed and bankruptcy situations. David has also worked at CrossWorlds Software, an enterprise applications integrations company, in the corporate finance group. David received a B.S. degree in Business Administration, magna cum laude, in Finance and International Business from Georgetown University and earned an M.B.A. degree from Harvard Business School.

Michel A. Del Buono – Analyst
Dr. Del Buono serves as a securities analyst for Scion Capital, LLC. Prior to joining Scion Capital in July of 2004, he was an Engagement Manager at McKinsey & Co, San Francisco, in the Corporate Finance & Strategy practice. Michel's focus was on working with Industrial & Energy clients on various aspects of investment strategy such as course-changing investments or M&A transactions, as well as conducting due diligence for major Private Equity firms on over $1B of LBO transactions. Michel received his Bachelor's of Science degree in Systems Engineering with High Honors from the University of Virginia, and he holds three graduate degrees: an M.Phil. in Economics from the University of Cambridge, UK; an M.Sc. in Engineering-Economic Systems from Stanford University; and a Ph.D. in Management Science & Engineering, also from Stanford University.

Leonie Foong – Analyst
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A Primer on Scion Capital's Subprime Mortgage Short
November 7, 2006

Subprime mortgages, typically defined as those issued to borrowers with low credit scores, make up roughly the riskiest one third of all mortgages. The vast majority of these mortgages fall well within the loan size limits set by Fannie Mae and Freddie Mac, but are not deemed eligible for purchase by these two mortgage giants for other reasons. That is, they are non-conforming. For these non-conforming subprime mortgages, the originator can certainly choose to hold onto the mortgage and retain credit risk in exchange for the interest payments. Alternatively, the originator can sell subprime mortgages into the secondary market for mortgages. This secondary market is vast and deep thanks to the invention of mortgage-backed securitizations back in the 1970s.

In a securitization, a finance company buys up mortgages from the original lenders and aggregates these mortgages into large pools, which are then dumped into a trust structure. Each trust is divided into a set of tranches, and each tranche is defined and rated by the degree of subordination protecting the tranche's principal from loss. The tranches are then sold in the cash market to fixed income investors by a placement agent – typically a well-known securities dealer. The lower-rated tranches may not be offered to investors, but may be retained by the finance company. Too, the dealer placing the securities with investors may choose to purchase some of these securities for its own account, either as an investment decision or to help ensure a full sale of the deal. At the time of the creation of the trust, a servicer, also rated by the agencies, is hired to administer the mortgages within the trust. The trustee will manage the trust and all relations with investors, including monthly reports. The month's end is typically the 25th.

For instance, we can take a look at PPSI 2005-WLL1, an early 2005 mortgage deal.

Tranche	Description	Moodys	S&P	Fitch	Principal
A-1A	Senior Float	Aaa	AAA	AAA	600,936,000.00
A-1B	Senior Float	Aaa	AAA	AAA	66,769,000.00
M1	Mezzanine Float	Aa1	AA+	AA+	29,049,000.00
M2	Mezzanine Float	Aa2	AA	AA	26,524,000.00
M3	Mezzanine Float	Aa3	AA-	AA-	16,419,000.00
M4	Mezzanine Float	A1	A+	A+	14,314,000.00
M5	Mezzanine Float	A2	A	A	13,472,000.00
M6	Mezzanine Float - NO	A3	A-	A-	13,051,000.00
M7	Mezzanine Float - NO	Baa1	BBB+	BBB+	10,946,000.00
M8	Mezzanine Float - NO	Baa2	BBB	BBB	10,525,000.00
M9	Mezzanine Float - NO	Baa3	BBB-	BBB-	5,894,000.00
M10	Mezzanine Float - NO	Ba1	BB+	BB+	6,315,000.00
M11	Junior Float - NO	Ba2	BB	BB	8,420,000.00
CE	Junior OC Reserve - NO				19,365,046.51

Here, it happens that Argent Mortgage Company and Olympus Mortgage Company separately originated a set of subprime mortgages, and each sold these mortgages to Ameriquest Mortgage Company. Ameriquest, which will be the seller in this deal, deposited these mortgages with a wholly owned subsidiary, Park Place Securities

Incorporated – PPSI. Park Place is therefore the depositor. Park Place refashioned this pool of mortgages into a trust, with Wells Fargo Bank being the trustee and Litton Loan Servicing being the servicer as set out in the Pooling and Servicing Agreement, or PSA. The Seller hired Merrill Lynch as the placement agent to sell the deal to investors. Those tranches designated "NO" were not offered to investors but rather retained by Ameriquest for other purposes. An investor buying a tranche will receive LIBOR plus a fixed spread that correlates with the tranche's rating and perceived safety.

Note the senior tranches, designated A-1A and A-1B, make up 79% of this particular subprime pool. That is, these senior tranches can count on credit support amounting to 21% of the pool as well as any additional credit support that builds up during the life of these tranches. If the pool experiences write-downs in excess of the credit support for the senior tranches, then the senior tranches will suffer erosion of their principal. This is deemed extremely unlikely by the ratings agencies, and these senior tranches therefore garner the AAA rating.

The mezzanine tranches in this pool include all those tranches that are rated, but not rated AAA. For the lowest rated tranche – M11 in this particular pool - credit support is just 2.3% at origination. Baa3, or equivalently BBB-, is considered the lowest "investment grade" rating, and the lowest investment grade tranche in this PPSI deal is M9, which had 4.05% in credit support at origination. Note the M9 tranche is just under $6 million in size, less than 1% of the original deal size – these are tiny slices of a large risk pool. Still, the ratings agencies say each tranche is worthy of a difference in the rating due to the historically very low rate at which residential mortgages actually default and produce losses. Because home prices have been rising so steadily for so long, troubled homeowners have been able to refinance, take cash out, and often reduce the monthly mortgage payment simultaneously. This has had the effect of reducing the rate of foreclosures. Also because of rising home prices, foreclosures have not resulted in enough losses to counteract the credit support underlying mortgage-backed securities. To be perfectly clear, write-downs occur when realized losses on mortgages within the pool overwhelm the credit support for a given tranche.

Credit support is therefore a key feature worthy of more attention. A tranche will not experience losses if any credit support for the tranche still exists. In addition to the structural subordination that contributes the bulk of credit support, finance companies build in overcollateralization – essentially, throwing more loans into the pool than necessary to meet the payment obligations of the pool – and the trust itself can engage in derivatives transactions to insure the pool against loss. An example might be an interest rate swap that produces excess cash for the pool as rates rise. Over the first couple of years, which are typically relatively problem-free for mortgages, one already normally sees an increase in credit support for all tranches. In an era of hysteria over a home price bubble, one would expect that the organizer of a new mortgage pool would include or extend use of these extra protections to help further bolster the credit support for the pool's tranches. As 2005 came to a close, this is exactly what happened, and this is why I find many more recent deals much less attractive from a short's perspective than mid-2005 deals.

As is always the case, timing is therefore important for an investor short-selling tranches of mortgage-backed securities. Catching a peak in home prices before it is generally recognized to be a peak would be critical to maximizing the chances for success.

Now, because the more subordinate tranches are so wafer thin, they are typically placed with either a single investor or very few investors. Securing a borrow on such tightly held subordinate tranches would be difficult, and as a result shorting these tranches directly is not terribly practical. A derivative method was needed - enter credit default swaps on asset-backed securities.

Credit default swap contracts on asset-backed securitizations have several features not common in other forms of swap contracts. One feature is cash settlement. Again, examining PPSI 2005-WLL1 M9 - the BBB- tranche - we see it has a size of $5,894,000. Because credit default swaps on mortgage-backed securities are cash-settle contracts, the size of the tranche does not limit the amount of credit default swaps that can be written on the tranche, nor does it impair ultimate settlement of the contract in the event of default. By cash-settle, I mean that the tranche itself need not be physically delivered to the counterparty in order to collect payment. An investor with a short view may therefore confidently buy more than $5,894,000 in credit default swap protection on this tranche.

As well, these credit default swap protection contracts are pay-as-you-go. This means the owner of protection on a given tranche need not hand over the contract before full payment is received, even across trustee reporting periods. For instance, if only 50% of the PPSI 2005-WLL1 M9 tranche is written down in the first month, the owner of $10,000,000 in protection would collect $5,000,000 and would not need to forfeit the contract to do so. If in the second month the remaining 50% is written down, the owner of protection would collect the remaining $5,000,000.

A mortgage-backed securitization is of course a dynamic entity, and a short investor must monitor many different factors in addition to the aforementioned credit support. For instance, as a mortgage pool matures, mortgages are refinanced and prepaid, and the principal value of mortgages in the pool declines. Prepayments reduce principal in the senior tranches first. Generally, the idea is that investors in subordinate tranches should not get capital returned until the senior tranches are paid off. There are some minor exceptions, but this is generally true. For instance, today, the current face value of the AAA tranches in PPSI 2005-WLL1, which was issued in March of 2005, is roughly $243,691,000 versus the original face value of $667,705,000 due to a high rate of refinancing. Those who can refinance will. Our focus is on those who cannot.

For those who cannot, some mortgages will go bad. Lenders tend to consider loans delinquent for roughly 90 days of missed payments, and then the foreclosure process looms. Typically within 90 days but occasionally up to 180 days after foreclosure, the real estate underlying the bad mortgage is sold. If the proceeds cannot pay off the mortgage, a loss is realized. If the cash being generated by the mortgage pool cannot cover the degree of losses, the mortgage pool takes a loss. This is applied to the most subordinate tranche first.

Most of these subprime mortgage pools will likely see maximum foreclosures a little over two years into the life of the pool. The reason is that most subprime mortgages included in these pools – typically 80% of the mortgages in the pools – are adjustable rate mortgages. As a result, the mortgage pool will experience its most significant stress when the initial teaser rate period ends on its set of adjustable rate mortgages. Generally, this period ends on average 20-24 months from the date of issuance of the mortgage pool.

Since the Funds shorted mortgage pools mostly originated in spring through late summer 2005, I expect the pools shorted will see maximum stress during the latter half of 2007. No one shorting these tranches would expect to see a payoff during the first year of holding the short and likely not even during the second year. In fact, the apparent credit support under each rated tranche will grow during the first year or two. If the thesis plays out as originally contemplated, the reduction in credit support and ultimately the payouts on credit default swaps would come shortly after the mortgage pools face their peak stress, or roughly 2-2.5 years after deal issuance.

In the interim, the value of these credit default swap contracts should fluctuate. In a worsening residential housing pricing environment, and with poor mortgage performance in the pools, one would expect that protection purchased on tranches closer to peak stress would garner higher prices, provided that home prices have not appreciated significantly during the interim. As well, credit protection purchased on tranches more likely to default should garner higher prices. I would note that during the summer of 2005, national residential home prices in the United States peaked along with the easiest credit provided to mortgage borrowers in the history of the nation. Recent year over year price declines have not been seen since the Great Depression.

With that in mind, let us examine how the tranches I selected as shorts are performing relative to the other 2005-vintage deals. The data in this table was compiled by a third party data provider. This provider captures approximately 80% of all 2005 home equity deals in its database, which is up to date through August.

Percentages	Bankrupt	Foreclosed	Real Estate Owned	Total
Loans in Scion 2005 Deals	1.04	3.48	1.32	5.83
Loans in All Subprime 2005 Home Equity Deals	0.56	2.94	0.75	4.25
Loans in All 2005 Home Equity Deals	0.28	1.48	0.38	2.14

I do believe trends such as these validate the proprietary criteria upon which I selected the pools for the mortgage short portfolio. While these numbers seem low, the Funds shorted the more subordinate tranches within these pools specifically so that the short position would not be dependent on the Armageddon scenario for U.S. residential housing.

Fundamental developments, however, do not necessarily play into pricing of these credit default swaps while we await peak defaults because most off-the-run deals simply do not have an active market. So, how exactly are the values of the Funds' positions priced during this time? In a nutshell, our counterparties set the values. The seller of credit default swap protection is the buyer's counterparty, and vice versa. The Funds have six counterparties from which credit protection on subordinated tranches of mortgage-backed securities has been purchased. The creditworthiness of our counterparties is an integral part of the investment thesis. We have chosen counterparties that are among the largest banks and securities houses in the world, and we have negotiated ISDAs with each of these counterparties. ISDA stands for International Swap Dealer Association, and an ISDA is the common term for the contract governing the dealings between counterparties to a swap transaction.

Importantly, we negotiated ISDA contracts that give us the right to collateral should our swap positions move in our favor. To the extent the Funds see the values of our swap positions move the other way, the Funds send collateral to our counterparties covering the decline in value of the positions. This mechanism protects each counterparty in the event of a default by the counterparty on the other side. The dealer counterparties are the marking agents for the Funds' positions, and therefore the values set by these dealer counterparties determines how the collateral flows on a daily basis.

Scion Capital has been using these same counterparty-assigned contract values that we use for collateral purposes to determine the net asset value of the Funds. The value of credit default swaps on subprime mortgage-backed securities is a calculation involving certain assumptions. For any buyer of protection to have confidence in the value assigned to his positions, he must have confidence in the methodologies behind the pricing data provided by his dealer counterparties. The pricing data we receive from our counterparties is often very old or stale-dated. These prices are sometimes tied to movements in the on-the-run index products, which contain neither any of our deals nor any deals remotely similar to our deals- almost all of which are off-the-run. We have found the methodologies to be frankly inconsistent. In the absence of confidence in counterparty marks, a third party may be considered, but today there is no sufficient third party marking agent for credit default swaps on mortgage-backed securities. Some may rather use a mathematical model to price the portfolio, but Scion Capital does not price its portfolio securities to models.

The Funds currently carry credit default swaps on subprime mortgage-backed securities amounting to $1.687 billion in notional value. As I selected these, I was not looking to set up a diversified portfolio of shorts. Our shorts will have common characteristics that I deemed to be predictive of foreclosure, and therefore they should be highly correlated with each other in terms of both the timing and the degree of ultimate performance. Again, ultimate performance matters much more than the valuation marks accorded us by our counterparties in the interim. In the worst case, I expect our mortgage short will fully amortize to nil value over the next three years, corresponding to an average annual cost of carry over that time of roughly six percent of current assets under management. Calibrating the more positive outcomes will become easier as 2007 progresses.

Michael J. Burry, M.D.
Scion Capital, LLC

RMBS CDS & Side Pockets - Some Good Questions

November 7, 2006

Can't the servicers manipulate these pools? Don't they advance interest? Generally, servicers may advance interest payments to the pool when a mortgage goes delinquent. Once a mortgage is foreclosed upon, the servicer's advance is typically billed to the mortgage pool. Servicers are themselves rated and in my view would have little incentive to refuse to foreclose upon mortgages or delay sales of real estate during a time of declining home prices. Recent data has implied that servicers have been more willing to take bigger losses on mortgages as national home price levels weaken. As far as deciding when a tranche should be written down, this duty is left to the trustee rather than the servicer. It is the trustee, not the servicer, which administers cash flows to investors within the trust.

Can't the manager of the mortgage pool replace bad loans with good ones? For reasons of fraud and similar concerns, it is often the case that a bad loan may be replaced during the first six months to one year of a trust's existence. Nearly all our shorts involve deals for which this period is past. To the extent such replacement of fraudulent loans happened, it was disclosed in servicer reports, and it was not significant.

***What is loss severity*?** Loss severity is the average percentage loss realized on mortgages during the trustee reporting period. Losses on mortgages are realized when the underlying foreclosed real estate is sold, but proceeds cannot fully repay the mortgage.

What is the deal with the step-down at three years? Is this a concern? This is a somewhat complex mechanism built into most mortgage pools that allows for the senior tranches to be repaid relatively quickly if the pool is performing poorly and to be paid down more slowly if the pool is performing very well. The 37th month is a frequent date for this mechanism to kick in. Given the subordinated status of the tranches we are short and the accelerated deterioration of these pools, this mechanism would appear to be not very relevant to our position.

What is interest rate swap protection and is it relevant? In the earlier years of a mortgage pool, income is relatively fixed, while the payout to investors in the pool floats based on LIBOR. Rising rates may cause payouts to exceed income, causing a mismatch. At the time the mortgage pool is structured, the seller may purchase an interest rate swap that itself is profitable in the event of higher interest rates so as to mitigate risk of a mismatch. These swaps typically have a fixed term. This is relevant. Not all pools have this feature, and all else equal pools with this feature tend to be less interesting as shorts.

How is your portfolio of mortgage shorts split by rating? On a notional basis, 41.6% and 49.8% of our shorts are on BBB- and BBB tranches, respectively. The remaining are A-rated tranches.

Is PPSI 2005-WLL1 representative of the rest of the portfolio? No. This is an example, and it is not meant to be representative. For instance, many pools do not have a credit enhancement, certificate of equity, or CE, tranche, like PPSI 2005-WLL1 does. Commonly, there is an overcollateralization layer that is not specifically set out as a tranche.

Do you really believe the dealers are colluding to mark your book low? No. I believe the dealers are acting in their best interests, but I have no evidence of collusion of any kind. I do not believe our counterparties best interests are necessarily aligned with the Funds' best interests, and I feel it is the better part of prudence to maintain that opinion. I generally feel people follow the incentives before them.

Why did you ever allow the counterparties to mark your books? I have not been aware of a better alternative. I have been wary of the conflicts of interest that would arise should we set foot on the slippery slope that is marking our own book.

Do your concerns with day-to-day valuation affect the enforceability of the CDS contract in the event the underlying tranche experiences write-downs? No. These are cash-settle, pay-as-you-go contracts backed by the full credit of our counterparty. When the trustee reports a tranche has had write-downs, we will have the contractual right to payment from our counterparty. There will be no assumptions involved, and valuation will not be a factor.

How will you mitigate losses if it doesn't work out like you think? Should I detect a reason for the Funds to exit some or all of these positions, I will seek out ways in which to liquidate the positions. I am hopeful that our careful monitoring of the Funds' positions will lend us the insights necessary to mitigate losses should the need arise.

What is the longest these credit default swaps on mortgage-backed securities can be in force? The stated life of each swap contract is technically 30 years. Practically however, prepayment speeds have determined the lifespan, or duration, of mortgage pools for nearly the entire history of the market in mortgage-backed securitizations. Most dealers estimate the life of the mortgage pools containing the tranches underlying the swaps in our portfolio at 2-3 years.

Isn't there an active market in CDOs? We do not invest in either cash CDOs or synthetic CDOs. The cash residential mortgage-backed securities, or RMBS, market is also very large, but we do not participate in this market. The securities we have invested in are credit default swaps, also known as CDS.

Do synthetic CDOs do the same thing as Scion? No. Synthetic CDOs are roughly similar in architecture to the PPSI example above, but with credit default swaps on specific corporate names or on specific asset-backed securities substituting for mortgages. Buyers of these swaps then provide the cash flows that will support the synthetic CDO. Generally, buyers of synthetic CDO securities go long a credit while the buyers of the swaps are going short the credit. Most of the supply of credit default swaps in 2006 is tightly linked to the issuance of new synthetic CDOs.

What is the ABX Index? An ABX index is an index of credit default swaps on mortgage-backed securities. There are multiple ABX indices, each defined by a vintage and an average credit rating. The first ABX index was launched in early 2006, and the structure of the index bears very little resemblance to the Funds' portfolio of mortgage shorts. I do not view any such index as a good proxy for the Funds' positions.

What are the other side pockets again? Why do the side pockets fluctuate in value a bit? From the perspective of an investor, the number and level of side pockets will depend on the timing of the investor's capital additions to the Funds. The other side pockets are Livedoor, Blue Ocean Re, and Symetra. All continue to be represented at cost. Any variation in side pocket value today comes from the fact that the Livedoor position is held in Japanese yen, while we report in dollars. This leaves that position exposed to foreign exchange movements. Additionally, side pockets may appear to loom larger when assets under management have fallen.

If you side pocket these and you get a lot of withdrawals, are the remaining investors stuck with very large positions in these side pockets? No. The nature of a side pocket is that exiting investors retain their portion of the side pocket. As a result, the remaining investors see no increase in concentration in the side pocketed position.

Will you allow investors transparency into all the different positions in the mortgage CDS side pocket? I hold no plans to offer transparency into these positions, nor do I expect to compromise the opportunity to trade out of these positions at opportune times.

Why are you not side pocketing the corporate CDS positions? Although we hold off-the-run single name corporate credit default swaps that I do not find to be very liquid, there is a bona fide and adequate market in corporate credit default swaps. A side pocket is not necessary.

How big is the corporate CDS portfolio? As of the end of October, single name corporate CDS amount to 3.27% and 3.55% of assets under management in the Scion Value Fund and the Scion Qualified Value Fund, respectively. The duration of this portfolio is roughly 3.5 years. These credit protection contracts cover $4.27 billion in notional value, largely focused on financial companies. A number of these companies are engaged in the mortgage business.

2008

First Quarter Letter

Scion Value Fund – A Series of Scion Funds, LLC

Scion Qualified Value Fund – A Series of Scion Qualified Funds, LLC

SCM Qualified Value Fund LTD.

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A common argument today concerning adjustable rate mortgages is that if the homebuyer plans to move before the adjustable rate kicks in, then the obvious choice is to choose an adjustable rate mortgage, lock in the lowest current payment, and achieve a more expensive house. Washington Mutual reports that one quarter to one third of home loans originated over the last year possess an adjustable rate feature. Such a program is good for the lender, the loan officer, the mortgage broker, the real estate agent, and nearly every party involved in the home purchase transaction. But the two major risks facing an adjustable rate mortgage borrower - that home prices and easy credit potentially both collapse during the fixed rate period – are precariously correlated.

- Scion 2Q 2003 Letter to Investors

Oil has been in a nominal trading range for so long that the market apparently feels prices cannot escape above $40/barrel. In truth, adjusted for inflation, oil prices have been on a decades-long slide and are not even half what they were in the 1970s. A rapid rise in oil prices above $40 has a reasonable fundamental basis, and would be almost a universal surprise.

- Scion 1Q 2004 Letter to Investors

Within the first quarter's letter, I expressed my sentiment that "very high oil prices were not only possible but probable." I defined "very high oil prices" as being in excess of $50 per barrel. I believe now as I did then that there is a reasonable fundamental basis for these higher oil prices. Speculators are being widely blamed for these higher prices, but I would say that to the extent fundamentals-be-damned speculators are involved, they are in for the luckiest ride of their lives… Since earlier this year, the Funds have held long equity and distressed debt investments, both domestically and abroad, that should benefit significantly from these higher oil prices.

- Scion 3Q 2004 Letter to Investors

I have written before of my similar belief that many of our financial institutions are simply becoming too big to save without consequence. Moreover, as they raced to become too big to fail, many grew at rates that outstripped internal accounting and audit controls as well as regulator resources.

- Scion 3Q 2004 Letter to Investors

I fear that no matter how conservative large public banks should be, they cannot be. The Seattle FHLB experience has been bad enough. The incentives in place for public bank executives and middle managers are even more contrary to safety. Manipulating capital adequacy appearances does nothing to change the underlying economic requirement. Rather, such a policy simply increases leverage beyond that which is apparent by traditional analysis.

- Scion 1Q 2005 Letter to Investors

Sometimes, markets err big time. Markets erred when they gave America Online the currency to buy Time Warner. They erred when they bet against George Soros and for the British Pound. And they are erring right now by continuing to float along as if the most significant credit bubble history has ever seen does not exist. Opportunities are rare, and large opportunities on which one can put nearly unlimited capital to work at tremendous potential returns are even more rare. Selectively shorting the most problematic mortgage-backed securities in history today amounts to just such an opportunity.

- Scion 3Q 2005 Letter to Investors

As for liquidity, where may it head next? Well, if the stock market wishes to value the Wal-Marts and Ciscos at fifty times earnings again, that would certainly accommodate a good amount of liquidity. But additional liquidity into stocks would have limited rationale, and rousing speculative excess requires a rousing excuse…Rousing excuses abound for gold and other precious metals. Big bullion dealer Kitco cites the return of central bank buying, and I would cite forthcoming dollar trouble stemming from a Federal Reserve program to reduce interest rates to offset housing-affected economic weakness. All the gold ever mined in the history of the world is only worth roughly the amount of U.S. dollars held by Asian central banks – a story unto itself. And this speaks nothing of the froth that could build should the world's citizens begin to move precious metals off the market *en masse*.

- Scion 1Q 2006 Letter to Investors

A spent U.S. consumer is looming, and the only question is when the public markets begin to discount such a development. The S&P 500 could easily finish the year in the negative, dragging many investment funds – too many of which are crowded into the same "value-but-for-a-dire-economy" trades – down with it.

- Scion 3Q 2007 Letter to Investors

2008 is going to be an interesting year. The full impact of the subprime mortgage-induced contagion is hitting Wall Street and Main Street simultaneously. American consumers who had relied upon their ever-appreciating homes as fountains of cash have neglected to save even a penny for years…What does the American consumer have to spend now? The American dollar ended 2007 in a fast-accelerating descent against most of the world's commodities and currencies. So prices are rising even as the American consumer is pulling back. Stagflation? No, I worry about something worse, and something somewhat unprecedented. Do I foresee yet another black swan? Damn birds cloud my skies.

- Scion Capital 2007 Letter to Investors

The SCM Qualified Value Fund is a Cayman Islands investment vehicle that feeds into the domestic Scion Qualified Value Fund. The portfolios of these two funds are therefore identical. The returns may vary slightly, however, due to different expense ratios. Within reason, I attempt to keep the Scion Value Fund and the Scion Qualified Value Fund *pari passu* in terms of portfolio composition.

Scion Capital is closing its dedicated Asian investment funds and returning capital to investors in those funds.

Black Swans

Among the financially successful people on Wall Street two years ago, one would have found many, many men who firmly believed in themselves. Today, I imagine that this is true of a smaller group of men. What is it that has turned so many into trembling versions of their former selves? For many, it would seem that they have encountered what best-selling author Nassim Nicholas Taleb calls "The Black Swan."

I know this, because not a few rushed to send me copies and otherwise alert me of this book's presence last year when it was published. The very first words on the dust cover state "A black swan is a highly improbable event with three principal characteristics: It is unpredictable; it carries a massive impact; and after the fact, we concoct an explanation that makes it appear less than random, and more predictable than it was."

Perhaps one wonders why it is that I quote so heavily from past letters of late. I must say that I have been astonished by how many now say they saw the subprime meltdown, the commodities boom, and the fading economy coming. And if they don't always say it in so many words, they do it by appearing on TV or extending interviews to journalists, stridently projecting their own confidence in what will happen next. And surely, these people would never have the nerve to tell you what's happening next if they were so horribly wrong on what happened last, right? Yet I simply don't recall too many people agreeing with me back then.

This is rather reminiscent of the dot-com boom and bust. In the aftermath, of course *everyone* knew it was a bubble. I live in Silicon Valley, and I do not know a soul who has ever admitted to buying into the bubble. Although, I remember the responses I got when I claimed it was a bubble in 1999.

The problem is that people tend to focus on the risks that convention says can be calculated, and they tend to miss the uncalculated risks that ultimately wreak havoc. Why? Well, because calculating risk is about the most brainless brainy endeavor one can imagine. At the end of the day, it will often be those with very little conventional training – those with an unconventional view – that will see the real risk clear as day. Maybe some of us have a divining rod gene. Maybe some of us just put in a bit more work - on the premise that nothing obviates risk like informed common sense.

Earlier this month, I took my family on our first extended vacation far away from California, and we ran headlong into a flock of black swans. Real, breathing black swans. You've got to be kidding me. One cannot make this stuff up. Or so I thought.

But, of course, this was indeed predictable. We were visiting Leeds Castle in Kent, England, and if I had done the work, I would have known about the flock of black swans that reside at this castle. And that is about how I view Mr. Taleb's premise of the Black Swan. I have found markets to be anything but random, and I find many of the future events that are bound to be dismissed as random or explainable only in hindsight in fact can be foretold in time with the rhythm of history. If one does the work.

My father, a mechanical engineer, used to dismiss random chance. The harder you work, the luckier you get, he'd say. I am convinced there is hardly a better rule by which to live. Very black/white, if you will.

The Markets

2008 certainly got off to a rollicking start. For us, it was relatively uneventful, but doesn't reading the financial press lately beat the heck out of any sporting event for sheer Darwinian drama? I know I did not watch a single game of March Madness, even with my alma mater UCLA racing to the Final Four.

According to Lipper, during the first quarter, the average U.S. stock fund fell 10.4%. The S&P fell nearly 10%, and technology-focused funds fell in excess of 15%. Fidelity's flagship Magellan fund was down 12.4%. In the wake of all this, it is worth noting that since the Funds' inception over seven years ago through quarter's end, the S&P has returned less than 0.8% annually.

And then you have the hedgies. Peloton Partners, a massive fund led by a former Goldman Sachs star trader, collapsed. Carlyle Capital imploded after defaulting on $16 billion in debt. John Meriwether, notable for leading Long Term Capital into the abyss, reportedly saw his current fund dive 28% during February alone. Near as I can tell, it was the same sort of trade that did him in. Evidently the secret to raising billions from "conservative" investors such as pensions and endowments is to engage in "positive carry" portfolio strategies that implode every ten years or so.

Banks and brokers have now cut nearly 49,000 jobs, and more cuts are coming as they reorganize and merge for a new paradigm of lower profitability. Need I say anymore at all about Bear? Goldman? Citi? UBS? Geez, the list goes on and the write-downs keep coming. Merrill Lynch is one of the more galling stories. The company started 2007 with $36 billion in equity. Since then it has written down over $30 billion. This is about what they made in the prior nine years in total leading up to 2007, including the dot-com bubble years. Breathtaking.

Perhaps I just do not understand what it is like to live and work in New York City. After all, many apparently believe that we are looking at a bottom in the credit crisis, marked most significantly by JP Morgan's bid that saved Bear Stearns from a truly spectacular bankruptcy. However, consider this exchange on the conference call announcing the merger:

> Merrill Lynch Analyst: Okay, so then just to cap it off, it certainly doesn't sound as if when you went in there you found a massive problem with respect to risk management or hedging. It sounds like given that you're saying that it's very similar to your own, it sounds like you found something that you're fundamentally comfortable with. Is that fair?
>
> Bill Winters – JP Morgan - Co-CEO: That's right. In fact what we've -- we were very pleasantly surprised to see that it was a very well run, tight operation with good risk controls and a risk discipline that was very similar to our own.

Oh, those brainless brainy endeavors…

Equities

I have long discussed the virtuous cycle that propelled home prices higher along with consumer spending. Now it is time for the vicious spiral that inevitably follows such carefree booms. Nothing that got us here is temporary or bound to be short-lived. The loans of 2003-2006 may not make another appearance for decades, and for a society built on leverage, that means something. We have now reached a point where the next step is the consumer stumbles, and the recession, which I believe started last fall, steps down to a deeper and more ominous level. Consumer confidence is currently at levels not seen since the invasion of Iraq - and with much better justification now than then.

I actually welcome this development. It is painful, no doubt, but a deep and lasting recession will be beneficial in the long run, as only such a consequence can scrub the economy of dangerous excesses and reconstitute a healthy appreciation for the riskiness of investments. To the extent bank executives, consumers and investors are bailed out, they will emerge ever more faithful in their greedy attitudes and lazy decisions. Essentially, moral hazard defined. To the extent bailouts fail to prevent unfavorable outcomes on Main Street, attitudes towards investments may be damaged for a period of time longer than anyone currently imagines.

The implications for investments, though, are relatively few and straightforward. Unless one can find certainty in facts that support a case for undervaluation within this paradigm, there is no need to take a position.

Recently, I have found such opportunity in a handful of securities in South Korea that have been severely battered of late, as well as in a Chinese media company and a global internet giant. Such positions amount to roughly one-third of the portfolio. Since last summer I have been favoring investment theses relying on secular growth rather economically sensitive or cyclical stories, and that remains true. As well, the Funds hold two investments in the energy sector, both of which offer attractive discounts to intrinsic value, and several other common stock positions. The Funds are roughly one-fifth cash, and that cash is held largely in foreign currencies.

Again, nothing that got the markets here today is bound to be short-lived. If history is any guide, market participants will not only yearn for the briefest of recessions, the most rapid of reversals in stocks, and the quickest end to the suffocating commodities inflation, but they will also trade accordingly. Furious rallies and subsequent reversals within the overriding trends are to be expected.

On the Valuation of Financial Institutions

Recently, the stocks of financial companies announcing additional write-downs have shown resiliency, often rising on the news. To many, this reflects a bottoming of sentiment in the sector, as investors look forward. However, one must recall that share prices reacted similarly each of the last two quarters in which substantial and sometimes shocking write-downs were announced. This perhaps reflects investors' memory of the terrific returns provided by these companies not so long ago, as well as their greed and their fear of missing a bottom.

Yet, it is worth considering what these companies look like when we look forward. Great difficulty accompanies any effort to value financial institutions today because share counts are in the midst of repeated dilutions due to emergency capital injections. With final share counts truly unknown, and capital adequacy still not fully addressed, a conservative approach to establishing even a market valuation is problematic.

Too, the perplexing size and serial nature of the write-downs at nearly every major bank and investment house globally is matched only by one's wonder at the source of the write-downs. Many of the risky structures and investments that caused these problems were never disclosed in regulatory filings. Investors unfortunately have had to learn new acronyms, such as SIV or ARS, at about the same time the structures behind these acronyms were being blamed for significant write-downs. In many respects, the quality of financial statements is every bit as inscrutable as those of Enron circa 2001. We should consider that for three quarters now, the executives at these firms have had every incentive to kitchen sink the quarter, and yet they keep finding more kitchen sinks.

The difficulty in evaluation does not end there, however. The fundamental nature of the American financial institution is evolving into one with commoditized business lines and lower overall profitability. This is especially true for banks, but brokers and investment houses will feel this same pinch. Since the early 1990s, when write-downs paved the way for supranormal returns on equity in a new era of off-balance sheet leverage, these institutions have earned outsized returns on equity capital employed. Even as the dot-com and telecom bubble burst, Wall Street pushed forward with ever-more creative use of derivatives in exotic credit structures that few could understand, but that would nevertheless become major contributors to these firms' outsized returns. Valuations of course followed.

Less leverage and lower returns on assets are now in the cards. Today's higher risk premiums and illiquid markets in credit will provide short-term gains for the more entrepreneurial firms, but the longer-term trend appears set. Any investment thesis in these companies must therefore be based upon modest returns on a substantially reduced equity base. I imagine the shares of these companies, in most cases, will become very boring before they become attractive again.

Basis for Concern, Revisited

> When home prices begin to fall, a natural level of weak support may develop around a loan-to-value ratio of one. That is, when equity in a home approaches zero, the homeowner ought to become reluctant to sell. History suggests any such strategy should prove foolhardy. Trends in housing tend to be long and headstrong, and hence not easily resisted…The development of significantly negative home equity among the same homeowners that also comprise the world's most voracious consumers would likely trigger several economic problems…banks would become reluctant to lend to home buyers. The effect would be to contract the credit available to would-be homeowners and therefore severely undercut the main late-cycle driver of demand…These problems would compound the worsening domestic employment situation, further reducing demand for residential housing and thereby producing the requisite positive feedback loop that historically has allowed burgeoning asset deflation to accelerate. As the real estate deflation wears on, it would not be unreasonable to expect that unemployment-induced income shocks mix in toxic fashion with the comparatively high mobility tolerance of the United States citizenry, motivating homeowners to start sending their keys to the bank in ever-increasing numbers. Many banks taking possession of increasing amounts of real estate will ultimately fail themselves. A catharsis could then take shape, and home prices would leg down yet again. After much pain both despair and disgust will settle in, and a bottom would begin to form.
>
> -Scion 2Q 2003 Letter to Investors

Consider it revisited, and affirmed.

Commodities

The Fed is being creative. I'll give it that much. But it would have been so much easier to have nipped all this in the bud. Now, they just invent one method after another of printing dollars. So carefree are policymakers about the dollar's plunge that I wonder if even the Fed realizes that it took 700 ounces of gold to buy the median home in the United States in 2001, and now takes only a little over 200 ounces of gold.

While many see a commodities bubble, I see a federal mandate to inflate commodities prices in dollar terms. The recent collapse in some commodities prices along with a strengthening dollar does little to dampen my enthusiasm for the sector. I fully expect such volatility along the way; that is the nature of the markets. In fact, the Funds established direct commodity exposure through futures contracts during the recent pullback. At recent prices, the total value of futures contracts amounted to less than 15% of the Funds assets.

It is an entirely reasonable argument to note that as the world slows down, other countries will start cutting rates, making the dollar relatively more appealing. As commodities have been the prime beneficiaries of a weak dollar, this improving state of the dollar would result in poor performance for commodities going forward. However, we must remember that the United States is the largest economy by far, and it has the most leveraged consumers by far. The primary cause of the rest of the world's ills will be secondary effects of the slowdown in the United States. Every other country will have some degree of strength derived from domestic and other non-US sources. At the end of the day, the credit crunch hurts the United States more than any other country. The sickest patient will require the most aid, and I would expect that aid will come in the form of Federal policies that hurt the dollar's value over a longer time frame.

Credit Derivatives

The Funds portfolio of credit default swaps on the subordinated tranches of subprime mortgage backed securitizations has been reduced to an insignificant size. Only three such contracts remain in force. I do not expect further meaningful impact on the portfolios from this sort of trade.

The Funds continue to maintain a short position amounting to roughly $750 million notional in corporate credits, concentrated most heavily in firms involved in one form or another of mortgage insurance. Late in 2007, I had reduced the positions to include mostly only those that I felt were most likely to default. Should these positions fall to a zero valuation, Scion Qualified Value Fund would lose about 19% of its value, and the Scion Value Fund would lose about 15% of its value. There remains substantial upside should one or more of the companies underlying our credit shorts encounter more distress or actually default.

Blue Ocean Re

Blue Ocean was set up in late 2005 to take advantage of an extraordinary pricing ability in the retrocessional reinsurance space. And. as Blue Ocean Re was conceived as a two year vehicle, much has gone according to plan. At this point, the investment in Blue Ocean Re has largely been wound up. We have received a significant amount of our initial capital back as well as some profits, and I expect additional distributions of capital and profits to be made during the remainder of this year.

Symetra Financial

As mentioned previously, at the request of greater than 40% of Symetra's shareholders this past June, Symetra Financial announced that it will register its common stock for a public offering. The IPO has now been delayed due to market conditions. Symetra's business itself is performing well. Of course, when full liquidity becomes available, the side pocket will terminate and cash and/or securities will be distributed back into the Funds. This investment has proceeded as expected since inception.

Audits & K-1s

I must point out the terrific job done by the Scion Capital back office this year, as our K-1s and audits were completed in timely fashion. Our COO and General Counsel Steve Druskin and our CFO Zaeed Kalsheker led the back office through a grinding, top-to-bottom reorganization over the past year that has put Scion back on firm footing. This was no sprint, and, as with most Herculean efforts, it is too easy to understate the accomplishment in retrospect. I trust investors have noticed the improvements.

Administrative Matters

To start the second quarter, the Scion Qualified Value Fund held $612 million in assets under management, and the Scion Value Fund held $133 million.

Scion Capital employs Citco Fund Services as the third-party administrator for the Funds. For capital account balances, domestic investors should contact Jennifer Winter in San Francisco at (415) 228-0390. Offshore investors may contact Carl Brenton in the Cayman Islands at (345) 949-3977.

Please contact Scion's Investor Relations Manager Sandy Hawkins with any questions you may have regarding your investment. Sandy's e-mail is shawkins@scioncapital.com, and she can be reached at (408) 441-8400.

Sincerely,

Michael J. Burry, M.D.

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The performance data in this presentation is intended to show the performance of the Funds over the periods indicated. The performance results reflect realized and unrealized gains; the reinvestment of dividends, interest, and other earnings; the deduction of transaction costs and all other fees and expenses, including a 20% performance allocation. The actual performance experienced by any individual investor may differ from the performance shown due to, among other factors, differing fee structures, the timing of the investor's contributions or withdrawals, and the investor's participation in any side pockets. The "Since Inception" returns were calculated by geometrically linking the annual returns. Performance allocations are calculated and accrued annually and generally are not finally determined until December 31 of each year. However, for purposes of this presentation, for each period the relevant Fund's return is calculated as if the performance allocation was calculated and accrued as of the end of that period. The performance data for recent periods has not been audited and may be adjusted as a result of a subsequent audit for the year of which those periods are a part. Past performance does not guarantee future results.

The S&P 500 Index is a broad-based unmanaged index of 500 U.S. stocks that is intended to reflect the risk/return characteristics of the U.S. large-capitalization equity market. Performance data for the S&P 500 Index was obtained from publicly available sources. The presentation of index data does not reflect a belief by Scion that the index is an alternative to the Funds or comparable in any way to any fund Scion manages. That data is included only to provide some indication of the performance of U.S. and global securities markets generally during the periods for which the Funds' performance data is presented. The indices are unmanaged and diversified (across companies, industries and sectors), while Scion may concentrate the Funds' investments in a relatively few stocks, industries, or sectors and may invest in stocks with smaller or larger market capitalizations and trade actively.

Michael Burry's FCIC Testimony

FCIC: The FCIC, the statute that created us tells to figure out the cause of the financial crisis in a whopping 18 months and tells us to look in various areas including securitizations and derivatives and that is why we are talking to and getting documents and information from various issuers, various hedge funds, various collateral managers, and et cetera, and you are one of the folks we decided to talk to because we read about you in "The Big Short." And we saw your appearance on 60 minutes. So thank you for coming in and what I wanted to do first that I do with everyone is can you just give me a quick background really quickly from college forward and after your attorney makes a statement.

MB (Attorney): No, I don't want to make any statement. Can we just identify everyone?

FCIC: Oh, Sure. Let's Just Go Around

I'm Sarah Knaus. I'll be taking the notes today.
Donna Norman.
Greg Hilbert
Jay Lerner
Jay Coolie
Dixie Newman.
Kim Shaffer of the Structured Products Background (inaudiable).
And, Tim Colman, Mia Havel, Jonathon Wear, And you know Dr. Michael Burry.
And Everyone here is with the FCIC.

FCIC: So with that, just give us your background and from college, educational background from college and work background.

MB: So, sure college was under-graduate at UCLA and I had a bachelor's of arts in economics I then preceded to the Vanderbilt school of medicine for an MD. I did a year of internship in internal medicine at the University of Tennessee hospital, and then I spent two years doing residency at Stanford hospital residency. After which I started Scion Capital which is (inaudible) was a hedge fund firm and I ran that until 2008.

FCIC: Um… OK we've had a chance to look at some of the documents which you've sent us and we thank you for those and what I'd like to do first is can you just walked me through the columns on this so that I know I'm actually reading it correctly? So if you could just identify with the various columns mean…

MB: OK, so intech steel. Intech is a data provider for these mortgage pools and this is just an Intech deal number was really important is that last part that nine and seven that tells you that tranche deal it is. So these are RMBS, residential mortgage backed security. Most securities have a cusip number and so do these. Deal issue date that's the date the deal was born. Again a lot of that is self-explanatory I think. Original certificate face value: So, that relates to tranche over here. Let's look at just the first line that's easy. M9 and nine was probably the BA2 or the BBB Minus Tranche. That troll much of this deal and original certificate face value of $11,968,000.00. How much more do you need?

FCIC: That's enough for now. That Column.

MB: Current certificate balances as of the date and these are of the date January 4 2007. As of that date the current certificate balance is the same as there's been no write-downs or changes in the amount of the certificate. So signed original total combines additional exposure so, originally when we first participated… purchased protection on the nine tranche of this deal we purchased $10,000,000 worth. And as of January 4, 2007 in the next column: H we still have $10,000,000 of protection. Again, that's notional exposure, that's not actually what it's worth; notional exposure protection or value protection. The total original loan balance and that's the total number… the total amount of dollars of loans and the deal and not just the M9 tranche that would be something approximating the original certificates face value.

FCIC: Isn't that the same as the face value of the entire securitization?

MB: Not necessarily. The total current loan balance as of that date is $429,028,969.00 So, the deal overall has been paid down typically through they refinanced it so you get the payments. So that's where the deal stands. The tranche is um… the current balance is still 11,968,000.00. But the whole deal has come down some. So the um… Then there is counterparty position and so… their abbreviated, so in this column its fairly self-explanatory like the major dealers on Wall Street so now that's MS is Morgan Stanley, GS is Goldman Sachs, BARC is Barclays, ML as Merrill Lynch, B of A. I'll go through them. A lot of those same…

FCIC: Sure. So these are all CDS positions?

MB: So what these are … These represent the… This is data regarding the tranche in the deal that was shorted and you can see over here in the counterparty position where is says GS-10. Let's look at the column… or rather row five, column K. It says barc dash five, ms – five, GS – 15. Oh so our exposure there is actually 25,000,000 and it's split up five million and Barclays five million and Morgan Stanley 15,000,000 in Goldman Sachs. So those we different positions obviously so it's not that these are each one of our positions because we have… within each one of these we could have multiple positions.

FCIC: Right but for example on the first one for the first Goldman deal listed on the sheet it means that you bought $10,000,000 CDS on the M9 tranche, right?

MB: We bought a credit default swap for protection with notional value of $10,000,000. So we didn't actually paid $10,000,000.

FCIC: I understand. And, there is nothing on the sheet that says what the premium payments were correct?

MB: Right, right.

FCIC: OK and I'd take it that when we see more than one counterparty listed that means when you originally purchased the protection you purchased it from three different counterparties?

MB: It could've been that… no not… Typically there would've been different dates from when we purchase those.

FCIC: OK, I'm sorry, what was the question again?

FCIC: For example on the one that we're talking about in row five? With Barclays five Morgan Stanley's five Goldman Sachs 15 my question was does that mean on May 5, 2005 that you bought $25,000,000 worth of protection on that tranche with the three entities? And the answer was not necessarily could've been a different case. And that was a correct re-summary of that right?

MB: Yes.

FCIC: Um, and then everything on this sheet is credit default swap position?

MB: Right. These are all credit default swaps position. These are all representative of our credit default swaps positions.

FCIC: I noticed that this sheet as of January 4, 2007 and I've had a chance to go through your most… Most of your year and investor letters and it looks like everything if not close to everything was closed out. And I know your fund doesn't (inaudible)

MB: I think they know what you're getting at. We gave you this because this is our peak exposures so, this would have everything before we sold anything. And then as of today there's nothing left.

FCIC: OK. And then, I'm assuming that this is (as I'm interpreting it) but those are just a list of the main folks that you dealt with at the various counterparties as you've purchased CDS?

MB: Roughly. Yeah those were the main ones. The main ones are on here.

FCIC: Ok Um (inaudible) And I know from looking ensure investor letters that at some point you hired some folk to work with you at Scion. And were you the one dealing with the folks in Morgan Stanley, Goldman, B of A, and Merrill Lynch or were you or your people(inaudible)

MB: Well there (inaudible) We had (inaudible) there were two functions. I dealt with the training, selection, and research but I did have back office staff that dealt with the collateral, and interpreting the daily marks and things. So it wasn't just me. I did have I think three others working on the back office functions just maintaining the portfolio and that sort of thing.

FCIC: Ok, you didn't submit, and I don't think I want it, but can you explain to me generally the documentation that would be created to do a transaction?

MB: Well generally I would agree to a trade over the phone and then will we would be faxed a term sheet and a term sheet would summarize the trade and I'd had led by back office know what I had done. They would confirm that the term sheet reflects what we actually did. And then we would agree to that and then those term sheets would get filed and we have a lot of them. On the back office side (which I didn't get involved in) there was a daily computation of collateral and I don't know all of the different paperwork that they created and calculated and all of that so I don't know where to find it really. But, I'm sure they create spreadsheets for that sort of thing.

FCIC: But as far as documentation for you, I get the term sheet(inaudible) Is there an actual contract?

MB: before we do the trades, we agree to an instant agreement and there's an annex to that. And there's a master to the annex, so there's actually a couple of agreements. But it's basically an agreement between us and our counterparty. And it governs not just these trades, but the general swap trades of that counterparty and the derivative trades of that counterparty. It could govern a lot of things but…It's a credit agreement between us and that counterparty and we negotiate that agreement. The terms sheet that it inevitably refers back to (inaudible)

FCIC: And I apologize for not being in the business and understanding the stuff, but is the term sheet different than the annex?

MB: Yes, that's all different; I didn't mean to confuse you.

FCIC: It won't be the last time. (Laughter) OK so there's one or two master agreements between you and each counterparty?

MB: There would be one for each fund. So every fund is its own LLC and we had four funds. But essentially it's the same document.

FCIC: Standard agreement?

MB: Not very standard. We negotiated specifically to protect ourselves

FCIC: OK. We'll let me demonstrate my ignorance again is there just one annex or is there an annex for each deal?

MB: Yeah(inaudible) NO. It's not for each deal, again there's just one annex. Every time we do this the only document that's created is a term sheet.

FCIC: OK. So then for each agreement there's a master sheet, an annex, and then term sheets.

MB: Right.

FCIC: OK. I will think about whether not we wanna get those.

FCIC: Is the term sheet just the confirmation?

MB: Yes. It's the same thing, so, sure.

FCIC: It's still a binding contract once it's finalized?

MB: Right, it's a confirm.

FCIC: Is there anybody besides Justin Green and Veronica Grinstein at Goldman that you were dealing with? Or that you recall?

MB: You know, Veronica was who I was dealing with, she was my main contact their and she was the front end sales person at Goldman. But there were numerous other people that came through the picture but they were people that I was dealing with them and continuous basis; Justin that was her assistant.

Actually that's just how I perceived it, I don't know if that is actually true. And, so he was always kind of helping out with Veronica. But I can't think of anyone right now, I don't remember anybody else that was significant as those two in our dealings.

FCIC: Ok, So I have a vague recollection from the Lewis book of that there may, at least he wrote, that there may have been some issues on the collateral posting when the economy starts to go south and things start looking good for you guys. On the CDS was that the case?

MB: What time frame are you talking about?

FCIC: I think probably '07. I'm looking at your investor letters; the end of 06. In terms of the position of your CDS, it looked like 07 was the first year that started to go good for you guys.

MB: The first year that started to go good for us was February of 07. Then really start to go good for us and unfortunately for a lot of people in June and July. So we did have, and not just with Goldman but with all of our counterparties, we (I call it prosecuting our marks) we would … earn about the daily values I bought with our counterparties quite a bit over the years. And there were a few times that stood out in terms of… A few time periods that really stood out. In June, after the Bear funds failed, the middle of June was a time that really stood out. Even with our relationship it stood out.

FCIC: My recollection is that the bear funds fell in July, but is June the time frame?

MB: I think it was (inaudible) Maybe I'm not recalling it correctly. I thought it was (inaudible) I thought there was something happened in early June.

FCIC: I take it the dispute was with the counterparties was, "Hey your marks aren't low enough, you should be posting collateral for us?"

MB: The argument was actually the… We have some communication difficulties with the counterparties over that summer. Specific dates I don't recall but um, there were… In regards to our agreements, the valuation dates daily at the end of the day New York time. And per our agreements the collateral movements needed to occur as of the valuation date. So we required daily collateral valuation back and forth. Which, when we negotiated it, was not very common, but that was a big point for me. A daily collateral flows. And so we monitored the market mainly through the indices and as a fairly opaque market. As a for instance if our marks were being let go or we are receiving daily marks or we thought that was moving in our favor, we would attempt to be sure that we were being marked fairly so that we could collector collateral. And so that was the nature of that. Sometimes it was about where they would mark us down, our positions against us when the market would seem to be going in our favor and we would protest. There are variations on this but, you know, I would give directions to the back office sometimes to let it go. It would work out. Other times I would say don't pay collateral were going to find out what's going on. So that's what… That's kind of the nature of the dialog.

FCIC: So the communication problems I mean I don't(inaudible)

MB: Yeah it was that the… we did receive excuses from different counterparties I think a Morgan Stanley, Goldman, and B of A all had what I viewed as dog ate my homework kind of excuses. Power failure, systems failure, and stuff like that and that irked me at the time and led me to…actually consider (inaudible) So, my fear was that… The reason that I demanded daily collaterals is because I thought to these could disappear very quickly overnight and it was protection against… It was me protecting against counterparty risk. And so my antenna went way up when they started delaying or sandbagging on marks and when they started looking into the conserving cash. And so we would react to we didn't get a response but I would come to some conclusion and my letters.

FCIC: Do you recall when you first negotiated the master agreements with these various banks?

MB: It was over the period from 2003 and even up into 2005 with the various banks. I think it probably had seven or eight agreements when it was all said and done and we did them at different times but it was basically from 03 to 05.

FCIC: Was there pushback on daily posting collateral requirements and if so by which counterparties?

MB: For the trade that you seem to be most interested in, Morgan Stanley was the one that really protested the daily and this is RMBS and CDS. They really thought that we're the only fund doing this to them and it was a burden on them and that most funds would be happy and that they actually only do it every month so we're just being a big headache to them and that sort of thing. We only had so much authority there, but we attempted to push it. But I think for a while there we actually said "OK we'll lay off. We want the values every day it will take collateral every week."
In negotiating this, I was negotiating as a new…. a fairly new hedge fund. And, I was a Physician with no prior experience (seemingly), so the negotiations were difficult and there was tremendous pushback as I attempted to get terms similar to what they would offer their better clients. So..

FCIC: And just so I understand the collateral posting terms are in the master agreement?

FCIC: But it was the daily that was unusual? Because even with their preferred clients they wouldn't usually do a daily…?

MB: We were told that the daily was unusual. Another one was with the Deutsche bank, but that was right at the beginning we actually… Deutsche bank fired us a client right in 05 because we were too aggressive in prosecuting our marks. So, we retained the positions with Deutsche bank we didn't do any trades with them at their request because the daily valuation and daily collateral was just too much of a burden for them and they said as much.

FCIC: Were there are other things that you wanted to say about the master agreement?

MB: So, there's something in this agreement called additional termination events or ATE's. One of those is the NAV. So this is the protection, their protection, against us losing assets and becoming a less creditworthy counterparty. Those were typically pretty narrow. You lose 10% and you're pretty much done. There was a monthly, quarterly, and annually NAV declines that could trigger these additional termination events that would allow them to tear up the contracts.
So we negotiated and I presented evidence that they were a volatile fund that I fully expected the volatile flows and we got much wider NAV triggers. The other thing that we negotiated on that was significant was the minimum transfer amount and threshold amounts. The idea being that … For instance Goldman originally said if you owe us 100,000, you need to send it. But we don't need to send you anything unless we owe you 25,000,000.

FCIC: Was at the numbers for the 25?

MB: I don't know about the numbers but it was small and the 25 I know. That was an extreme example but that's generally how banks approached us. But I wanted us to be equal or close to equal. If it was 300 are 500 that'd be OK, so we negotiated until we got close to equal. And I wouldn't enter into it unless they got close to equal. So, those were the two in addition to daily those were the two that we negotiated on pretty hard. For the spreads, I think it was 15, 30 and 40. 15 in a month, 30 in a quarter, and 40 in a year. These are percentages. It wasn't just performance; you could be performing fine but if you lost half your capital through withdrawals… It wasn't really a measure on performance as much as it was a measure on how much capital you had to back up this trade. So, and the other thing that was an issue that we couldn't change was the valuation agent. So the valuation agent was set as basically the dealer. What it essentially says is the dealer is the valuation agent and whatever the dealer says is the value is the value. That really didn't come into the negotiations so we accepted that for our fund accounting as well.

FCIC: Was that not part of the negotiation because the bank said, "Look this is it take it or leave a term," or did you try to change it?

MB: it was not part of the negotiation, and I think I was aware that time there was no third party in this market. This is an opaque, nontransparent, illiquid market. Possibly some of these things that I bought would never trade again until I sold them. So there's no good third party. You need to rely on something. I could rely on the model that I could create but I wasn't going to do that. So I relied on the dealer's and the valuation as just about everyone does.

FCIC: and when you say the dealer to that mean the actual counterparty?

MB: Yes.

FCIC: So each counterparty for each CDS was the actual valuation?

MB: Yes.

FCIC: So was there a mechanism if there was some sort of dispute in those marks?

MB: There was. Yes.

FCIC: Well what was it?

MB: It was in our terms sheet. It wasn't specifically RMBS or CDS agreement; it was a general dispute agreement that was required to go out to four neutral parties to get evaluation on the security. And then if you can't find four, what they say goes and that's the resolution.

FCIC: If you can't find four, what they say ….they being the dealer?

MB: Yes.

FCIC: Let me just interject with something because I think this is a very complicated dispute resolution provision. When you say four neutral parties, is the term reference market makers?

MB: Right.

FCIC: And that means, generally speaking…?

MB: I wasn't being very clear there are so… You had to find for essentially reference market makers or established market makers to provide quotes and obviously when it comes to RMBS there is no such thing. So, the dispute resolution was pretty much you set the value, we protest, and you set the value and that's pretty much how it works.

FCIC: So these marks then, I think you probably already answered my question, but from other folks and we heard about you do the dealer pole and then, here's our bid and then will actually do the trade at that price. Maybe that then didn't make a difference given the illiquidity… where you were buying the CDS on, but was that part of that deal in your contract?

FCIC: Would you then discussing evaluation issues get into different assumptions arguing about delinquency, recovery, payments, any of that? Would you be arguing those numbers or were you just like come on 90 or 70 or 20…?

MB: Absolutely, you have to break it down into the components. The discount rate has been low for a while. The one that is problematic for me was the CPR or the prepayment speak. Which itself was a calculation but, the idea that…. So… Should explain that or… While you know it so?

FCIC: I actually didn't do mortgages…

MB: Well …the value that…what goes into the value of the contract that we've entered into really… All have to explain it. A corporate contract … what goes into a corporate contract is… you enter into a five year contract so say you entered a five year contract you know what you paid, you know what the premium, is you know how long it is, you know what the interest rates can be … you configured out. So you have the market and you can figure out what it should be. So with the RMBS there is obviously prepayment. Nobody knows what the term is. The stated term is 30 years, it will never get there. So something called a spread duration call were basically the duration of this contract is going to be determined to a great extent of the prepayment speed which is commonly called the CPR so the value changes dramatically if you have say a 45 CPR and the spread duration has to be 2.1 years or something like that. But if you move that to 85 the CPR rate than the duration crashes down. So that obviously affects the value; when the duration falls the net present value falls. A so we would argue on this quite a bit as were practiced your calls. And again there's nothing we could do if they moved it to someplace I didn't think was appropriate.

FCIC: Would they argue that, "Well the implied CPR from ABX is 'this'," or were you arguing security by security for different CPRs?

MB: well it was tough because I was … Will I think it was the first to trade these so my mortgage portfolios were maturing at a different speed than the regular markets. So with the indices there are these things called recovery locks, and they are actually markets and recoveries and things like that. And there's actually a market for CPR and there's markets for all of the stuff. So the problem was that, the our contracts were earlier than what most people saw with the market. For instance the ABX 06-1… The ABX indices the first indices were actually 06- indices. And that was already nine months after our first trade essentially. So I didn't think that going to the market was really the way to evaluate this. You know, come '07, this was already a 24 months. So the CPR rate for that month…if you just look at that month, the 24th month or the 23rd or 24th month on a typical arm with a two year teaser rate, that is going to shoot up in those couple months. So in any event the CPR rate on our underlying reference securities were just different than the market generally showed. So you had to argue I know what it says but were on the 24th month in a 25th month that goes… So those were kind of the valuation arguments that I had and I would handle this if I understood it better.

FCIC: There's no reinvestment in RMBS correct unlike a CDO or…?

MB: I didn't deal in CDO so I don't know

FCIC: Were your securities that you shorted… Were the trusts' of the securities able to reinvest in other mortgage is if they were to experience a lot of the prepayments or were they just lying down?

MB: Essentially no. For reasons of fraud if they can replace mortgages at the beginning in the completion of six months, but the trustee your servicer… but not for prepayments. They had something called a step down mechanism for handling that to keep the reinvestment risk to a minimum for the seniors and for the senior tranches in the pool. Some anyone that's pretty interesting…

FCIC: So when you're having these disputes with whiff of the various counterparties up let me ask were there certain counterparties where there were more disputes with than others?

MB: On the baseline we fought with them all. I think that we actually found Morgan Stanley to be the most difficult to deal with. Obviously we ended up giving them weekly evaluations so a… Goldman and B of A both … There's really different reasons. Goldman and B of A … Well Morgan Stanley would often stalemate our portfolio. They wouldn't change our marks for a long periods of time and that was hugely frustrating for us especially once we got into later of '07. Then we started to wonder about their security as an entire company.

FCIC: I thought that started to…

MB: Well, what I'm talking about is this problem of stalemating… We gave it to them every week I think somewhere in the summer of 07 but that stalemating was a problem for them for… Throughout the trade with their trades with them. And again even if you go five days before you know we wanted the valuations every day we want to transfer collateral. It gets complicated and how they move it every day they tend to move it with the indices every day and if they don't move it with the Indus see in our favor and the next day they moved when the indices are not in our favor and they keep doing that the eventual effect is harmful to us so. We were interested in getting those valuation confirmations every single day even if we were only transferring collateral every week. Then there was Goldman a significant… I took it as… Also understand that when I'm dealing with the street I tend to think from a lay perspective that they're all crooks. And I believe the worst when I would see evidence in my portfolio that maybe they were playing games. So I thought that B of A at the end of '06, I thought B of A and Goldman were playing games with their year-end numbers and we could see that in our book. And that's all I can know at that time. And since then things we found out about that period … But at the time I thought what's going on here for golden because that's all I knew. The spreads got ratcheted down significantly and then they got held steady for… And then there was the other period with Goldman, which was a pretty frustrating period in June of '07. But it happened where if B of A that summer and it happen with Morgan Stanley that summer so I'd say was those three. You'll see that those three are our main counterparties too.

FCIC: And when you say that the June 07 time period was frustrating, why wasn't frustrating?

MB: Well the market was starting to move and was represented by the indices and the sentiment and the commentary in the market was that the market was moving and should have been moving in our favor. It seemed that there was a hitch in the marking process and valuating process during that time. So…

FCIC: Did you ever have any discussions with those counterparties at that time about how they were marking their marks. Or those counterparties … were they in short position?

MB: No.

FCIC: Um, when you said the information in your books in the end of '06 time frame indicated to you that maybe Goldman was playing games to make their numbers look better… What you mean by that?

MB: Just that … I can remember the date but it was 45 days before Christmas and there was (I think it was the 21st), we saw our marks of Goldman up take a fall which hurts us and benefits the party and the other side. And it seemed out… really way out of line with whatever was happening in the market. And then after that they just went silent until and through the year end. So I tended to believe that a lot of companies play games to help their year-end some things like that so that's what I thought was happening.

FCIC: And I thought I heard you say too that later on you found out that the additional information about Goldman…

MB: Well it's just common … It's just what's been in the news out know anything specifically…

FCIC: And when you say what spend the news you mean…the decision that they decided to go short tour of the end of 2006?

MB: That's not my understanding. My understanding from the news is that they decided to wrap back wrist in that area. And so now I'm might interpret it that they decided to ratchet by knocking down my marks and holding it steady for the rest of the year. But that's all speculation on my part and just from what I see, read, and hear about in books and things like that.

FCIC: Did you have any discussions with Grinstein or Green in Dec. '06 time period about…? About your concerns?

MB: No. I don't remember very well but I do remember that there was discussion amongst us at the end of the year that it seemed like Goldman taken the last week off… maybe vacation?

FCIC: OK did you know what the time that Goldman's fiscal year actually ended in November?

MB: Yeah I found out later (laughter) …that what I'm saying is that there's things I know now that I didn't.

FCIC: So they were later?

MB: I think that yeah ,What I mean to say is that my original logic for there was probably not right.

FCIC: You know one of the things that we are doing is investigating that type of potential conduct. Are their documents that you guys have that would explain what you're talking about here? Things that say yeah well this is the sheet that I'm talking about. Things that made us question was going on at Goldman in the last couple of weeks and 2006?

MB: IS there a document or documents?

FCIC: Whether it's a financial report of what going on the market versus the marks or email traffic between you and your staff, or email traffic between you and Goldman, you know I mean anything like that that would help us to get a better idea of… Since now your recollection is more than a couple of years away.

MB: I'm sorry I receive most of my information from my back office. So when it comes to the marks I would just get this information from them and again and not super familiar with what documents were produced other than… I mean I was just told what was happening.

FCIC: Generally, communications with the counterparties: phone, e-mail, or other?
MB: Sometimes email, but a lot of phone conversations. A lot of it was time sensitive so get on the phone…

FCIC: Sure, and in terms of e-mail communication, is that you or was it the back office or was it both?

MB: They would have been corresponding, probably not with these people but with Goldman's back office I would imagine. Because they would get their marks via e-mail.

FCIC: So are you saying here's what the marks are?

MB: Right.
FCIC: And would those emails…

MB: I didn't receive those emails but somebody did.

FCIC: People in the back office of Scion got the daily mark emails and those I understand it take it you've seen them before right?

MB: Yeah, Not very often though. I mean if I can recognize it …but no. I probably have seen it before.

FCIC: What I'm getting at is could you generally just explain what was in that document? I'm assuming it wasn't just a number with securities right?

MB: What was in the document was on number, literally. It was this position and this many dollars. So, some kid and spread but mostly it was in dollars and that was with the position was. So you could compare it to the prior collateral position and decide which way to go.

FCIC: With no explanation of methodology?

MB: No not in the daily marks.

FCIC: Does that mean that there was an explanation of methodology in a periodic basis?

MB: This is what I was talking about earlier when I would get on the phone and complain. And I would get responsive onto what was happening.

FCIC: Can you just sort of backup? And I know I've read your investor letters, but generally explain to us which are thinking is and when you first decided that there was problems and housing market and when you first looked into these positions?

FCIC: So is the question when or what made him decide?

FCIC: Both. When and Why.

MB: Let's see… I was… The way that I got involved in housing and all was by… I was a stock picker and I was pretty much a long-oriented stock picker. So, I started looking at home builders which were all in the press and a lot of people were saying that they were undervalued securities. So I looked at them and I decided that I didn't think they were terribly attractive because they were benefiting tremendously from the increase in land values on their inventory and that this was contributing to a great extent on their returns. And it led me to… So I didn't think too much of the home builders and I let them go, but I wasn't really thinking that housing was going to collapse, I just moved on. And in looking at them I started thinking about how housing was financed. This was 2002-ish and I started looking at the mortgage insurers and PMI in particular. Then I compared it to MGIC which is another mortgage insurer and I read their filings. I noted that they were getting involved in so-called insuring negotiation transactions or bulk transactions. So what the time I didn't even know what they were so I said OK what are these and I think I like to study insurance so I did notice that their strength was there typically there line of business to go into the auction basically insured by an auction process that doesn't guarantee them any unusual knowledge that might advantage them in their underwriting. So, I moved to looking at the mortgage pools a star and understand how they work. This was by spring of '03. What it did was it lead me to start getting involved in the credit default swap markets so that's another story but in studying and understanding RMBS, it was an information that I used too much other than to just monitor the market for a while and I actually instead moved to purchasing some credit default protection on some financial companies and that was a result of something else. So 2003 was when I first started and critiqued derivatives and I learned a lot about the credit derivatives market over the year or two leading up to 2005. That's when we did all these and that sort of thing. I was particularly interested in the history of the housing or I should say the history of the derivatives market and how it developed and so that's also another part.

Against the backdrop of what I thought was a very easy regulatory and monetary climate, a team to view the stress free yield and what people would do for yield as irresponsible. And I understand it but it's still irresponsible, and actually thought that the government was acting pretty badly in the late nineties. I think that going back to 97 and 98, I thought that the governor was acting pretty irresponsibly with regards to moral hazard and increasing the risk of giant bubbles in our system. And after the tech crash, 911, WorldCom, the interest rates obviously fell and there was other mechanisms in place as well to put credit into the system. And I noticed that it was affecting the housing markets through the types of mortgages that were being introduced. And so I termed that extension credit by instrument because once rates had fallen by certain level, interest rates for our forty year lows weren't going any lower. How do you stimulate demand? And one way is to create different Mortgage Products that essentially allow home prices to rise? So on the back of this easy credit there's also the whole issue of how mortgages are being originated. Typically through a mortgage broker into an originator in an originate and sell model mortgage originator that would then sell off the mortgages to Wall Street increasingly so.

I saw all kinds of problems with agency risk, moral hazard, and adverse selection throughout that entire process. And when you pile all these things up, what I came to worry and have significant worries about the housing market in '03 and that's when I turned to investors as a basis for concern. I didn't think that or warn that these were multi decade cycles or that we shouldn't jump to any conclusions. By 2003 I saw the introduction of interest only mortgages and I watched those with interest as they migrated down the credit spectrum and into the subprime market. And when they had migrated down the credit spectrum about as far as they could go down … other products were created. Notably, in my view, the option arm for negatively amortizing a mortgage; which I viewed as the most toxic mortgage that could ever be imagined. And, I thought at that point since home prices had been rising at a rapid rate, essentially on the back of easy credit with no accompanying … virtually no accompanying rise in our wages or incomes… that I came to a judgment in 2007 (2 years hence so it would be a final kind of judgment on housing).

Those people seeking out those two year arms seek to go refinance. So I was watching these mortgage pools, and it came to a point where I paired my understanding of the derivatives markets to what I saw in the mortgage pools. I called up Deutsche Bank and asked if … well actually I thought that they would start trading RMBS and CDS fairly soon. Based on the history of the development … because I had derivatives. There's CDS on corporates and it just played out over the 3 or 4 years. After the whole thing with one of your main members where it got shotted down and the whole commodities modernization act and all of that … You had this play out where at that point you're dealing with these off contracts. But once the CDS got standardized, it took off to a point and then synthetic CDS's came around. And then it really took off… And so it made sense that this would happen in asset backed securities to me because you couldn't naturally hedge this. You had a market that was bubbling over and people were going to realize this soon. And you couldn't hedge these positions. If you had a big mortgage book and you were a big mortgage fund or a bank, then how are you going to hedge these positions? So as the original corporate CDS was created to hedge loans at banks, I figured the mortgages books are so important to the economy and to every institution so, it makes sense; the CDS makes sense. So they weren't ready at that time.

FCIC: Excuse me, I just want to understand then sequentially and I apologize for the interruption. But, you were expecting … you were at the forefront of the shorts but you were expecting that there would be demand for going shorts by buying dealers? Or by investors and mortgages? By Whom?

MB: By anybody looking to hedge. So, hedge funds with DAR issues. Banks, mortgages, and certainly some of the banks with mortgages …

FCIC: So anyone with mortgages?

MB: Yes anyone with mortgages but that was an awful lot at the time. So I thought that there would be demand for this so that's when I called Deutsche, but they weren't ready yet. They didn't have it available. So, I told them to call me when they did.

FCIC: Is this like mid – '05?

MB: March of '05.

FCIC: Why Deutsche Bank?

MB: Deutsche Bank was the one who.. It's a good question since we weren't trading with Deutsche Bank. But, Deutsche Bank, I was actually talking with Angela, my sales person, and she agreed to put me in touch with their trader. It was some guy named "Rocky" that she knew, and I only talked with him once; that one time. But he's on that sheet. But this guy Rocky was a senior trader at Deutsche bank, so I always had a good relationship with Angela, even though it fell apart. So I asked her, "Hey Angela, what do you know about this? And have you heard about it…?" "No, talk with Rocky." And when I was talking with Rocky, I heard, "Oh they're doing it one offer, but nothing is standardized." He can do something for me, you know maybe we can get something together and maybe we can do something … but it's not going to be a standardized term sheet or a standardized contract that's really tradable amongst all counterparties. And I didn't want that. I wanted something that was freely tradable, there were no baited amongst counterparties. So, we couldn't do anything at that time so I just went on with my other stuff.

FCIC: But may I ask, you said … I noticed that Deutsche Bank isn't a counterparty to any of the trades that are on the Scion of ABS portfolio spreadsheet here, is that …?

MB: Which Bank? Deutsche Bank?

FCIC: Deutsche Bank, right.

MB: Right.

FCIC: So you didn't do any of the mortgage related … CDS trades with Deutsche Bank. With what you were talking about earlier were different trades with Deutsche Bank where they fired you as a client.

MB: Yeah, so those were corporate CDS trades. But, you're bringing up a good point. So, this does not have our Deutsche Bank trades on it; because, I sold them to Gregg Lipmann in late '05.

FCIC: So this only has … the listing that we are talking about only has trades that existed as of January 4th2007? Those that were still on the books?

MB: Well … that is correct but there's only one set of trades that are not on here. There's 60 million notional that we did with Deutsche Bank that was off our books by late '05. So I'm sorry about that, I had actually forgotten about that.

FCIC: Everything else is on here?

MB: Yes.

FCIC: OK, So we've seen some (or I have at least seen) your investor letters and a sort of a supplement explaining securitizations and subprime. And we are interested in talking to folks in their views that saw the market before others… Is there other writings that you have in terms of showing your views on the market in the early 2000's other than what we've already seen that you've produced?

MB: No.

FCIC: Your investor letters were quarterly?

MB: Yes.

FCIC: Um … as you're coming up with your views throughout the two thousand three, four, five, six, seven – timeframe, are you talking to other investors that are taking positions like yours? I don't recall that at least from Lewis' book at least. I recall people in that book that are taking short but I don't recall them … I don't recall anything in that book where you talk with other folks that have the same views and they're making the same trades because of discussions with you or otherwise.

MB: Right, No.

FCIC: Excuse me. Are you reading street research about mortgages and disagreeing with it all? Or finding any of it interesting to you?

MB: No.

FCIC: I take it that you've read <u>The Big Short</u> (laughter).

MB: Yeah … Yes.

FCIC: Well we're not going to go through it but just generally, anything in there that struck you as wrong in terms of how it describes you in that book?

MB: You know … I'll preface this by saying in just reviewing it lately I have read it once and I don't remember it very well. But I was reading some just today and I was going, "wow I don't remember reading that…" So there might be a few things. But, I think that, ugh, I work with Michael pretty closely as making sure that he had the story. What he put out there seemed to be pretty close to what actually happened. My wife liked it (laughter all) so it's one of those things that struck people as true. People that knew me said that seems right and I certainly felt that it was a pretty accurate portrayal.

FCIC: Any discussions then with any of the other folks in the book?

MB: No.

FCIC: Either before the book came out? And I mean when I say any of the other folk like whether it's Mr. Eisman, whether it's any of the three from Cornwall… ?

MB: I think that I've only spoken with … I didn't hear of any of these people before. I never heard of any of them before except for Gregg Lipmann . So Greg Lipmann I spoke with in November '05. And then there's Eisman, where I just had a brief "how ya doing?" call after booking. Nothing subsequent.

FCIC: But when you did the trades with Deutsche Bank to begin with, you didn't go through Lipmann…?

MB: No.

FCIC: Well then, did he call you and say, "Can I buy back these positions for Deutsche Bank?" How did that happen? Did you contact…? I mean how did you guys…get in touch with each other?

MB: OK, Lipman actually reached out to me at the time as if we had interacted before. I didn't remember interacting before. And, he was interested in buying back the positions with Deutsche Bank. And he was interested in buying … and wanting me to present the rest of my portfolio to pick through. You know, then I just said no, and that's pretty much the extent of it.

FCIC: How did he know about your positions to begin with? Did he tell you?
MB: You know I have no idea how he knew that I had positions. I think that we had about a billion short at that time, and I had no idea how he knew at that point.

FCIC: Did he have an idea (inaudible)?

MB: I don't recall. But I had no idea how he knew because these letters didn't go to the trading side or counterparties. They just went to the credit side, and they weren't supposed to be shared. But, I assumed he had gotten my letters or had heard about me marketing, or something like that. Speaking of, you asked earlier about Deutsche Bank and why would they deal with me; they didn't cut me off until after we did those RMBS trades. So, yeah it was June 2005 was when they cut us off, after May 19th 2005.

FCIC: So your 2007 annual letter says that you've gone from like radically reduced your position from $6.7 billion in late 2006 to $800 million. Earlier I asked you and you said there's nothing there now. When were all the positions closed out by? Do you recall?

MB: The RMBS – CDS stuff, by (I believe) the first quarter of '08… probably by March of '08.

FCIC: So do you recall if you had any CDS with Goldman in the third quarter of '08 when AIG goes down?

MB: RMBS – CDS?

FCIC: Anything.

MB: I don't know if we had any corporate or sovereign CDS. We may have … but it would have been very small and it would have been residual type positions. RMBS – CDS we wouldn't have had. But to be clear we sold off all … we ended up trading out of all of our positions except for two. And, we actually held them just for spite. Just to show that they go to zero. So they went to zero when… It's funny about the way the contracts are written. It's in the book as, what happens if the written back up and we're no longer around but nobody cares.

FCIC: Right, right, right.

FCIC: So obviously we're looking up how, different factors might have contributed to the financial crisis. Because of your involvement I guess I am curious as to what your net verdict is on the derivatives market. You said deregulation of the CFMA was a factor. How did that contribute to the mortgage bubble?

MB: Well … I think the mortgage bubble was not a function of derivatives until the last year or so, in my view. I think that derivatives were a huge problem that were run by a bunch of 30 year olds, and there was very little gray hair in the whole process. You know, maybe later on. I think that if the market was properly regulated at the beginning, and that act hadn't been passed … I don't know if the CFTC is the one to do it, but if the market was properly regulated it never would have grown like it did. Unless it was some political appointee running it (which it would have been). But I really believe that we were better off without the derivatives.

FCIC: Are we talking about credit derivatives?

MB: Credit derivatives. Yes. I think that the standardized market for credit derivatives, is not necessary. I think that for parties that want to hedge books, they can do the one offs. But, I think when you make it standardized, it's a slippery slope in general, and people went wild with it. I don't know how much you've gotten into synthetic CDO score where all the structured products that became options on this stuff. I mean it got insane. It was whatever the wizards could dream up and people honestly though Wall Street is smarter than Washington. So, my view is that you shouldn't allow that which you can't regulate or understand. So, I thought it was a huge mistake to see that market for whatever Wall Street just wanted to do with it.

FCIC: But you said one offs would be ok. So still the customized…?

MB: Well I think there's a need … there's going to be a need for. But you know those custom one offs were super liquid between counterparties for hedging purposes. There is an argument to be made that you shouldn't allow what I did. I mean, not that I think what I did is wrong, but it's … you shouldn't allow the naked … and not just the shorting but actually just the accepting of risk derivatively; which is really a big problem. Because, you know, when I did the shorts I was mostly putting on the position of mostly hedgers that were really doing it. But there were people on the other side who were eating up just everything and they were looking for whatever and this was an easy way to create something out of nothing. And so Wall Street did. I think it's a catastrophe, and I think it was preventable. There were rules that I wrote about in my letters. And while I don't remember them very well right now, it was in 90 … as early as '97 and '98 basically regarding the capital money for derivatives that were basically allowed for accounting for derivatives in a more beneficial way for institutions to use them. So, I … you look at the whole bastille thing and the modernization act.

FCIC: Are you talking about the capital treatment?

MB: Mm-hmm. (yes)

FCIC: The one that allows for more leverage because banks didn't have to hold capital that …

MB: Yes; exactly. In '97 and '98. I put that in my letters in my first instinct when I first read about that. And when I started thinking about the market I read about that and thought, "Ok well this is not going to be good."

FCIC: So they can't hold equities but they were allowed to hold derivatives? Or, um, equity derivatives?

MB: Right. So you don't have the same capital requirements on derivatives as you do on any other type of investment that you may make. And there's no reason for that. I mean, you're accepting all of the same risk; actually even more so it turns out. So, but, I have a lot of views on all this but it's … I think it was a mistake to … then there were some FASBE rules in late 2004 regarding insurance companies and allowing them too … I can't remember them very well but I put them in the end of my 2004 letter (I think) or my last 2003 letter. But, it seemed like the system wanted this to continue. And obviously it was a huge boom for our society for the bubble to go on like it did and like it was going on, but, I think there was … it was part of the system to try and keep it going. I mean, I saw that and from '97 to '98 on I just felt that there was this government which was not involved. They wanted housing price appreciation, they wanted loans to go to people that don't deserve them, and they're doing that while you then have all of these originate and sell lenders showing up who don't originate any loans; they just sell them!

So they have no concern … they get their revenue on the gain of the sale of these mortgages. And that introduces all kinds of risk into the system, and they're usually going through mortgage brokers, just to throw some more risk on them. So we have this agency problem, and the moral hazard involved there. So basically lenders were not going to check excess credit risk at the door. People aren't going to do it … the borrowers themselves? I mean, it's an open question were the borrowers any less greedy than the people on Wall Street. I mean, everybody wanted to better their lives and everyone wanted the bigger house that they couldn't afford … but it's just all through the system. There was no checks; no balances. So once I ascertained that government was absent, and the banks weren't concerned about credit risk, and I knew that people weren't going to do anything about it… then it's just wait and watch and see what they create and what they do that could blow us all up.

FCIC: Did you see the Cash CDO as a significant element when it started to be based on ABS and taking up all of the middle Tranches of ABS…?

MB: I think that's a problem, but it wouldn't have come like this. I think it is a problem though, but it's a matter of degree. In my view, banks should not … you should not allow an originate and sell type bank. Banks should be required to hold some of the loans that they make in any category of loan. So it's not just you need to hold 70% of all the loans because then they'll sell of all of the bad ones. I mean, any type of loan that they make, they need to hold a certain percentage of those on their books, and they need to take that risk. If you just make it a flow through entity, where they get fees off the pass through… That was obviously a bad idea. At least I thought so.

FCIC: But when you have the derivative products, can't they just hedge whatever they hold? And then end up in the same place?

MB: They could but I think that that's just a much easier process to regulate and to keep hold of. They wouldn't be nearly the size that … because then you have real products behind mortgages and it's a different … you know with the derivatives and the way that they were going, everyone was taking risks on securities and there was no assets so… I am all for, and personally much more than Mind or Faulk are saying. But… just the idea that banking should be the calmest and most boring industry. It's how we regulate our money supply. It's how we manage our monetary policy. The banks need to be there to do the jobs that we need them to do.

FCIC: And the way that you described the investor agreement, it seems very biased in the favor of the dealer, and against the investor.

MB: Well that's the whole issue of, do we really want our dealers to have proprietary trading desks and … I think that we should have M and A banks, and we should have banks, and then we should have brokers. And they should all be separate and they should all do those basic activities. And, I think that we're … I think in Goldman, there were people who were working on both sides. What I mean is that there were people in Goldman who disagreed with going long on the market and those people disagree with people going short. And the Goldman outfit blew up! I mean, you know, it got really hurt by all of this. And those were some of the best and brightest. They created this to keep their best and brightest. Then there was other people in Goldman who were the best and brightest that said, "Yeah I don't agree with you." But it was just within the thing. So, it's all … why should Goldman even be doing this? If you want to run a hedge fund, then start a hedge fund. Go and do that or do something else. So, I certainly thought throughout this whole process that the position of the firm was influencing our marks to some degree because I knew that our marks, whatever our marks were, were how they were marking their books. So, if they're holding them low and maybe they've got a firm position as a firm that reflects that they like them to be low; and vice versa. And they could keep going forever…

FCIC: Wouldn't they want you to? (Laughter)

FCIC: Just to clarify if I may; all of your trades related to mortgages were single named?

MB: Yes.

FCIC: And did you know either when you entered into them or at a later point, how many if any became part of the synthetics CDOs or hybrid CDOs?

MB: Yes. So, um…. Yes I knew that they were becoming part of synthetic CDOs.

FCIC: So, you had some understanding that that's why they were looking to you to take the short position?

MB: Yes. That was how risk was bought in the derivatives market. I assumed that these things went into synthetic CDOs unless Goldman or somebody was willing to just take it on, that whole risk on themselves, it was going into a CDS – CDO.

FCIC: And did you have contact in any way with any CDO managers?

MB: No, no CDO managers.

FCIC: And did you have thoughts at the time (given your views) why does anyone continue to invest in synthetic CDOs?

MB: I think it's ridiculous. I mean you can still go out and do every single thing. I think it's ridiculous and have strong views on what we're still able to do now.

FCIC: Were you ever aware that, perhaps, the ultimate counterparty on any of your trades was AIG?

MB: I'm sorry … Say that again?

FCIC: That if a dealer has given you protection that perhaps they had gone to AIG and that AIG might have been their counterparty? I mean, if you don't know that's fine but …

MB: Yeah it would be speculation on my part.

FCIC: But you never had any conversations that said, "This is where we get our …?"

MB: No, no. This is where we get … yeah, no. Nothing like that. The idea that AIG wants to sell out protection; nothing like that.

FCIC: Just to ask a similar question just if I may for clarity… So you had a general sense that your purchase of protection would be part of synthetic CDOs, but you didn't really know at all who the investors in the CDOs or the investors in the AAA markets or the mono lines … or did you look at the mono lines or pay attention that they might be involved?

MB: Oh sure. So I had the general idea that AAA credits would be buying this protection. So, I know that even before I put on this trade, I had a problem with AIG, and I would short AIG because I knew… before my first RMBS trade I already had concluded that specifically AIG and the other AAA mono lines don't have to post collateral like the rest of us. And, should they run into trouble … basically what happened was that they needed to post collateral. And, that would be catastrophic, because that would be built up and they couldn't possibly have the cash on hand, given the way they run their businesses. I had a big problem with the AAA mono lines as well. I just didn't consider these to be AAA.

FCIC: Did you have a short position in those too?

MB: Yes.

FCIC: When did you put on your short for AIG?

MB: I think it was in that timeframe: the spring of '05.

FCIC: Did you know separately that maybe they were involved in your trades? That they were writing this protection?

MB: I had actually suspected that they were writing this protection and that all these AAA might be writing it on themselves.

FCIC: How would they do that?

MB: You know just with writing protection on themselves one way or another.

FCIC: I've heard that a couple times but I just don't fully understand how they could have done that and how I might figure out if they've done that. So maybe you could explain that?

MB: Well, it seems kind of strange, but once you filter it through a few different securities … well filter it through structures on the derivatives market. You could potentially get to where the ultimate buyer doesn't think … or know who they are facing or what they are doing.

FCIC: So they could have been doing it, and not knowing it as opposed to doing it and knowing it?

MB: That the buyers of the risk … well … the ones that are ultimately taking the other side of the trade don't know that AIG is there.

FCIC: Is that because AIG corporate credit would have been in some sort of CDO?

MB: Well it was. I mean there were corporate synthetic CDOs. … There were synthetic CDOs in the corporate CDO market. Huge, huge.

FCIC: So for example, if AIG (which we know it did) had a corporate credit business in addition to its asset back securities CDO credit business, if it had pools of corporate credit in which it was riding the senior protection of the senior most tranche, then presumably those pools could have included AIG?

MB: I think that you are getting beyond me a little bit …

FCIC: But is that what you were thinking of? And in terms of them writing protection on themselves? Or were you using a different type of example to do that?

MB: I think that they had a different idea to write stuff as a general rule for protection on themselves. I just wondered if maybe when AIG goes through the accounting scandal, when spreads get really high, then they might jump in and take advantage of that, someway in the derivatives market. Um, but it's all speculation on my part. With AIG I was just looking with the fact that they are a AAA, they're busy, they're impossible to analyze, but I shorted their credit but it was just on the fact about collateral and just what I knew about AAA counterparties and collateral and what I thought was coming down the road; but not with AIG, just in general.

FCIC: You talked about the particular terms of the master agreement which you negotiated for your own confirmations and master agreements. Did you specifically negotiate any terms related to the collateral trigger points? Not that it would change hands daily but what …?

MB: Right, so the threshold amount or minimum transfer amount? Or the credit … you don't generally get to negotiate what the credit will be. I was very … the credit events in the corporate CDS market went through a number of generations, so you follow those. There's the "modifieds," the modified structures. And so I didn't get to negotiate those too much. I would say that it was a big issue though, obviously with Argentina and JPMorgan some years before what the credit event actually was. A lot of those CDS players didn't actually get paid. And that was on my mind.

FCIC: So you said that most CDS's on the other side of the trade was synthetics; so that's where the demand was on the selling of protection for the most part? You were talking about the corporate CDS market but also the ABS CDO market I guess?

MB: OK, an ABS CDO? A synthetic ABS CDO? Can you say that again?

FCIC: You said that you had a suspicion that the CDS you were taking, that the other side would end up in a CDO.

MB: Or it would be held on the books of the prop desk or whatever.

FCIC: So I was just asking about the corporate CDS that you were writing, the 405 as well as the CDS, RMBS, the CDO you were writing …

MB: Well, the corporate CDS… when I got involved with corporate CDS, the synthetic CDO machine was really up and running and roaring ahead. You pretty much just assumed it was a lot of going into synthetic CDOs and corporate space. That wasn't true with RMBS CDS.

FCIC: Oh that wasn't true with RMBS? OK.

MB: RMBS CDS when I first started, there was no ABS synthetic CDO going at all. Obviously Goldman started up Abacus. And, Goldman was really aggressive in that market.

FCIC: So at some point over the period when you were taking CDS positions in RMBS, those might have ended up as well in the synthetic CDOs but not at first.

MB: Yeah, I mean … my understanding at the time was (well my assumption), was that it would end up in synthetic CDOs eventually. And eventually these would really get going in an asset backed market. But at the time, I knew the market wasn't really going very strongly. It didn't start up until 6 months after I started. It didn't really get going until basically late '05. I mean there was a couple Abacus deals in those last 6 months, but … My understanding was that, at the time, Goldman had to warehouse some of that risk, because you didn't sell a synthetic CDO every week. You had to take that risk on over the period of a month or two. And it had to be structured somehow then you'd sell it. There's not much more, I mean it's not really that big of a market. In fact B of A and all these others weren't in it.

FCIC: And just technically that's wasn't an innovation, they would just countertrade so that they would make a deal with you and then just turn around and do a similar trade with the CDO…

MB: I don't know exactly how they did it. I wasn't involved on that end at all.

FCIC: Ok, so did anybody ever know then or?

MB: No.
FCIC: OK

FCIC: And so you chose not to participate in any of the indices. Like you could have gone short different versions of the AVX?

MB: Right. That's correct. I chose not to involve myself with indices. So, you know … you probably want to know why? (Laughter)

FCIC: Yes. And then, in addition I would like your policy view of the utility of the existence of those indices.

MB: OK. So my recollection was the AVX indices of the credits that were put in there were not great credits. And certainly when everything went bad they weren't bad too, but they weren't the worst credits. The other thing was that they were often split rated, meaning that Moody's and S&P disagreed with what the rating should be. And, so, in my view maybe the BBB was a little bit more like a BBB+. And, you know, I had also been told and had the idea that they were really made to be sold to insurance companies and that sort of thing. They were meant to be a bond where they took all these things and structured things that looked like a bond. And it just makes it so easy, I put that in one of my letters too, that it made it so easy to accept this risk. And, I thought that those, initially when it was put out I thought that it would jump. I thought that people would be buying it and that it would be a very popular product in terms of people wanting to buy it.

FCIC: In going along and taking the long side of it?

MB: Right, right. Taking the long side of it and the opposite of what I was doing. And so then, as far as the policy of having those still around … I don't think those are still around. Wasn't '07-2 the last one? Yeah, I think so.

FCIC: So which was more important this time just spreading contagion or just being bad for the mortgage market? The synthetic CDO, or the AVX index? I mean which of these do you think was used more?

MB: I have no …. I don't know. I just don't know. At the time, I think I put it in my letters, I think that they were both at work in the market.

FCIC: Sorry, I'm always trying to unpack different elements with this to better explain causality and the timing of causality. There are arguments that academics and others make that, and you are suggesting in some way too, that the existence of the synthetic market amplified the housing bubble. So the question then becomes was it, and I'm sorry, when I say the synthetics market I really do mean the RMBS CDS and synthetic CDOs rather than in my terminology cash CDOS. Because it's a slightly different argument if you will. So, I think the argument goes that, dealers or originators or anyone in the mortgage marketplace, once they had an ability to short, were even less concerned with the actual mortgages and the real stuff that they were creating because they had a hedge against it. That's sort of one stage of the argument or hypothesis if you will. Another stage is just, by this market taking off and various people placing lots of different bets in it, that certain institutions lost a lot of money and certain other folks made money. But, the folks who lost tended to be systemically important institutions. So, it affected credit creation and the economy and etc. Would you care to comment on any of that or change those hypothesis or anything?

MB: I really do want to help you understand this, but I don't know if I can add much to either of those thoughts. As it turned out, derivatives were the reason that so many of these companies got in trouble. My argument is a little more simple.

FCIC: When you say these companies, who do you mean?

MB: Our dealers; AIG. I just think that like most of our arguments mine are a little more simple. I just thought that, you know, as it turned out, derivatives were hugely important to the businesses of some of our most important institutions. And, somehow, one way or the other, I thought (I think at one point) it was truly their hedging also. I lost that thought later but early on I thought it was for the banks to do, too… the hedging. I thought a lot of it would be hedging initially. But clearly there was a lot of directionality in this with a lot of our institutions in this. And I think it just proves the point that we can't handle it. There's some other issues with it too which aren't my direct experience regarding that natter, which you've probably heard of. And I think that there is a … Again, a lot of this stuff I am finding out now through new sources, so I can't really comment … I'm trying to comment just on my thoughts from what my experience was.

FCIC: We're also interested in your opinions based on your … your experience would allow you to make judgments and accumulated wisdom about this marketplace. So, we're … I am asking you beyond your direct experience for your views.
And if I could add specifically, it would be about a point that you just raised about finding out

some of this stuff now from the news accounts… I mean, could you comment on transparency and how there was a lack thereof. And how that affected your experience in dealing with the counterparties and how that may have affected how people could view their market generally and actually measure the risk that was there?

MB: Well, it was a dark market. It's not a transparent market.

FCIC: I'm sort of wondering just how you ever would have heard about a master agreement.

MB: Ok, so originally what happened there was … this is not very relevant so I'll say it pretty quickly. I was onto WorldCom pretty quickly and they went from investment grade to bankrupt overnight. So I ended up doing ok with their bonds on the way back up, but, I wondered why didn't I make more money on this? And I wasn't a short. I don't like to short equities. I'm not generally a short guy, so I basically noted though that it went from investment grade to bankrupt overnight. So it hit me, that's the way to short. Companies that you think look so gilded now, but you think might tumble, with asymmetric risk taking. So, especially leveraged companies, and I noted that there were a lot of these highly rated super leveraged companies where you could buy credit, because you can't buy credit default swaps on junk, or stuff that's below investment grade, so… That was how I came to investigate CDS's so I bought books. I bought Janet Tavakoli's 1998 book and that was the first book I read.

FCIC: That didn't sell quite as many copies as The Big Short (laughter)

MB: But it was helpful. I didn't take all of those equations and buy them, but I basically got the basics of the market from that. And then it's just a matter of … the other opaque market but nowhere near as systemically significant is the junk bond market. In 2002 I was very active in the junk bond market. And, I made a lot of contacts with these dealers initially in the junk bond market and then moved because it was pretty easy. I mean it was, "Oh hey, if I want to trade CDS what do I do?" And then just move over, because it wasn't something too exotic.

FCIC: So you said that the standardization was actually a bad thing, but that actually seems to be where the treasury and the congress is going right now…?

MB: Well the idea is to standardize everything so that you could have this really open and transparent market. The problem is that you have this mass delusion and nobody wanted to stop it. So, I think that stocks are freely trading and we still have the dotcom bubble. I mean like, there are these mass delusions and everybody wants to do it, then there's no stopping it unless it just doesn't exist. I just don't think that we can trust our society, and I can get into it, but I don't think we can trust us to recognize it. I'm still waiting for a president to say, "We're gonna have a recession. It will be a little one, but it will save us a bigger one later." But we won't get that I don't think. So I think we need to take the scissors our of out hands.

FCIC: So you mentioned Milton's Opus before and I was just wondering what you had in mind with that.

MB: Well that was my attempt to rapidly expand the size of my bet. So, it didn't work and I wasn't able to raise money for it. I didn't market it too heavily, but that was the intent which was to do a lot more of these trades.

FCIC: By raising more capital to …?

MB: Right, because I had a fund that … there was limits as to how far I could take this trade in my fund. It was a diverse; it was a fund that invested in stocks generally and debt instruments sometimes. And credit derivatives were within our purview but it didn't feel good to make it too big within the fund. So I said, "OK we're at a good size now, I still want to do more of this, so let's open a separate fund for it."

FCIC: So why, I'm sorry if you answered this before and I didn't hear it. What price were you charged for you CDS protection, generally speaking?

MB: On residential mortgage backed securities?

FCIC: Mm-hmm. (yes) The range of basis points for the protection …?

MB: For BBB- or BA3 it was … I think it was between 140 and 275 or something like that I would imagine. And then with BBB, or BA2's it was probably like 85 to about 185. And these are basis points.

FCIC: Right. And, sorry just to get back briefly… Just back to Gregg Lipmann and Deutsche Bank. Did you ever see his presentation how to short mezzanine tranches and subprime…?

MB: No. It really gets to how I don't talk to people. (Laughter)

FCIC: OK. I just want to make sure in case we cut that off a little earlier. I just wanted to make sure there wasn't any more interaction with him. If there was back and forth with this idea…

MB: Not at all. No. There was just that one day.

FCIC: OK. Thank you. So, the last couple of questions then since everyone's done, which are the questions that we tend to ask everyone. Anyone that you think would make sense for us to talk to which would help us to understand how derivatives and the financial crisis.

MB: Boy there's a good way to make friends … (laughter)

FCIC: We keep it all confidential. We don't say, "Dr. Burry told us to call you." Unless you think that would help. I see where you're lawyer's mentioned in the book sums Dustin. Who was involved in the negotiating…?

MB: He was, but the thing was I negotiated it and he is really more of my COO and was more responsible for other people mostly. He was … I was with the one that basically directed it. And the problem with me is that I don't talk to anybody, and I did all this on my own; none of my other analysts worked on it. Steve just did a few things at my direction, so he wasn't himself very involved. You know, for reviewing our initial instant agreements I had outside council for that.

FCIC: Who was that?

MB: We're talking so many lawyers, no offense to anyone (laughter). Um, Robert something? I can get you the information, but he was the … he is the guy. I mean I probably got it from one of the dealers, but he is the guy. Somewhere out here, it was in Washington, D.C.

FCIC: If you could let us know then that would be great. And then my last question is, you have mentioned both way back when we talked on the phone and then here again today that you wanted to help us to understand. Is there anything that you haven't told us to help us understand?

MB: Yeah I think my monologue a while ago kind of got that across. But, I guess the one point that I would make is that it's a mistake, given the position of what you are trying to do now, it's a mistake to lay all of the blame on one institution or one set of institutions. And I think for us to learn as a society, I think that we all need to take some of the blame.

FCIC: Ok, well thank you very much for your time. We very much appreciate you coming in, and particularly traveling across the country. It was very nice of you to do that, so thank you very much.

MB: Alright, thank you.

Vanderbilt Chancellor's Lecture – Michael Burry April 5, 2011

Thank you, Chancellor.

Early last year, I had a brief discussion with longtime 60 minutes anchor Steve Kroft about the stories he had done over his career, and whether he had any favorites in the field of medicine. As part of this discussion, I related my opinion that although he and I had met as a result of my activities in finance, I had not met one person in finance who could crack the top 50 I met in medicine. And I daresay, with all due respect to Stanford, 45 of those people are here at the Vanderbilt Medical Center, or were trained at the Vanderbilt School of Medicine. So you see, it is a terrific honor for me to address you today. I have nothing but the highest respect for Vanderbilt and the people here.

As the Chancellor so kindly mentioned, I was fortunate enough to have author Michael Lewis stumble upon my story nearly two years ago. Perhaps some of you have read his new book, The Big Short. Today, I appreciate the opportunity to address you directly regarding what happened to our economy, and where we're headed.

As some of you know, my formal education is not in finance. In fact, my time as an undergraduate at UCLA was a seemingly random walk through Economics, English, and Biochemistry, without even one course in accounting.

Too, as has been written, I have Asperger's Syndrome, which places me on the autism spectrum, and a childhood cancer left me with a fake left eye since I was 2. Both conditions have actually been huge blessings in a rather nifty disguise.

Perhaps for these reasons among others, however, in my ideal world, it would matter not whether I could look someone in the eye, or whether I could stay awake during lectures. Performance would matter above all else. From an early age, the financial markets therefore held a natural appeal. In my view, men are at their best when scrambling from the abyss, and are typically something less at all other times.

Still, finance seemed something I could always pursue on the side. Some volunteering I had done with children at UCLA led me down another path anyway. And so, in the summer of 1993, I chose to enroll at the Vanderbilt School of Medicine. Nevertheless, from the beginning I studied business along with medicine. For instance, after my first year at Vanderbilt, as a student summer extern at the Rehabilitation Institute of Chicago, I came to study why it was that rehabilitation medicine was doing so well even as others struggled.

I wrote up my conclusions, and looking back at that paper, written in 1994, the year of Forrest Gump, I see the same type of research that led me to conclude in 2005 that the US Economy would start to collapse in 2007. Within various bits of legislation, from the creation of Medicare in '68 to the Tax Equalization and Fiscal Responsibility Act of '82, and the Social Security Amendments of '83, I found the catalysts for private market trends that have come to dominate health care for decades. From that summer on, my focus was on the interplay between the actions of our government, and the over-reactions of the private market. The most important consequences, it seemed, were almost always unforeseen.

A few years later in ‘98, I was a resident physician at Stanford, but as Russia defaulted, and Long-Term Capital buckled, and the Federal Reserve panicked, I was paying close attention. In fact, I came to see the Fed’s actions late in ‘98 as a significant contributor to the ensuing blow-off top of the dot com and telecom bubble in ‘99 and early 2000.

I put my thoughts about stocks and markets up on a web site I was running during the latter half of the 90s. And what I wrote seemed to attract attention. When I criticized the prospects for index funds and hyperlinked to Vanguard, Vanguard’s attorneys kindly told me to cease and desist. I was an early Amazon Associate, but it really seemed to pay off when I got a gig writing for MSN Money at a dollar per word. That was especially great for me since I’m wordy (as you’ll see).

A couple years later, as I launched my investment partnership Scion Capital, Vanguard Chairman John C. Bogle would ridicule me as a charlatan in a Forbes magazine cover story. It was a portent of things to come. Whatever success I was bound to achieve, I would repeatedly face severe doubt from the well-credentialed who looked down on my lack of credentials. This, it seems, is an essential feature of many American success stories. So, to Bogle’s point, I’m just a doctor, what would I know about markets?

Well, Scion Capital started out ok anyway. I had left medicine with $145,000 in debt and no assets under management, so of course it got better from there. It was a wild ride from the get-go, as I dived into bankruptcies, telecom blowups, asbestos issues, toxic stubs and other nasty places where I thought profits might be hiding. My fund was structured with a lot of flexibility, but I never gave my investors much transparency into what I was doing. Quite honestly, I suspected from the very beginning that it would perhaps frighten them unnecessarily.

Soon, however, my attention was caught by the growing importance of the housing sector. The amount and type of leverage, the generations-old assumption that prices always went up (if you waited 3 years anyway) and the very broad societal participation called out to me. This was not just a case of a few early adopters or venture capitalists acting badly. The entire economy depended on home price appreciation – consumer spending, jobs, securities markets, all of it. Soon, I would see financial Armageddon looming, with housing as the trigger point.

In predicting when and how the collapse would occur, my focus was again on the actions of our government and the response of the private sector. This was much in keeping with my studies in Chicago a decade earlier.

So let’s consider the history. The idea of an “American Dream” involving homeownership has been around for nearly a century. Nearly every modern president promoted it in one way or another. The government helped returning GIs buy homes after World War II, and the government securitized the first mortgage portfolio back in the early 1970s. Private securitized mortgages followed shortly thereafter.

President Reagan would sign the Secondary Mortgage Market Enhancement Act, which among other things allowed pensions and insurance companies to invest in securitized mortgages, and a short time later he made these securities a lot more tax efficient. To be clear, securitization of mortgages meant there was nearly no limit on the amount of mortgages originated by lending institutions. All considered it harmless, a good thing for the American Dream. But all this desire to satisfy the Dream needed a tool, something that would make home loans themselves much more affordable for those without the income, credit, or assets to afford one.

Stepping back to '82, the Depository Institutions Act legalized the Adjustable Rate Mortgage in the United States. These adjustable rate mortgages, or teaser rate mortgages, would, in various forms, be the primary mortgage product at the heart of housing's implosion two and a half decades later. But Adjustable Rate Mortgages did not take off as a mortgage product until additional regulatory and legislative changes in the 90s and early 2000s jumpstarted the market for affordability products in the mortgage space.

Specifically, during the '90s, the Community Reinvestment Act of '77 was reinterpreted by Treasury Secretary Robert Rubin and President Bill Clinton. The general point was to increase pressure on banks to make more loans to less creditworthy customers. And they did. Subprime mortgages experienced a mini-boom in the '90s – issuance rose roughly five-fold during the decade before a mini-collapse. Bill Clinton had a name for this drive: The National Homeownership Strategy.

Then in 1999 the Gramm Leach Bliley Act repealed the Glass Steagal Act of 1933, and officially removed the increasingly leaky separation between the activities of Wall Street firms and depository banks. This freed banks to experiment and to expand into new lines of business, none more fateful than experiments with derivatives and asset backed securitization. The private market therefore gained the capability to mount a massive response to all the government's efforts to stimulate housing.

We all remember '99 well, but in fact our global village underestimated many, many risks throughout the 90s. And so we had to deal with the stock market crash, Enron, 9/11, Worldcom, and eventually War.

The Federal Reserve stepped in, cutting the discount rate it charges banks from 6% to roughly 1% in order to stave off recession. Other key short term rates followed. Not at all coincidentally, from 2001 to 2003 we saw American home prices, which had moved largely in line with changes in household income over the decades, suddenly accelerate up and away from the household income trend line.

Home prices had good reason for such deviation. From 2001 through 2003, rapidly declining short-term rates - to lows not seen since the aftermath of the Great Depression -induced a boom in adjustable rate mortgages. A homeowner's dollar went a lot farther during the teaser rate period, and so home prices rose unnaturally. Risk would be low as long as home price appreciation was strong, thanks to refinancing options. It was a positive feedback loop, with full blessings of the US government.

In fact, amidst early fears that the housing market was getting ahead of itself in 2003, Fed Chairman Alan Greenspan assured everyone that national bubbles in real estate simply do not happen. As I surveyed the national trends in housing, I wondered whether common sense ought rule against the application of precedent to the unprecedented.

Mr. Greenspan went on to advise Americans in 2004 that they were underutilizing the new types of adjustable rate mortgages. And in 2005, he lauded the technologies enabling subprime borrowers to acquire homes. Tragically for all of us, the Fed had the authority to block any lending practices it deemed deserving of such treatment, but it had absolutely no will to do so.
In any event, by 2003, mortgage rates stabilized at 40 year lows. And, importantly, plain vanilla Adjustable Rate Mortgages had already come into widespread use.

This was a big problem for lenders with a growth mandate.   They needed to stimulate more loan volume despite stable mortgage rates and inadequate income growth. At this point, if home prices were to rise significantly, they would have to float almost entirely on the back of the type and quality of mortgage credit provided to the buyer. Critically, Interest rates alone would no longer determine affordability. In my letters to investors, I termed this “credit extension by instrument,” and it took our housing market into a new paradigm. It was the private market’s time to overreact.

The instrument chosen for subprime borrowers by lenders in 2003 was a relic from the 1920s – the interest-only payment option, applied to an adjustable rate mortgage. Lenders, by implementing a mortgage feature they had long avoided, showed, for all to see, they were interested in growth more than they were interested in maintaining credit standards.

By fall of 2004, I noted for my investors that Countrywide Financial, a very large mortgage lender, reported Subprime mortgage originations up 158% year over year despite a 24% decline in overall originations. Evidence was manifest – banks were chasing bad credits, inclusive of housing speculators. The only question was how far they could go. Fraud jumped.

The point at which the provision of credit was most lax would mark the point of maximal price in the asset.

I imagined the top in the housing market would be marked by a mortgage in which home buyers of subprime quality were enticed to buy with teaser rate monthly payments near zero. I was very aware lenders would take this to the nth degree. Thanks to securitization, any loans the banks did not want to keep, they could always sell on through Wall Street to a world of investors simply ravenous for yield.

Importantly, because subprime mortgages were being turned into securities, there were mandatory regulatory filings, and this is how I educated myself.

By summer of 2005, these documents revealed that interest only mortgages had taken a substantial share in the subprime market, often more than 40% of subprime mortgage pools that were passing through Wall Street on their way to investors. This was up from just 10% a year earlier. Simultaneous second lien mortgages ramped up, and the stated income option inspired a new vernacular – liar loans. In some mortgage pools, 40% of subprime loans were for second or vacation homes. Yet as of late 2005, Moody's and S&P, so crucial to the securitization process, were not reacting at all.

The top would soon be fast upon us. As the subprime Interest Only Adjustable Rate Mortgage started to touch maximum sales channel penetration, we saw the introduction on a wide scale of yet another, more extreme teaser rate mortgage called the pay-option ARM. In this new type of mortgage, never before seen in a widely standardized format, the borrower could pay next to nothing each month, and the unpaid interest would simply negatively amortize into the growing mortgage balance. Rampant cash out refinancing had already made the home a magical ATM and now housing had its magical credit card.

Yet, it was blessed by both lenders and investors. This was what I had been waiting for: peak credit. Such a mortgage product would only exist as long as home price appreciation was the central assumption. And Home Price Appreciation was not long for this world precisely because these mortgage products existed.

Some of these sorts of mortgages started making their way into subprime channels too. I knew this because by 2005 I could see these mortgages being packaged into Alt-A mortgage securitizations. But not all of these were sold through to the Street.

Incredibly, Washington Mutual and Countrywide, two very national giants in home loans, began to load their own balance sheets with these pay-option ARMs. Facing another slowdown in loan volumes, these companies saw the negative amortization feature as a way to show loan growth in a slowing market. Yet, these companies, in doing so, also expressed confidence in home price stability in the event of a slowdown in loan origination. Of course, this is what the ratings agencies, the Federal Reserve, Congress, the President and all the President's men believed too.

I disagreed. I saw absolutely no chance of home prices going sideways, or stabilizing for any significant length of time. Once home price appreciation was no longer a given, these new types of mortgages would simply disappear. Home prices, starved of peak credit, would necessarily fall, and fall steeply as mortgage options crumbled away.

The crisis, in my view, would start no later than 2007, by which time teaser rate periods on the vast majority of these new types of mortgages would expire, or reset, for a population of homebuyers trapped in a mortgage they could no longer afford. And on the way down, housing would take consumer spending and jobs with it, setting up a positive feedback loop of a very damaging variety.

So, I decided to short the mortgage market - and profit from the collapse. I set out to buy credit default swaps on subordinated tranches of subprime RMBS. In doing so, I gained a new level of insight into how Wall Street really works.

I called different Wall Street banks to try to convince them to trade in this market with me. Initially, I found no takers. This whole effort was complicated because it was important to me that this security would be standardized, such that if I bought a credit default swap from one dealer counterparty, I could easily trade the credit default swap to another dealer counterparty. Bespoke one offs were full of contract and counterparty risk and were not my thing.

Nevertheless, by May of 2005, we agreed to our first trades shorting the subprime mortgage market with Deutsche Bank. We worked on the soon-to-be-standardized contract language a bit, and in the first days of June '05, the first trades were finally executed. We would ultimately use nine different dealer counterparties, though I avoided Lehman and Bear. Goldman Sachs would feature prominently. To be clear, these credit default swaps would rise in value as mortgages suffer losses.

Now, I wanted to short tens of billions of these mortgages. This was an epic investment opportunity and I shamelessly invoked Soros in my letters to investors. I even attempted to set up a separate vehicle just for this purpose, which I called, and this is for the English majors, Milton's Opus, in the summer of 2005. The effort showed I cannot sell ANYTHING. It met with incredible skepticism from my investors, and when I reached out to outside institutions with the idea, they simply went off to do it themselves. Milton's Opus never got off the ground. Milton's Opus, of course, was Paradise Lost, and I had no doubt that was where we were headed.

By late 2005, I was still alone as a directional short on this market. Goldman and DB in particular seemed very interested in what I was doing. In fact, I would short about $1.8 billion notional in RMBS, and about $6.6 billion notional in corporate credits, including AIG, Countrywide, Washington Mutual, Fannie Mae, and Freddie Mac.

AIG was particular interesting because I knew that AIG need not post collateral for its derivatives trades as long as it had a AA or better rating. This information came to me during our negotiations on credit agreements with Goldman Sachs and Bank of America. So I theorized in emails to my staff as far back as April of 2005 that a run on AIG would manifest itself in collateral calls as a result of a ratings downgrade. That no one else theorized this would lead to the unnecessary nationalization of AIG just a few years later, and would cost taxpayers some $180 billion.

By February of 2006, we were essentially done buying CDS on mortgages, as the ratings agencies finally responded by requiring more collateral in certain subprime mortgage pools. In fact, by that time, the median price of new and used homes had fallen from August 2005, according to the National Association of Realtors. Early mortgage defaults on the summer 2005 vintage were at record levels, as was the glut of new home inventory. Some panic was evident in various articles at the time. It was time for the world to see what I saw. Yet mortgage spreads continued to fall – the implied risk in mortgages was decreasing as 2006 progressed.

Many have wondered why the markets did not send an appropriate warning signal. The answer is that in late 2005, technical factors came into play that kept the credit derivative markets from sending any warning signal.

To this point, Synthetic Collateralized Debt Obligations (CDOs) relying on Credit Default Swaps on subprime RMBS were ramping in a big way as correlation traders sucked up the most subordinate, hardest to sell tranches, and tradable ABX Indices tracking the market for credit default swaps on RMBS emerged. These Indices catered to those needing an easy way to take on a lot of yield without a lot of analysis, such as investors and correlation traders.

Together Synthetic CDOs and the ABX Indices helped distribute risk far and wide, and in exponential fashion relative to the underlying real world mortgages. This would not be a good thing, no matter what the Street's risk model said. And to be clear, there was only one risk model that they all used.

2006 would in fact be the year systemic risk was supersized. It was the year, for example, when Merrill Lynch took its subprime exposure from a few billion to more than 50 billion. Ultimately, Merill would have to write off over 40 billion in mortgage assets – virtually none of which was on its books prior to 2006. This was the year that really got Wall Street.

As I wrote to investors as 2006 got underway, "It is simply a tragedy of fate that ever-lower returns encourage ever-increasing leverage, with only one possible ultimate outcome. It is a tragedy of our times that our regulators will do nothing about it." As an aside, this is again true today.

I warned investors that 2006 would be difficult for us. It turned out more difficult than I had imagined. Our counterparty dealers priced, or marked, our book of CDS, and our ongoing fight with these dealers such as Goldman Sachs and Morgan Stanley over the validity of these marks hit absurd levels. We were forced to side pocket our RMBS CDS trade.

Facing a very angry crowd of investors, many of whom were demanding their money back, I closed our Hong Kong Office, cut salaries, and laid off staff. We were threatened with lawsuits, and I had to consider liquidation of the fund at December 2006, at the worst possible time. I instead liquidated billions of our corporate credit default swap short positions in something of a fire sale. As our distress was reported in the press- and back then the only press I got was bad press- dealers looked to take advantage. We would receive less than 1/10th of 1 penny on the dollar for many of them, hurting our performance more so. Ultimately, our massive sales shaved billions in putative gains from our portfolio.

But I knew my analysis was correct, and not one of the detractors seemed to be able to get any of the details right. We retained the positions we could. This began to pay off in 2007.

Not that even 2007 was easy. Recently, US Senator Carl Levin provided specific evidence for something that we already knew. That is, our Wall Street bank counterparties –all 9 of them - were trying to screw us right up to the end. The games these counterparties played with marks – or pricing - on our positions - I could talk about those for hours.

But Senator Levin was investigating Goldman in particular, and he disclosed telling emails that showed Goldman adopted a "short squeeze" to drive down the price of credit default swaps such as those held by my funds. As Mr. Swenson, a senior executive at Goldman, said in an email, "We should start killing the shorts in the street…This will have people totally demoralized. " In an another email he said he wanted us to feel quote, " maximum pain." What had happened from our point of view at the time was that Goldman had been moving to our side of the trade as early as December 2006, and was working to get into our trade even bigger themselves in Spring of 2007, so a lower price for the Big Short benefitted Goldman Sachs - and that is how Wall Street works.

In late June of 2007, credit spreads started marching higher, and then they just took off for good once Goldman and others were in on the same side as my trade. Then it was AIG's turn to complain about Goldman's marks.

Incredibly, it would later be reported, that more than $60 trillion in credit derivatives existed at the peak. And the hyperbole would be "that is greater than the value of all goods and services created on planet earth." But it's roughly equal, and who really knows what the gross product of Earth is anyway? Still, $60 trillion, how? Credit derivatives on an underlying asset could be worth multiple orders of magnitude more than the asset because all asset-backed derivatives settled in cash. That was the secret sauce of the Doomsday Machine.

And so the crisis unfolded, with the market providing a signal far too late. Even so, Fed Chairman Ben Bernanke and Treasury Secretary Hank Paulson continued to underestimate the situation. I was apoplectic.

Secretary Paulson now claims that even if he knew what was going to happen, he could not have done anything about it. But let's be clear. Hank Paulson was US Treasury Secretary fresh from the apocryphal top job at THE Goldman Sachs in that summer of '06, and he orchestrated the once unthinkable government takeovers of AIG, Fannie Mae, Freddie Mac, and the bailouts of Wall Street. He was anything but an impotent tool, and he had a running start unlike any other. But if he truly felt that way, this is an absolutely devastating commentary on how government works.

In fact, as books and articles on the crisis proliferate, it becomes clear that at nearly every failed or severely troubled major institution and within every relevant department of the US government, there was someone whose insight was every bit as farsighted as mine, and in some cases even more so. However, NONE – ZERO - were in the top job. That our CEOs, our Governors, our Presidents, our Chairmen, did not see this coming, and did not adequately prepare their constituencies, is an indictment of the manner by which we choose and enable our leaders.

But such would not be the conclusions made in 2008. By the second half of the year, with the government targeting commodity hedge fund managers with punitive subpoenas, the global attack on so-called speculators and, again, hedge funds, the nationalizations of Fannie, Freddie, and AIG and their liabilities, the Federal Reserve's wide open monetary policy, and TARP, I worried about the future of a nation that would refuse to acknowledge the true causes of the crisis. In my view, an historic opportunity was lost. America had instead chosen its poison as the cure, and the second greatest generation would never be born.

Today, I expect the US government to attempt to continue easy money policies into the next presidential term, past the meat of the foreclosure crisis and the corporate and public refinancing humps. With junk bonds – incredibly - at all-time highs, yes, quantitative easing seems to be working, for now. But this is an invalid validation of what America is doing.

This is in fact a Pyrrhic gamble, as we continue to debase our currency. Bernanke says he is not printing money. Again, I disagree. As it stands, I get an email from the Federal Reserve every single day saying they're monetizing 7 or 8 billion dollars or so of Treasuries each and every day thanks to QEII. In fact, QE II – not Queen Elizabeth but quantitative easing – QE II's size and breadth raises the severe question of the Treaury's needs.

The government's borrowing of money for the purpose of injecting cash into society, bailing out banks, brokers, and consumers, is a short-sighted, easy decision for a population that has not yet learned that short-sighted and easy strategies are the route to long-term ruin.

We never quite achieved the necessary catharsis to stoke a deep re-evaluation of our wants, needs, and fears. Importantly, the toxic twins of a fiat currency and an activist Fed remain firmly entrenched, even more so with the financial reforms enacted last year.

In fact, the Federal Reserve, despite having newly acquired broad powers of regulation, has insisted that nothing in field of economics and finance was of help in predicting the crisis. Such a conclusion is worthless. It guarantees we will make the same mistakes again.

So…I have a problem with our leaders…I should note that I've been very much overwhelmed on several occasions when considering the colossal mistakes of our leaders. We need better leaders, but very frankly, this need is unlikely to be met. A problem cannot be solved if it can never be acknowledged. Taxes need to be raised, loopholes need to be shut, spending needs to be cut if we are to have any hope of returning to a stable base. Certainly homeownership should not be a policy of the US government, and the banking system needs substantial reform and even bank breakups. Glass Steagal needs a second run in a strong form. And those 22.5 million public workers have no business unionizing against the taxpayer. The list of things that likely won't happen but should happen goes on and on.

As citizens of these United States, we should carefully consider what one trillion means. All personal income taxes collected in a year do not so much as add up to $1 trillion dollars, and yet by 2020 interest expense on our national debt alone could exceed $1 trillion. When you consider our $1.7 trillion annual deficit, also consider that the Treasury takes in just over 2 trillion dollars a year. 2 Trillion also happens to be roughly the amount of bank and government debt held now at the tremendously bloated Federal Reserve. Think about it, two trillion seconds is 64,000 years. Our country's math is scary big, but what's even more scary is that it simply does not work.

Arguments on blooming prosperity and economic recovery must be considered alongside the fact that all the debt and all the money being printed is very much a real bill, a real tax that has not yet come due, except with respect to savers and those on fixed income.

As such, sober analysis on the part of the individual is paramount. We must remember that entire societies can and often do follow the wrong path for a very long time, and that there is nothing wrong with breaking from the social norm to ensure good outcomes. Legacies are a terrible and sometimes fatal burden in a rapidly changing world, and common sense must rule when it comes to career paths and life choices. Though the situation seems to call for it, it is not a time for the responsible individual to tolerate any level of blind faith directed toward any man or woman. It is absolutely not a time to follow.

All that said, I might suggest opening a retail banking account in Canada.

Again, thank you for your attention. I am happy to answer questions.

UCLA DEPARTMENT OF ECONOMICS COMMENCEMENT SPEECH TEXT
Dr. Michael J. Burry
June 20, 2012

Thank you, Professor Farmer. Class of 2012, congratulations! It's quite an achievement to graduate from UCLA.

You know, it is nice to be back in Westwood. I certainly have fond memories of my time here.

In many ways, the campus is much the same, but in some ways I can see it is different. I do know your campus life has been much different than mine. Twenty years ago I had no Internet, no smart phone, no cell phone. But I did invest my summer earnings in stocks and futures, and I remember being absolutely starved for information. I had to send away for financial statements, sometimes waiting weeks for a response. And I would take a near daily trip to Westwood to pick up a *Wall Street Journal* to check yesterday's stock quotes.

Today, it's much different. Information swarms us. It comforts us. It disrupts us. It's an Age of Infinite Distraction, for those so willing. You are the generation that has had instant messaging, Facebook, Twitter, and Angry Birds nagging your fingertips at every moment. It's been arguably as addictive as any other drug throughout history. And I do imagine it took some terrific willpower during your studies to study.

Of course, it's not lost on anyone that you started your term at UCLA in the midst of a global financial panic, the consequences of which are far from settled. The fault is not your own, but the future it leaves certainly is.

As a result of what happened while you were growing up, you now face a future that will feature either another great recession during your 20s. OR, during your 40s, a US debt-to-GDP ratio exceeding 200%. And that's not me, that's the Congressional Budget Office. Me? I think they're ignoring reflexivity, and I think you face both.

Now Greece was at 160% debt to GDP when the last of its nine lives started running out. From my perspective, this is all the more tragic because the financial meltdown was both predictable and preventable. This was no black swan, and no other serendipitous excuse should be acceptable to anyone.

Of late, Europe's convulsions are in the news. Even this should not be surprising. Back in 2006, when a bunch of us shorted Portugal, Italy, Greece, and Spain, we called them the PIGS for a reason. I can explain it in one sentence: When the entitled elect themselves, the party accelerates, and the brutal hangover is inevitable. Californians, and indeed all Americans, ought to take note.

My career after UCLA arced in such a manner that I found myself right in the middle of the financial meltdown, profiting from it because I had predicted it. I had been a Chicken Little, or a Cassandra; to some, especially in government, I'm one lucky SOB. In truth, I was just trying to figure it all out.

From my earliest years, I found that life, for all its amazing possibilities, very often does not make sense, and, at least as often, is not fair. Today, it is absolutely not fair—the world you are being dealt. There are many ways to deal with an unfair world. One may tune out, drop out, run away. One may get angry. One may fight. One could do ultimately what I did: Accept the world for what it is, work hard to exploit the opportunities it presents, and try to do so in as just a manner as possible.

Now, there are two kinds of working hard - you can work smart or you can work dumb. When I was in sixth grade, my dad dumped a pile of bricks in the backyard. And after school, he had us - me and my brothers—move the bricks to the side yard. The next day he had us move them back to the backyard. The next day, back to the side yard. and so forth. This continued for quite a while. I'm not sure what he intended by this. But I did learn that hard work for hard work's sake alone would not do.

Later, in observing the tenure system so endemic to academic ventures, I would think to myself, “Hey! They’re just moving a pile of bricks.” In fact, I began to doubt traditional education. I committed myself to educating myself as opportunities arose.

Still, as I graduated from UCLA, I headed to Vanderbilt Medical School. I had read *Liar’s Poker* by Michael Lewis, and it nearly convinced me that even if I could become a great money manager, I should not.

Besides, medicine appeared just. My interest in medicine would fade, however, as I studied the economics and regulation of health care while in Chicago in 1994. The government payer would weigh far too heavily on that playing field and I did not think it would be fair enough.

So during medical school, I put up a website—some ideas on stocks and markets. As I graduated medical school in 1997, Microsoft out of the blue offered me a dollar a word to write for the new MSN Money website. Being both wordy and in debt, naturally I said, “YES!”

So therefore during my medicine internship, I wrote for Microsoft, and I ran my website. There were synergies between two of the three, and I had unknowingly found a back door to Wall Street.

None of this was nearly as well planned as it seems in retrospect. There were a number of crises, including a divorce, and at one point I was so despondent over my direction that I even applied to law school. Again and again, I figured as long as I kept asking questions – and working so hard to answer questions - I would eventually find my way.

As I turned 29, I ran out of reasons why I couldn’t or shouldn’t, and left medicine to start an investment firm. At that point, the decision came very easily. As perhaps should be the case more often than not, I simply weighed the paths before me, without considering the path on which I had been.

At Scion Capital, my job 24/7 was to ask questions and seek answers. I mostly examined stocks and bonds as long investments. But one day I came across a subprime Residential Mortgage Backed Securitization. And I wondered if I could figure out any of that.

Other questions soon followed.

“Why are home prices diverging up away from the household income trend line?”

Answer: If it’s not income, it’s leverage.

“What exactly are the incentives of lenders that make mortgages only to sell them on through to Wall Street?”

Answer: Volume, at the expense of credit standards.

“When interest rates bottom, how far could these lenders push mortgage terms in order to keep refinancings, home prices, and loan volumes rising? “

The answer to this question would put a ticking timer on the boom, and a date on the crash.

Back in 2005, other questions stood out.

“How much is consumer spending dependent on cash-out refinancings?”

“What percentage of jobs are dependent on the assumption of rising home prices?”

“Won’t AIG have to start posting massive cash collateral for the first time if it were downgraded?”

"Is it not worrisome that Fannie Mae cannot find term sheets that describe perfect hedges against its massive mortgage portfolio?"

"Are the ratings agencies so conflicted that they could actually be this blind?"

In my letters to investors, I described a downturn that would be unprecedented, with no counterpart in the modern era. Wall Street's risk models would fall all at once.

And every single CEO and every single politician would be disastrously wrong. I put my money where my mouth was. At its peak, I was short $8.4 billion worth of subprime mortgages and certain financial companies. The most we could lose was less than $100 million—thanks to credit derivatives.

And at first, we did lose; it was a negative carry trade. Investors, business partners, and even employees questioned strategy. Lawsuits were threatened. Our distress was reported in the press, and Wall Street looked to squeeze our short.

Besides all this, I had to stomach what I knew was coming: a tragic end to the follies. This was not fun. I did not tap dance to work. But the firm survived, we turned the tables on Wall Street, and I became the 1% in a way I never imagined when I was in sitting where you sit today. I had bet against America, and won.

In 2010, I published an op-ed in *The New York Times* posing what I thought was a valid question of the Federal Reserve, Congress, and the President: "I saw the Crisis coming, why did not the Fed?"

Never did any member of Congress, any member of government for that matter, reach out to me for an open, collegial discussion on what went wrong, or what could be done. Rather, within two weeks, all six of my defunct funds were audited. The Congressional Financial Crisis Inquiry Commission demanded all of my emails and lists of people with whom I had conversed going back to 2003. And a little later, the FBI showed up.

A million in legal and accounting costs, and thousands of hours of time wasted, all because I asked questions. It seemed they would pump me at gunpoint, or not at all.

That summer, the Federal Reserve put out a paper that concluded nothing in the field of economics or finance could have predicted what happened with regards to the housing bust and subsequent economic fallout. Ben Bernanke continues to backfill this logic, and I fear that history is being written wrong yet again. But ignorance is willful.

As we move forward as a country, it is worth considering mainstream economics and finance in light of recent events.

Our nation's economic policies are borne of a synthesis of theories on how to deal with the Great Depression of the 1930s, yet seems unable to honestly examine the most recent one. Sadly, at the highest levels of economic thought and government, questions are not tolerated. It is as if we are dealing with the binary judgment of a fundamentalist religion.

Finance theory and practice fare no better. The continuing crisis makes a mockery of the principles which have guided credit policy and risk management since the 1960s. As it turns out, information is not perfect. Volatility does not define risk. Markets are not efficient. The individual is adaptable. But the Dark Ages of Finance allow no such light.

Mainstream economists and finance practitioners, please check your premises. You have contradictions before you.

Truthfully, I do not expect much to change. Practically speaking, history has demonstrated the ability of sovereign nations to justify themselves and to postpone the moment of crisis. This will be even more true for the United States, as the largest economy by far, with the strongest central bank.

As a result, over the course of your lives, you will experience withering but stealthy attacks on your quality of life, as government attempts to manage its faltering finances. You will see declines in the quality of health care, the quality of education, the quality of public safety, and the quality of our currency.

Of course, this is a false prophecy. I am simply describing what is already happening.

Class of 2012, by graduating today, you are taking a step—another step—on a path that is fairly well worn; a path that in and of itself defines little about your future. Many have started from where you start today and done great and wonderful things. But many, too, have lived lives of another sort.

Whatever you see as the next obvious step, consider whether you are being true to yourself, your strengths, your weaknesses, your needs—before you take it. The next decade or so, before you have kids, before you get married, is the most flexible, most genius decade of your life. You ought consider stepping outside your paradigm for a fresh look now and again.

If you are considering a career on Wall Street or in Washington, DC, you should be aware of the social proof that operates there. This is that many if not most people will be doing questionable things that obviously make money, and that obviously earn respect from common peers.

If you find yourself in such a place, I would ask you to consider a rule I learned as a physician: First, do no harm.

Besides, life is not that short. Life is well and long enough for you to come to regret any activity or habit involving an exchange of long-term risk for short-term benefit. This is what many if not most Americans did during the refinancing and consumption boom of the last decade, and it was what our government did in egging on the boom. This is also the gospel of drunk drivers and cheating spouses.

Of course, when you encounter the opposite—the short-term risk exchanged for long-term benefit—consider hitting that button again and again and again.

Past may be prologue, but this is not true for the individual. The individual can think different, and the individual can act different, than those that got us all into this mess. No matter how the economic tides may sweep away the majority, an individual can stand clear.

Each of your lives, individually, is an epic chance. You can leave here today and you can choose to never stop learning, never to stop asking questions. I must say, it will not be without staggering difficulties. There will be times when you will stare at yourself in the mirror and wonder, "*Why?*"

But faced with a setback, you will be most creative. Under stress, you will think better, and act stronger.

So much so, that looking back, it will seem as though it was all meant to be.

Thank you and good luck.

MSN Money Articles

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By Michael Burry 2000/2001

Strategy

My strategy isn't very complex. I try to buy shares of unpopular companies when they look like road kill, and sell them when they've been polished up a bit. Management of my portfolio as a whole is just as important to me as stock picking, and if I can do both well, I know I'll be successful.

Weapon of choice: research

My weapon of choice as a stock picker is research; it's critical for me to understand a company's value before laying down a dime. I really had no choice in this matter, for when I first happened upon the writings of Benjamin Graham, I felt as if I was born to play the role of value investor. All my stock picking is 100% based on the concept of a margin of safety, as introduced to the world in the book "Security Analysis," which Graham co-authored with David Dodd. By now I have my own version of their techniques, but the net is that I want to protect my downside to prevent permanent loss of capital. Specific, known catalysts are not necessary. Sheer, outrageous value is enough.

I care little about the level of the general market and put few restrictions on potential investments. They can be large-cap stocks, small cap, mid cap, micro cap, tech or non-tech. It doesn't matter. If I can find value in it, it becomes a candidate for the portfolio. It strikes me as ridiculous to put limits on my possibilities. I have found, however, that in general the market delights in throwing babies out with the bathwater. So I find out-of-favor industries a particularly fertile ground for best-of-breed shares at steep discounts. MSN MoneyCentral's Stock Screener is a great tool for uncovering such bargains.

How do I determine the discount? I usually focus on free cash flow and enterprise value (market capitalization less cash plus debt). I will screen through large numbers of companies by looking at the enterprise value/EBITDA ratio, though the ratio I am willing to accept tends to vary with the industry and its position in the economic cycle. If a stock passes this loose screen, I'll then look harder to determine a more specific price and value for the company. When I do this I take into account off-balance sheet items and true free cash flow. I tend to ignore price-earnings ratios. Return on equity is deceptive and dangerous. I prefer minimal debt, and am careful to adjust book value to a realistic number.

I also invest in rare birds -- asset plays and, to a lesser extent, arbitrage opportunities and companies selling at less than two-thirds of net value (net working capital less liabilities). I'll happily mix in the types of companies favored by Warren Buffett -- those with a sustainable competitive advantage, as demonstrated by longstanding and stable high returns on invested capital -- if they become available at good prices. These can include technology companies, if I can understand them. But again, all of these sorts of investments are rare birds. When found, they are deserving of longer holding periods.

Beyond stock picking

Successful portfolio management transcends stock picking and requires the answer to several essential questions: What is the optimum number of stocks to hold? When to buy? When to sell? Should one pay attention to diversification among industries and cyclicals vs. non-cyclicals? How much should one let tax implications affect investment decision-making? Is low turnover a goal? In large part this is a skill and personality issue, so there is no need to make excuses if one's choice differs from the general view of what is proper.

I like to hold 12 to 18 stocks diversified among various depressed industries, and tend to be fully invested. This number seems to provide enough room for my best ideas while smoothing out volatility, not that I feel volatility in any way is related to risk. But you see, I have this heartburn problem and don't need the extra stress.

Tax implications are not a primary concern of mine. I know my portfolio turnover will generally exceed 50% annually, and way back at 20% the long-term tax benefits of low-turnover pretty much disappear. Whether I'm at 50% or 100% or 200% matters little. So I am not afraid to sell when a stock has a quick 40% to 50% a pop.

As for when to buy, I mix some barebones technical analysis into my strategy -- a tool held over from my days as a commodities trader. Nothing fancy. But I prefer to buy within 10% to 15% of a 52-week low that has shown itself to offer some price support. That's the contrarian part of me. And if a stock -- other than the rare birds discussed above -- breaks to a new low, in most cases I cut the loss. That's the practical part. I balance the fact that I am fundamentally turning my back on potentially greater value with the fact that since implementing this rule I haven't had a single misfortune blow up my entire portfolio.

I do not view fundamental analysis as infallible. Rather, I see it as a way of putting the odds on my side. I am a firm believer that it is a dog eat dog world out there. And while I do not acknowledge market efficiency, I do not believe the market is perfectly inefficient either. Insiders leak information. Analysts distribute illegal tidbits to a select few. And the stock price can sometimes reflect the latest information before I, as a fundamental analyst, catch on. I might even make an error. Hey, I admit it. But I don't let it kill my returns. I'm just not that stubborn.
In the end, investing is neither science nor art -- it is a scientific art. Over time, the road of empiric discovery toward interesting stock ideas will lead to rewards and profits that go beyond mere money. I hope some of you will find resonance with my work -- and maybe make a few bucks from it.

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Journal: August 1, 2000
• Buy 800 shares of Senior Housing Properties (SNH, news, msgs) at the market.

Why Senior Housing Properties looks so sexy
OK, time to get this thing started. What will a Value Doc portfolio look like? The answer won't come all at once. Depending on the complexity of the pick, I'll share one to three of them with each journal entry. I do expect to be fully invested in 15 or so stocks within two weeks.

My first pick is a bit complex. **Senior Housing Properties** (SNH, news, msgs), a real estate investment trust, or REIT, owns and leases four types of facilities: senior apartments, congregate communities, assisted living centers and nursing homes. Senior apartments and congregate communities tend to find private revenue streams, while assisted-living centers and nursing homes tend toward government payers, with the associated intense regulation.

As it happens, running intensely regulated businesses is tough. Within the last year, two major lessees accounting for 48% of Senior Housing's revenues filed for bankruptcy. With this news coming on the heels of Senior Housing's spin-off from troubled parent **HRPT Properties Trust** (HRP, news, msgs), it is not hard to understand why the stock bounces along its yearly lows.

But not all is bad. From here the shares offers potential capital appreciation paired to a fat dividend that weighs in at $1.20 per share.

First, the bankruptcies are not as bad as they seem. Senior Housing has retained most of the properties for its own operation, gained access to $24 million in restricted cash, and will gain three nursing home for its troubles. The key here is that the reason for the bankruptcies was not that the operations lacked cash flow, but rather that the now-bankrupt lessees had acquired crushing debt as they expanded their operations.

In fact, if we assume that rents approximate mortgage payments – which is not true but is ultra-conservative, then during the first quarter of 2000, the bankrupt operators generated $80 million in accessible cash flow before interest expense, depreciation and amortization. This is significantly more than the rents paid to Senior Housing. So while the general perception is that Senior Housing just took over money-losing operations, this is not so. It is true that while the bankruptcy proceedings go through approvals, Senior Housing will be lacking it usual level of cash flow. But this is temporary. Once resolved, cash flows will bounce back, possibly to new highs. The bankruptcy agreements provided for operating cash flows to replace rents starting July 1, 2000.

While we wait for the better operating results, the dividend appears covered. Marriott is a rock-solid lessee that derives its 94% of its revenue from private-pay sources and that accounts for over $31 million in annual rent, which approximates the annual dividend. The leases are good through 2013, and are of the favored triple net type. Income from the Brookdale leases -- 100% private pay and similarly rock solid -- provided another $11.2 million in annual rents. A few other properties kick in an additional several million.

Benefits of the Brookdale sale
Recent events provide more positive signs. Senior Housing agreed to sell its Brookdale properties for $123 million. While on the surface the company is selling its best properties and letting its best lessee off the hook, investors should realize the benefits.

One, the company has said it will use the proceeds to pay off debt. This will bring Senior Housing's total debt to under $60 million. Because of this, Senior Housing's cash funds from operations will dip only $1.5 million to $2 million, by my estimation, thanks to interest expense saved.

Two, Senior Housing stock lives under a common conflict of interest problem that afflicts REIT shares. Its management gets paid according to a percentage of assets under management. It is not generally in management's personal interests to sell assets and pay off debt. Rather, they may be incentivized to take on debt and acquire assets. With property assets more highly valued in private markets than public ones, that Senior Housing is selling assets is a very good thing, and tells us that management is quite possibly inclined to act according to shareholder interests.

Three, the Brookdale properties cost Senior Housing $101 million, and are being sold for $123 million. Yet the assumption in the public marketplace is that Senior Housing's properties are worth less than what was paid for them. After all, Senior Housing's costs for the properties, net of debt, stands at just over $500 million while the stock market capitalization of Senior Housing sits at $220 million. The Brookdale sale seems to fly in the face of this logic, as does a sale earlier this year of low-quality properties at cost. The Marriott properties approximate Brookdale in quality and cost over $325 million alone.

Combining the last two points, if management proves as shareholder-friendly as the most recent transaction, then the disparity in value between the stock price and the core asset value may in fact be realized, providing capital appreciation of over 100% from recent prices. In the meantime, there is a solid dividend yield of over 14%, an expected return of cash flows from the nursing home operations, another $24 million in cash becoming unrestricted, a massive unburdening of debt, and a very limited downside. When will the catalyst come? I'm not sure. But there are plenty of possibilities for the form it will take, and with that dividend, plenty of time to wait for it.

Watch reimbursements
A risk, as always, is reduced reimbursements. While the government is the big culprit here, and Marriott does not rely on the government, the trend in reimbursements is something to watch. A more immediate risk is the share overhang from former parent HRPT Properties, which has signaled -- no less publicly than in Barron's -- that it will be looking to dispose of its 49.3% stake in Senior Housing. Another pseudo-risk factor is the lack of significant insider ownership; the insiders are apparently preferring to hold HRPT stock.

All told, I still see a margin of safety. While the share performance over the next six months may be in doubt -- and we just missed the dividend date -- the risk for permanent loss of capital for longer-term holders appears extremely low. It's an especially good buy for tax-sheltered accounts. I'm buying 800 shares.

Journal: August 2, 2000
• Buy 150 shares of Paccar (PCAR, news, msgs) at the market.

Paccar is built for profit
Here's where it starts to become obvious that, despite the contest atmosphere of Strategy Lab, I do not regard my investments here or elsewhere as a contest. Over the long run, I aim to beat the S&P 500, but I will not take extraordinary risks to do it. On a risk-adjusted basis, I'll obtain the best returns possible. Whom or what I can beat over the next six months is less important to me than providing some insight into how I go about accomplishing my primary long-term goal.

With that said, I present a company that I've bought lower, but still feel is a value. **Paccar** (PCAR, news, msgs) is the world's third-largest maker of heavy trucks such as Peterbilt and Kenworth. We're possibly headed into another recession, and if Paccar is anything, it is cyclical. So what on this green earth am I doing buying the stock now? Simple. There is a huge misunderstanding of the business and its valuation. And where there is misunderstanding, there is often value.

First, consider that the stock is no slug. A member of the S&P 500 Index ($INX), the stock has delivered a total return of about 140% over the last 5 years. And over the last 14 years, the stock has delivered a 384% gain, adjusted for dividends and splits. So it is a growth cyclical. One does not have to try to time the stock to reap benefits.

In fact, despite the high fixed costs endemic to its industry, Paccar has been profitable for sixty years running. With 40% of its sales coming from overseas, there is some geographic diversification. And there is a small, high-margin finance operation that accounts for about 10% of operating income and provides for a huge amount of the misunderstanding. The meat of the business is truck production.

The competitive advantage for Paccar is that the truck production is not vertically integrated. Paccar largely designs the trucks, and then assembles them from vendor-supplied parts. As Western Digital found out, this model does not work too well in an industry of rapid technological advancement. But Paccar's industry is about as stable as can be with respect to the basic technology. So Paccar becomes a more nimble player with an enviable string of decades with positive cash flow. **Navistar** (NAV, news, msgs), the more vertically integrated #2 truck maker, struggles mightily with its cash flow.

Let's look at debt

Over the last 14 years, encompassing two major downturns and one minor downturn, Paccar has averaged a 16.6% return on equity. Earnings per share have grown at a 13.2% annualized clip during that time, despite a dividend payout ratio generally ranging from 35% to 70%. Historically, it appears debt is generally kept at its current range of about 50% to 70% of equity.

But the debt is where a big part of the misunderstanding occurs. In fact, companies with large finance companies inside them tend to be misunderstood the same way. Let's examine the issue. Yahoo!'s quote provider tells us the debt/equity ratio is about 1.8. Media General tells us it is about 0.7. Will the real debt/equity ratio please stand up? With a cyclical, it matters.

So we open up the latest earnings release and find that Paccar neatly separates the balance sheet into truck operations and finance operations. It turns out that the truck operations really have only $203 million in long-term debt.

The finance operation is where the billions in debt lay. But should such debt be included when evaluating the margin of safety? After all, liabilities are a part of a finance company's ongoing operations. The appropriate ratio for a finance operation is the equity/asset ratio, not the debt/equity ratio. With $953 million in finance operations equity, the finance equity/asset ratio is 19.5%. Higher is safer. Savings and loans often live in the 5% range, and commercial banks live in the 7-8% range. As far as Paccar's finance operations go, they are pretty darn conservatively leveraged. And they still attain operating margins over 20%. I do not include the finance operation liabilities in my estimation of Paccar's current enterprise value.

Why can I do this? Think of it another way -- the interest paid on its debt (which funds its loans) is a cost of sales for a finance company. And yet another -- the operating margins of over 20% -- indicate that the company is being paid at least 20% more to lend money than it costs to borrow the money.

The leading data services therefore have it right, but wrong. Just a good example of how commonly available data can be very superficial and misleading as to underlying value.�Beware to those who rely on screens for stocks!

There is also $930 million in cash and equivalents, net of the finance operations cash. The cash therefore offsets the $203 million in truck company debt, leaving net cash and equivalents left over of $727 million. Subtract that amount from the market cap of $3.12 billion to give essentially a $2.4 billion enterprise value. So not only is there a whole lot less debt in this company than the major data services would have us believe, but the true price of the company -- the enterprise value -- is less than the advertised market capitalization.

Examining cash flow
Now come the ratios. Operating cash flow last year was $840 million. What is the free cash flow? Well, you need to subtract the maintenance capital expenditures. The company does not break this down. One can assume, however, that, of the annual property and capital equipment expenditures, a portion is going to maintenance and a portion is going to growth. Luckily, there is already a ballpark number for the amount going to maintenance -- it's called depreciation. For Paccar depreciation ran about $140 million in 1999. So in 1999, there was approximately $700 million in free cash flow.

Can it be that Paccar is going for less than 4 times free cash flow? Well, it is a cyclical, and Paccar is headed into a down cycle. So realize this is 4 times peak free cash flow.

In past downturns, cash flow has fallen off to varying degrees. In 1996, a minor cyclical turn, cash flow fell off only about 15%. In the steep downturn of 1990-92, cash flow fell a sharp 70% from peak to trough. Of course, it has rebounded, now up some 700% from that trough. The stock stumbled about 30% during the minor turn, and about 45% as it anticipated the 1990-91 difficulties.

The stock is some 35% off its highs and rumbling along a nine-month base. Historically, that seems like a good spot. The stock tends to bottom early in anticipation and rally strongly during a trough. The stock actually bottomed in 1990 and rallied 135% from 1990 to 1992, peaking at 474% in 1998. Now down significantly from there and with signs of a slowdown in full bloom, the stock pays a 7% dividend on the purchase price. Management policy is to pay out half of earnings, and makes up any deficiencies during the first quarter of the year. The stock is sitting above the price support it has held for about 2 years.

What makes the stock come back so strongly after downturns? Market share gains and solid strategy. In fact, during the current downturn, it has already gained 200 basis points of market share. And its new medium duty truck was ranked number one in customer satisfaction by J.D. Power -- this in a brand new, potentially huge category for Paccar.

And no, there is no catalyst that I foresee. Funny thing about catalysts -- the most meaningful ones are hardly ever expected. I'm buying 150 shares.

Journal: August 3, 2000
• Buy 200 shares of Caterpillar (CAT, news, msgs) at the open.

• Buy 400 shares of Healtheon/WebMD (HLTH, news, msgs) at the open.

This cool Cat is one hot stock
Today, let's go with two ideas, on the surface terribly divergent in character. The first is **Caterpillar** (CAT, news, msgs), which is bouncing along lows. Whenever the stock of a company this significant starts to reel, I take notice. Everyone knows that domestic construction is slowing down. I don't care.

Why? Let me explain. Let's pose that a hypothetical company will grow 15% for 10 years and 5% for the remaining life of the company. If the cost of capital for the company in the long term is higher than 5%, then the life of the company is finite and a present "intrinsic value" of the company may be approximated. But let's say the cost of capital averages 9% a year. Starting with trailing one-year earnings of $275, the sum present value of earnings over 10 years will be $3,731. If the cost of capital during the remainder of the company's life stays at 9%, then the present value of the rest of the company's earnings from 10 years until its demise is $12,324.

What should strike the intelligent investor is that 76.8% of the true intrinsic value of the company today is in the company's earnings **after** 10 years from now. To look at it another way, just 5.7% of the company's intrinsic value is represented by its earnings over the next three years. This of course implies that the company must continue to operate for a very long time, facing many obstacles as its industry matures.

Caterpillar can do this. Let's take a cue from the latest conference call. When people in the know think of quality electric power for the Internet, they think of Caterpillar. Huh? Yes, Caterpillar makes electricity generators that generate so-called quality power. There are lots of uses for power that's uninterruptible, continuous, and free of noise, but some of the largest and fastest-growing are in telecommunications and the Internet.

Caterpillar is the No. 1 provider of this sort of power, and the market is growing explosively. In fact, Caterpillar's quality power generator sales had been growing at 20% compounded over the last five years, but are up a whopping 75% in the first six months of 2000 alone. Caterpillar expects revenue from this aspect of its business to triple to $6 billion, or 20% of sales, within 4 1/2 years. "This is our kind of game," the company says.

General sentiment around Caterpillar is heavily influenced by the status of the domestic construction industry. But while domestic homebuilding is indeed stumbling, we're talking about less than 10% of Caterpillar's sales. Caterpillar is quite diverse, and many product lines and geographic areas are not peaking at all. In particular, the outlook for oil, gas, and mining products is bright. In fact, Caterpillar's business peaked in late 1997/early 1998 and now appears to be on a road to recovery. The market has not digested this yet.

The balance sheet is also stronger than it appears. Caterpillar is another industrial cyclical with an internal finance company. I don't count the financial services debt, as I explained in my Aug. 1 journal entry. Hence, long-term debt dives from $11 billion to $3 billion, and the long-term debt/equity dives from 200% to just 55%.

The enterprise therefore goes for a rough 11 times free cash flow. Cash return on capital adjusted for the impact of the financial operations reaches above 15% over its past cycles, with return on equity averaging 27% over the last 10 years. Also, management is by nature conservative. Keep that in mind when evaluating its comments on the potential of the power generation business.

The main risk is that, in the short run, investors may take this Cat out back and shoot it if interest rates continue up. I'm buying 200 shares here along the lows.

Healtheon/WebMD

Remember when I said that my contrarian side leads me to the technology trough every once in a while? **Healtheon/WebMD** (HLTH, news, msgs) has no earnings, yet there is a margin of safety within my framework. The premier player within the e-health care space, the stock has been bashed due to impatience. So here sits a best-of-breed company bouncing along yearly lows, some 85% off its highs.

Healtheon/WebMD has the unenviable task of getting techno-phobic physicians to change their ways. Such things do not happen overnight. The fact remains that some $250 billion in administrative waste resides within the U.S. health care system, and patients and taxpayers suffer for it. Healtheon/WebMD is by far best positioned to provide a solution.

Recent acquisitions either completed or pending include Quintiles' Envoy EDI unit, CareInsite, OnHealth, MedE America, MedCast, Kinetra, and Medical Manager.

Assuming all these go through, there will be 170 million more shares outstanding than at the end of last quarter, bringing the total to 345 million. Medical Manager's cash will offset the $400 million paid for Envoy, leaving Healtheon/WebMD with more than $1.1 billion in cash and no debt. Quite a chunk, especially considering that many of the company's competitors are facing bankruptcy.

Challenges -- less than 40% of physicians use the Internet at all beyond e-mail -- seem outweighed by bright signs. WebMD Practice has 100,000 physician subscribers, up 47% sequentially. For reference, there are only roughly 500,000 practicing physicians in the United States. The company now offers online real-time information on 40 health plans covering about 20% of the U.S. population. The sequential growth rate in WebMD Practice use runs about 41%. Consumer use is rolling ahead at a 70% sequential clip. The company is not all Internet, either. The breakdown: 44% back-end transactions, growing 41% sequentially; 30% advertising, also seeing growth; 10% subscriptions, growing at 47% sequentially; and 16% products and services. All told revenue was up 68% sequentially. This will decelerate, but it does not take a mathematical genius to figure out that even single digits can be significant when we're talking about sequential growth.

The acquisitions are putting other strategic revenue streams into play. OnHealth is the leading e-health destination. CareInsite is the company's only significant pure e-competitor and has the AOL in. Medical Manager will place Healtheon/WebMD by default into physicians' offices. A potential juggernaut in the making, but don't expect Healtheon/WebMD to tout this -- several acquisitions still need to past anti-trust muster.

Based on the company's current burn rate, it has about 4 1/2 years to straighten things out. There is no proven ability to turn a profit, and I am no fan of co-CEOs, either. Moreover, one must always be wary of the integration phase after a series of acquisitions -- the seller always knows the business better than the buyer. Recent insider buying by venture capital gurus John Doerr and Jim Clark is also not heartening, as it appears to be simply for show.

Still, the company appears to have the human and financial capital to build a successful organization in an industry there for the taking. With enough cash for 4 to 5 years, the post-acquisitions company will start with $900 million in annual revenues growing at a weighted compound average rate over 200%. The business economics are not Amazonian, either; margins will improve with higher sales. The price for this ticket? About $4 billion all told, or about half what the ticket cost to put together. I'm buying 400 shares, with a mental sell stop if it breaks to new lows.

Journal: August 4, 2000
• Buy 800 shares of Clayton Homes (CMH, news, msgs) at the open.

CMH: Best of an unpopular breed
Clayton Homes, a major player within the manufactured housing industry, is an excellent candidate for best-of-breed investing in an out-of-favor industry. But before investing in Clayton, one should make an effort to understand this fairly complex industry. Let's take a look how Clayton makes money.

Specifically, money can be made -- or lost -- at several levels of operation. A company can make the homes (producer), sell the homes (retail store), lend money to home buyers (finance company), and/or rent out the land on which the houses ultimately sit (landlord). Clayton is vertically integrated and does all these things.

When Clayton sells a home wholesale to a retailer; the sale is booked as manufacturing revenue. Clayton may or may not also own the retailer. The retailer then sells the home to a couple for a retail price; the sale is booked as retail revenue if Clayton owns the retailer. In Clayton's case, about half of its homes are sold through wholly owned retailers.

The couple may borrow a large portion of the purchase price from Clayton's finance arm. If so, that retail revenue is booked as equivalent to the down payment plus the present value of all future cash flows to Clayton resulting from loan repayments. The firm can be either aggressive (aiming for high current revenues) or conservative (minimizing current revenues) in booking this revenue, also known as the gain-on-sale. Since inherently this gain-on-sale method causes cash flow to lag far behind income, a conservative approach would be prudent.

Now that Clayton has loaned the money to the couple, the firm can sit on it and receive the steady stream of interest payments. Alternatively, Clayton can bundle, or securitize, the loans and re-sell them through an investment banker as mortgage-backed securities. Because the diversified security is less risky than a single loan, Clayton can realize a profit on the sale of the mortgage-backed security, especially if the firm was conservative in estimating the loan's value in the first place. Moreover, Clayton's finance arm can act as the servicing agent for the security and earn high-margin service fees.

Finally, through Clayton's ownership of land and some 76 communities, the company can sell or rent land to the couple for the placement of their new manufactured home.

During Clayton's fiscal 2000 third quarter, 25% of net income came from manufacturing, 20% came from retail, and 8% came from rental/community income. The key to the valuation, however, is that Clayton has a large finance and insurance operation – coming in at 52% of operating income in the most recent quarter. All told, 44% of operating income is recurring -- community rents, insurance, and loan payments. Clayton has over 140,000 people making monthly loan payments.

Clean record in troubled industry
Obviously, there is the potential for abuse. Many other companies in the manufactured housing industry, such as **Oakwood Homes** (OH, news, msgs) and **Champion Enterprises** (CHB, news, msgs), have indeed exploited that potential. One way was to originate poor-quality loans in the first place. This "lend to anyone" approach goosed retail sales in the short-run, but led to uncollectible receivables. Worse, in recent years, companies would borrow money themselves to pay up to 20 times earnings for retail operations, only to loan money much too freely to customers. They would then aggressively book gains-on-sale only to have to take charges later as these loans proved bad. This simply cannot be done in a cyclical industry. Indeed, it was the aggressive over-expansion by many players that caused the recent inventory glut and cyclical downturn.

Clayton never participated in these excesses. In fact, despite the sub-prime category into which the industry's loans fall, loans originated by Clayton have a delinquency rate of only 1.65%. And while other manufacturers struggle, Clayton still runs every single one of its plants profitably. The last quarterly report made 65 of 66 quarters as a public company that Clayton has recorded record results. Now, amidst bankruptcies and general industry malaise, Clayton can take its efficient, Internet-enabled operations and strong balance sheet and go shopping.

Shopping? Clayton has expertise in "scrubbing" manufactured home-loan portfolios. The company has shown itself to be not only a terribly efficient manufacturer (building plants for 25% of the price others pay to buy, and achieving profitability within two months), but also a keen underwriter and evaluator of risk. For instance, in a recent transaction, Clayton purchased $95 million in loans. It will scrub these loans, stratifying them for risk, shaking them down for near-term repossessions, and re-issuing them at a profit within a year. Clayton will insure the loans, as well as service the loans, for recurring income.

Conservative company
Clayton strives to be conservative in its revenue recognition and acquisition strategy. It imposes the barest of office spaces on its executives, and provides all its employees direct and indirect motivation to improve company-wide efficiency and performance. For instance, it matches 401(k) contributions only with company stock, and plants are rewarded on individual profitability measures rather than volume of production.

Over the last two years, the company has used about 75% of its cash flow to buy back stock. And now, as management says we are at the very bottom of an industry downturn, Clayton stands as one of the best-positioned players, with a pristine goodwill-free balance sheet and the best management in the industry. Others are still stuck in the mud of their own excesses. As it happens, the industry is self-cleaning -- Clayton simply gains share during downturns.

The shares are at risk for a near-term catharsis with the potential bankruptcy of Oakwood Homes. Nevertheless, with Clayton's shares trading at less than 8 times earnings despite an unleveraged and consistent return on equity greater than 15%, I'm buying 800 shares.

Journal: August 7, 2000
• Buy 350 shares of Carnival (CCL, news, msgs) at the market.

You've got more time than you think
Before I get to today's pick, let me take a moment to respond to the recent suggestion that as a 29-year-old, I simply possess long-term investment horizons. Hmmm. Living in Silicon Valley proper, I could write volumes in response. Suffice it to say that the twentysomethings I meet are not often interested in my 10-to-20-year analysis horizons. Although you may trade frequently, the wind should be at your back. If all else fails, a long-term hold should pull you through. And the only consistent, prevailing wind in the investment

world is that of the present value of future cash flows.

As a practical matter, professional investors are absolutely handcuffed by short-term quarterly expectations. That's why I don't run a mutual fund -- I need control over what sort of investor becomes a client. Of course, financial planners often impose the same quarterly bugaboo on their private money managers. I stay away from those as well. Focusing on quarterly targets is not a method for removing undue risk. On the contrary, it throws the portfolio manager in with the cattle call that is modern investment marketing -- even though increasing firm assets is of little direct benefit to an individual client -- and by default places the portfolio manager's operations in the "risk equals reward" paradigm. The competitive advantage therefore rests with those investors who can go where inefficiency reigns and risk is uncoupled from reward -- beyond the quarterly and/or yearly performance mandate.

Health care will continue to improve, and many people should live a lot longer than they or their financial planners think. As a result, it hardly seems imprudent for people older than me to consider the longer, safer road to investment success. Twentysomethings and thirtysomethings have no unique claim on this path, and often ignore it anyway. It is a complex subject, but without issuing too broad a generalization, there is often time to accept longer-term rewards regardless of age.

Cruising with Carnival

Now let's get back to picking a few good stocks. Given the space left, I'll go with one -- **Carnival** (CCL, news, msgs). As the No. 1 cruise operator in the world, Carnival Corp. has five cruise lines – Carnival, Holland America, Cunard, Seabourn and Windstar -- spanning 36 wholly-owned ships with capacity for more than 45,000 passengers. Carnival also markets sightseeing tours and through subsidiary Holland America, it operates 14 hotels, 280 motor coaches, 13 private domed rail cars, and two luxury "dayboats."

Carnival also owns 26% of Airtours, which operates more than 1,000 retail travel shops, 46 resorts, 42 aircraft and four cruise ships. Carnival and Airtours co-own a majority interest in Italian cruise operator Costa Crociere, operator of six Mediterranean luxury cruise ships with capacity for 7,103 passengers.

During the 1990s, the world was Carnival's oyster. Return on assets marched steadily upward from 8.4% to 13.3%, and return on equity was similarly stable, ranging between 20.1% and 22.5% over the 10-year period. And this is not leveraged -- debt as a percentage of capital fell from 51% to under 13% over the same period. This, of course, implies that return on invested capital steadily rose, and indeed it did, from 9.8% to a bit over 15%.

Recently, however, fuel costs skyrocketed and interest rates rose just as the supply of ships caught up with softening demand, resulting in pricing pressure. Return on equity slipped under 19%, and the stock fell 60% off its highs and now touches the bottom it hit during the October, 1998 currency crisis. After the initial hit, it was hit some more with news of a soft second half of 2000 amid several cruise cancellations.

Carnival still best of breed

The basic demographics still favor the industry -- affluent baby boomers will live longer and become a more-significant part of the passenger mix. And Carnival remains the best of its breed, with the highest margins and best management. Moreover, it has historically been difficult to predict the demand fluctuations in the cruise industry. Soft and strong periods alternate without a lot of reason at times. There are reasons now for softer demand and the pricing difficulties, but it is just as possible that with the U.S. economy still fundamentally strong, demand will fluctuate back to the strong side sooner than most think.

In the meantime, here's a stock trading at just 11 times earnings despite a long record of 20% growth. With the company maturing and growth slowing a bit, momentum players have abandoned the stock completely, and few are willing to be patient for the hiccups to stop. The recovery could take the stock up three-fold in the next three to five years. The company is currently a little over 60% through a $1 billion stock buyback it announced last February. In the process, about 10% of the stock has been retired. The company has also been working to broaden its product reach into the baby boomer segment. A recent alliance with Fairfield, a large timeshare operator, is the most tangible evidence of this to date, but other distribution channel initiatives are forthcoming.

The downside risk is low, as simply replacing the ships and other critical operating assets of Carnival would cost more than the current market capitalization, which prices the brand equity as a negative number. And for those investors wanting to stick it to the IRS, here's a chance to do it. While headquartered in Miami, Carnival is a Panama-chartered corporation and does not pay U.S. income taxes -- the overall tax rate is less than 1%. Ironically, the biggest real threat is this thumb in the eye of the IRS. Will the IRS find a way to tax Carnival? It is an open question, but one that Carnival feels is answered in its favor.

Perceptions of the company and the industry are profoundly negative on Wall Street. At an enterprise value less than 11 times EBITDA and with the shares trading at replacement value, I'm buying 350 shares.

Journal: August 8, 2000
• Buy 1,000 shares of Huttig Building Products (HBP, news, msgs) at the market.

Off to a slow start
Relative to the indices, it appears that I've gotten off to quite a slow start in this Strategy Lab session. A minor reason might be that I, as with all Strategy Lab participants, was able to execute my first trade on Aug. 1, but the indices' tally started on July 28th. The market did rally a bit during that time. It's tough to beat the S&P, but especially so when there's a handicap.

Even accounting for the handicap, however, I am still lagging the S&P. This is largely because, while my general theory involves being fully invested, I've been adding only a stock or two per day as the markets rally. Why did I not just throw a batch of stocks out there all at once? Because my view of the purpose of Strategy Lab is to give you insight into how I operate. As it is, I'm editing my 2,500+ word analyses down to 1,000 words to fit in this medium. To shorten them much more would give short shrift to the thrust of Strategy Lab.

Another factor to consider is that I write here about stocks that I personally would buy now. I have plenty of stocks in my portfolios that are extended 40% or more. Those are stocks I would not necessarily buy for the first time now. So they do not get into my Strategy Lab journal. Within a six-month time frame, start-up costs and untimely decisions seem magnified in importance. Nevertheless, I hope you're getting what you came for.

Building a portfolio with Huttig
Today, I'm buying an ugly stock in an unglamorous business. Surprise, right? **Huttig Building Products** (HBP, news, msgs), spun off from **Crane** (CR, news, msgs) last year, is a leading distributor of building products such as doors, windows and trim. Revenues topping $1.2 billion are accompanied by razor-thin margins that contribute to misunderstanding and to the sub-$100 million market capitalization. Actually, including debt, the enterprise value attached to Huttig is about $218 million.

I first obtained this stock during the spinoff, as I was a Crane shareholder. I soon rid myself of it. From the 10K and the proxy, I could not find much to love. Then I read the annual report, made available within the last few months. A call to the company confirmed and enhanced the discovery, and now I'm a fan. Let's look at why.

Synergistic savings
At the time of the spinoff, Huttig acquired Rugby USA and increased revenues over 60% in one swoop. Rugby USA had been owned by the Rugby Group, a British maker of cement and lime. The U.S. business has been an inefficient operator in much the same industry as Huttig, the industry's most efficient operator. So efficient that in a thin margin, cyclical industry like distributing building products, Huttig has been profitable since the Civil War.

Huttig confirms that they are ahead of plan to save $15 million through synergies with Rugby. Taking into account these synergistic savings, Rugby's $15 million in EBITDA (earnings before interest, taxes, depreciation, and amortization), and additional volume discounts, Huttig should realize at least $30 million in additional EBITDA as a result of the acquisition. Moreover, Huttig expects to whip Rugby's substantial but inefficient operations into Huttig-like shape. By doing so, Huttig should squeeze another one-time gain of $20 million out of working capital. This $20 million can be subtracted from the purchase price. Adjusted, Huttig acquired Rugby and $30 million in additional EBITDA for only $40 million. Smart management.

Going forward, Huttig will have tremendous free cash flow. Free cash flow averaged $21 million per year for the three years before the acquisition of Rugby. Now, EBITDA jumps to at least $60 million, and free cash flow jumps to at least $35 million. Plus, in the short term, the $20 million or so that comes out of Rugby's working capital. As a result of this, during calendar 2000 Huttig is well on track to bring its $122 million in debt down to $82 million. Reasons? Reduced interest expense and expanded ability to pursue acquisitions in this fragmented industry -- an industry where Huttig as the leader only has an 8% share. So what we are looking at is an enterprise trading at just 3.1 times EBITDA, and only about 5.1 times free cash flow. Keep that in mind when you think of the 130 years of profitability Huttig has achieved.

Despite the stated intent to acquire more firms, we do not have to worry about a willy-nilly acquisition policy. As the Rugby acquisition suggests, Huttig's executives are shrewd and aligned with shareholder interests. In fact, while I have a few problems with EVA -- Economic Value-Added -- theory, it is a useful and shareholder-friendly tool for evaluating executive decisions. Huttig is a pioneer in its industry as far as using this theory to evaluate and reward executives for their choices. Huttig is also a fan of GE's "Six Sigma" quality-improvement program. These executives appear to be committed to doing right by shareholders. That's a rare and valuable find today.

Odds and ends
There are some other odds and ends that make Huttig interesting. Seth Klarman, known for his intellectual and strict value discipline, has accumulated a large chunk of the float. Consider that portion of the float locked up. Also, recently, a large distributor of wholesale doors left the business. Huttig is expanding to meet the demand. Because of this, sales may rise over the next year or two even if, as seems probable, the homebuilding market turns south.

The big price risk near-term is that the Rugby Group -- the company that sold Rugby USA to Huttig -- now holds some 32% of Huttig's shares. This firm may be a price-insensitive seller in the open market, and has the ability to sell 20% of its position without restriction. This is a price risk and not a business risk. As such, I am not terribly worried about it. Neither are the insiders.

Huttig should be attractive to acquirers. A firm or group of investors with the means and the interest would find Huttig a no-brainer, especially once the savings and cash flow become apparent over the next few quarterly reports. With a shareholder advocate as chairman, it is unlikely that a takeover would be unfriendly to shareholders. Recent transactions in the industry suggest a private market value at least $10/share. With the shares trading at less than $5, I'm happy to buy 1,000 shares.

Journal: August 9, 2000
• Buy 200 shares of Axent Technologies (AXNT, news, msgs) at the market.

My 'buy' rules
With the market rallying since just prior to the start of the Strategy Lab, I must admit that many of the stocks I wanted to write about have already appreciated some. This is problematic because even if I like a stock fundamentally, I am rarely willing to buy more than 15% above technical support.

I also generally use broken support as an exit point. "Sell on new lows" might be another way to put it. If I buy a stock 50% above support, then I must watch a gargantuan loss develop before I eat it. At 15%, I'm looking at only a 13% loss before support is broken. Combining these guidelines allows me to put the odds a bit more on my side. I look at it as an extra kick to help out my fundamental analysis. This is not how most value investors operate, but it is something that has contributed to my success. Of course, my rules are not absolute, and I do make exceptions.

A worthy exception

Today I'm buying an exception. **Axent Technologies** (AXNT, news, msgs), a provider of e-security solutions to businesses, will be acquired by **Symantec** (SYMC, news, msgs) for one-half share of Symantec stock per share of Axent. There is no collar, and Axent now trades way up off its lows, with no immediate support. But Symantec is bouncing along at about 8 months of support in the high $40s, and I'm listening to the arbitrageurs. Now, in general, arbitrageurs are very shrewd. As in options and futures, arbitrage is a game played successfully only by the very smart or very advantaged. Information is digested with extreme speed and immediately reflected in the arbitrage "spread," the difference between the price Axent now trades and the price where it will be taken out.

At the time of this writing, the spread is only 2.3%. Of late, spreads in the technology sector have been much, much larger. So this tiny spread tells me a few things. When evaluating the spread in a stock transaction without a collar, we are really looking at, first, the chances the deal will go through, and second, the value of the acquiring company's stock after the deal executes.

With about five months until the close of the deal, a 2.3% spread gives an annualized return on par with Treasury bills. In other words, the market has decided this deal will go through. Deal closure is rarely a 100% safe assumption, but it can approach 100% if the deal seems to make sense strategically and is structured in a way that financing and anti-trust clearance are non-issues. That seems to be the case with Symantec's acquisition of Axent.

The tiny spread also indicates that the new post-acquisition Symantec will be worth at least the current share price of Symantec. I agree, but feel this is conservative. Symantec should be worth more. Assuming today's prices, the market capitalization of the new Symantec will approach $4.05 billion. This, for $1 billion in revenues growing 27% for at least several years. Accretion to cash flow should begin by the end of fiscal 2001. Intuitively, there's value here, but let's explore it some more.

The real deal

The deal gives Symantec's Chief Executive Officer John Thompson a potent arsenal in his quest to make Symantec a one-stop e-security shop. A former IBM executive, he has infused an awareness of the company mission throughout his workforce and made cost controls a priority. The new company will benefit from Thompson's management as it offers products covering the gamut of the current e-security field. Axent provides a head start as it brings on a host of gold-plated customer wins, including 45 of the Fortune 50 and a recent long-term contract -- the industry's largest ever in terms of revenue -- to provide managed-security solutions to Xerox Europe.

In response to the deal, a **Network Associates** (NETA, news, msgs) representative criticized Symantec's strategy of "being everything to everyone." Yet a Visa e-security expert tells me that a one-stop shop is what everyone has been waiting for. I must admit that the same expert is taking a wait-and-see approach to Symantec, as he is not used to thinking of Symantec as an enterprise-level company. He also criticizes Axent's products as a bit rough and lacking in support, and notes that Symantec still will not offer a product implementing Public Key Infrastructure (PKI) technology. E-security experts have touted the benefits of PKI, but developing a PKI product is a difficult task involving cross-platform incompatibilities. It is uncertain whether Symantec needs one at this point. With a solid balance sheet, it is likely it can acquire its way into the market if the need arises. I am also counting on Symantec bringing some order to Axent's support operations.

Symantec's free cash flow runs higher than its net income, as does Axent's. Both are accumulating cash on the balance sheet; combined, the companies have nearly $650 million in cash and no debt. Accounting for lower overall gross margins thanks to increased service revenue and taking management's guidance for operating expenses, we can expect about $200 million in free cash flow for the year ending March 31, 2001. Hence, today's stock prices imply an enterprise trading at about 17 times free cash flow. With Symantec upgrading its revenue guidance and both Axent and Symantec beating estimates significantly, Symantec appears to trade at nearly a 50% discount from where its growing intrinsic value now sits.

One may wonder whether Symantec could have developed products like Axent's for less than the cost of acquiring Axent itself. This would have been a poor choice in an exploding industry. In addition to products, Axent brings human capital, which may as well be renamed "vital capital" in the technology space, and it is the first mover in providing comprehensive intrusion-detection solutions. The evidence is in the customer wins. Symantec just bought a foot in the door of 45 of the Fortune 50. That's a pretty big off-balance-sheet asset in Thompson's hands. I am choosing to buy Symantec through Axent. I have confidence the deal will go through, and hence I'd like to claim the spread. I am buying 200 shares of Axent at the market.

Journal: August 11, 2000

• Buy 500 shares of Huttig Building Products (HBP, news, msgs) at a limit of 4 5/8.

• Buy 100 shares of Healtheon/WebMD (HLTH, news, msgs) at a limit of 11 5/8.

• Buy 50 shares of Axent Technologies (AXNT, news, msgs) at a limit of 24.

Loading up on favorites

Today's trades are a near repeat of yesterday. I'll try to buy 500 shares of **Huttig Building Products** (HBP, news, msgs) at a limit of 4 5/8, and I'll go with another 50 shares of **Axent Technologies** (AXNT, news, msgs) at a limit of 24. Also, I'll add another 100 shares of **Healtheon / WebMD** (HLTH, news, msgs) at a limit of 11 5/8. No new picks, but let's review the events of the week.

Did you see whom **Active Power** (ACPW, news, msgs), the week's high-flying IPO in the power generation sector, touted as a technology partner? **Caterpillar** (CAT, news, msgs). It's a pretty good partnership -- Caterpillar is the brand stamped on the partnership's end product. Who's the man here? Caterpillar.

No bombs on the earnings front

Healtheon/WebMD reported a great quarter. There are a lot of metrics to consider, but the bottom line is losses are shrinking as revenues grow -- that's a very important point, as it goes to the viability of the business model. With $1 billion in cash and no debt, this business is not just viable -- it's a gorilla. New information for me includes management's claim to have already identified $75 million in synergistic cost savings to be had over the next few quarters. The 30% growth in physician registrants on WebMD Practice provides a bit of an upside surprise as well. That's a difficult market to crack, but WebMD Practice already has 26% of it. I'm watching the new lows warily.

Clayton Homes (CMH, news, msgs) reported numbers in line with estimates, giving the company its second-best results ever as its competitors report losses. Clayton will emerge from this downturn in fine condition.

Senior Housing Properties (SNH, news, msgs) also reported earnings, which should turn out to be the worst-case quarter for the company, as the bankrupt lessees are no longer making minimal payments. Starting at the beginning of the current quarter, Senior Housing began realizing direct operating cash flows from the properties vacated by the bankrupt lessees. What the latest results do show is that funds from operations clearly cover the dividend.

Three earnings reports from companies under stress and no total bombs. I'll take that.
I'll have new picks on Monday.

Journal: August 14, 2000

• Buy 200 shares of Pixar Animation Studios (PIXR, news, msgs) at a limit of 33 3/4.

To infinity and beyond with Pixar

Pixar Animation Studios (PIXR, news, msgs) is a stock sitting where no one can get it. Even if analysts or portfolio managers like the long-term story, the Wall Street Marketing Machine will not allow them to buy it

The problem? Pixar's next feature film will not be released until November 2001 -- a full two years after the last, "Toy Story 2." No matter that the first three releases -- "A Bug's Life," "Toy Story," and "Toy Story 2" -- establish Pixar as a 1.000 batter later in the season than any other major studio before it. No matter that Pixar promises at least one theatrical release per year from 2001 on, and has beefed up its talent pool with the likes of animation guru Brad Bird. For Wall Street, this is a timeliness issue.

Not for me. As I discussed back in my Aug. 3 entry, even for a growth company, only a tiny fraction of the intrinsic value of a company results from the next three years. Heck only a fraction of today's intrinsic value depends on the next 10 years. The key is longevity -- will Pixar be around and making money 10 years from now . . . and beyond? Certainly.

In part, I get this confidence from CFO Ann Mather and CEO Steve Jobs, as well as the talent that Pixar seems to attract. The teams that created the first three hits are still around for the next four that are already in production. During the most recent conference call, Steve Jobs prefaced his remarks with the declaration, "I am a forward looking statement." No doubt, Steve.

Animated cash flows

But I would never invest in this company if I couldn't see the financial kingdom behind the magical one. And I do. Pixar is generating cash at such a rate that it is building its new Emeryville digs out of cash flow-- with no financing -- and still laying down cash on the balance sheet. At present, cash on hand tops $214 million. Jobs is a fan of cash flow and cash strength because he thinks it helps him negotiate with Disney. "Hey, if you don't want a piece, we'll just finance it ourselves..." Whatever the reason, I like cash too.

The next year and a half will include the driest quarters Pixar will ever see. Still, Pixar sees the coming pay-per-view release of "A Bug's Life" generating gross revenues of 15-20% of worldwide box office receipts before Disney takes a cut. And "Toy Story 2" will go into home video release this October, generating about 35 million in unit sales over its lifetime at a higher average selling price than originally forecast. Helping to generate enthusiasm for this release -- and to help cement the evergreen nature of the "Toy Story" characters -- will be a new "Buzz Lightyear of Star Command" television show, which debuts this fall as part of Disney's 1 Saturday Morning program.

These are additional revenue phases for established assets. To believe in Pixar as an investment, one has to believe in the evergreen nature of its creations. Pixar's full product life cycle, managed correctly, can be extremely long. And as Pixar releases more films, more life cycles are put into play, overlapping and creating smoother and larger earnings streams.

Pixar is guiding us to earnings of $1.30 this year, but it is likely we'll see earnings exceeding $1.35. History tells us Pixar's free cash flow runs quite a bit higher than its net income. That's how cash on the balance sheet jumps $17 million in one quarter despite net income less than half that. As an enterprise less its cash, the price of Pixar is currently trading at about 21 times accounting earnings, but only about 14 times free cash flow. Earnings will fall next year, and the stock is heavily shorted in anticipation. It's not like me to say this, but getting into the quarterly accounting minutiae here is a bit counterproductive. The business plan is intact and there is a working program for creating brand equity.

For instance, every one of those 35 million copies of "Toy Story 2" home video product will feature a trailer for next year's "Monsters, Inc." Kids will be watching this over and over again. And when "Monsters, Inc." comes out on video, will it have a trailer for another upcoming release? Of course. And will these products ultimately end up on pay-per-view? Of course. Pixar's catalogue itself creates lead-ins to new product success.

Concessions from Disney?

In 2004, Pixar will release its final film under the distribution agreement with Disney. This agreement is an onerous one that Pixar agreed to when it had much less success under its belt. Currently Pixar only gets 50% of the gross revenues of its product after Disney deducts the costs of its distribution and marketing. Disney's claim on distribution and marketing fees is such that the entire domestic box office for a film can mean no profits for Pixar. Already Pixar is of sufficient strength to extract a much more lucrative deal from Disney. After a few more blockbusters, Pixar will be in a position to restructure a new agreement with tremendous implications for Pixar's bottom line.

The key is that any additional concessions from Disney should flow nearly untouched to the bottom line. An additional concession of 20% of profits after distribution costs should result in roughly a 40% boost to Pixar's operating income from a given film. Knowing this, we can estimate that in 2005, we should see a big boost to Pixar's income and at the minimum rejuvenation of its growth rate. Pixar's cash earnings over the next 10 years alone could approximate $30-$40/share in present value. And the profits should not fizzle too much even after 10 years. Of course, this is very rough because we do not know what the new Disney contract will bring. But I like it when my margin of safety does not require a calculator.

The risk is that the films flop. If this were Fox, I'd worry. I'll try to buy 200 shares at a limit of 33 3/4.

Journal: August 15, 2000

- **Place order to buy 400 shares Deswell Industries (DSWL, news, msgs) at a limit of 13.75.**

Deswell Industries -- solid gold

Deswell Industries (DSWL, news, msgs) is a contract manufacturer of metal and plastic products as well as electronics. Traded on the Nasdaq but based in Hong Kong, Deswell runs an efficient operation that employs such techniques as on-site dormitories for its workers -- tactics that are profitable but not generally practical in the United States. One might consider this as a competitive advantage, but as a small company based in China, the firm's shares are met with distrust and general avoidance. While the stock trades daily, the volumes are miniscule

Common products made by Deswell include printed circuit boards, telephones, computer peripherals, and electronic toys which are sold to original equipment manufacturers that brand the end product. Hence, Deswell is behind the scenes -- **Vtech Holdings** (VTKHY, news, msgs) and Epson are major customers. Deswell has a reputation for timely, efficient operations and has been winning larger and more numerous contracts over the years. Business with Epson is expected to triple over the next year, and business with Vtech is experiencing solid growth as well.

Deswell is a growth company but pays a generous dividend. Its officers own the majority of the stock, and rely on dividends as a partial salary replacement. Why? Dividends are not taxed locally. What this means is that in the long term, Deswell shareholders receive a quite generous payout every year -- often approaching double digits. And we can count on the dividend being preserved.

But excellent working capital management -- the latest quarter's 47% increase in sales came with less than 20% increases in inventory and accounts receivable -- keeps cash flow so strong as to continue funding quite significant growth. This is not often seen in companies with high dividend payouts.

Show me the business

You can see where this is heading. CEO Richard Lau pays little attention to the stock price, preferring to focus on the business. Investor relations is farmed out, and institutions generally ignore the company. What all this adds up to after backing out the $5.33 per share in cash is a stock trading at about $8.50/share after earning $2.01/share over the trailing four quarters -- and quite a bit more than that in free cash flow. This despite recent revenue growth in the 40% range and additional growth expected for the foreseeable future. By the way, the cash on the balance sheet is held in U.S. dollars.

The malaise in the stock over the last few years has been linked to difficulties in its electronics operation, but the latest quarter saw an 80% revenue jump in that division. Mr. Lau expects continued strength there as the market for portable communications devices heats up. Moreover, Deswell is attaining a critical mass in terms of capacity -- the company is increasingly seen as a realistic option as a contractor on even very large jobs. The expected 250% growth in Deswell's Epson contract over the next year is evidence of this. Expansion is being funded out of cash flows.

Another concern hovering over Deswell has been the effect of the rise in petroleum prices on its plastics business, which depends on resin as major input. But management hedged its supply such that there was no material effect on the business despite the parabolic rise in oil prices. This is a smart move, indicative of management's savvy in its field.

Contract manufacturers as stocks are split into quite disparate valuation categories based on size. Deswell trades at an enterprise value/EBITDA ratio of 2.7. **Solectron** (SLR, news, msgs), with sales 200 times Deswell's, trades at an enterprise value/EBITDA ratio of 30. **Plexus** (PLXS, news, msgs), with sales ten times Deswell's, trades at an enterprise value/EBITDA ratio of 40. And Deswell's return on capital and equity are quite a bit better than these other firms. The potential for multiple expansion with growth in revenues is hence quite significant.

I am looking to buy 400 shares at a limit price of $13.75.

Journal: March 9, 2001

- **Buy 500 shares of DiamondCluster International (DTPI, news, msgs) at 14 3/4 limit, order good until cancelled.**

- **Buy 1,400 shares of GTSI Corp. (GTSI, news, msgs) at 4 3/4 limit, good until cancelled.**

- **Buy 10,000 shares of Criimi Mae (CMM, news, msgs) at a 75-cents limit, good until cancelled.**

- **Buy 800 shares of Senior Housing Properties Trust (SNH, news, msgs) at a 10 limit, good until cancelled.**

- **Buy 1,000 shares of London Pacific Group (LDP, news, msgs) at $6.65 limit, good until cancelled.**

A diamond in the value rough
As a value investor, one of my favorite places to look for value is among the most out-of-favor sectors in the market. In order to obtain maximum margin of safety, one must buy when irrational selling is at a peak. Ideally, illiquidity and disgust will pair up in tandem pugilism. Ben Graham suggested bear markets offer such an opportunity. Right now, technology is in a bear market. One of the key themes is that business customers are putting off purchase decisions today in order to minimize expense in the near term -- and hence protect near-term earnings guidance. In the long run, this is a bad management decision, and in the long run the purchases that need to be made will be made.

The major software makers have been hit, as has nearly any company selling high-ticket items to big business. The market has visited particular scorn on the e-consulting companies, which have been lumped into one basket and simply heaved overboard. Within this sector, there are a variety of companies, however, and the stronger ones cater nearly entirely to blue-chip businesses. The ones that catered to dot-coms in particular are suffering quite severely, and rightly so. The stronger ones, however, have big cash balances and dot com exposure in the low single digits -- they have also demonstrated a capability of managing a business for positive returns on investment, and hence come off more credible l to intelligent executives of top corporations.

Based on an analysis of accounts receivable quality as well as cash conversion cycles, two e-business integrators stand out as among the best. One is **Proxicom** (PXCM, news, msgs); the other is **DiamondCluster** (DTPI, news, msgs). Both have demonstrated the ability to produce positive cash flow while growing significantly, but more importantly, both have extremely minimal exposure to questionable clients such as dot-coms. Their clients -- Fortune 500 companies -- will indeed eventually return to the prudent path of spending on high return on investment projects.

Of these two, my favorite is DiamondCluster. DiamondCluster has the best margins and working capital management in the business, despite working with blue chip clients that often demand favorable credit terms. The management team is quite strong, and in the coming quarters nearly half their business will come from overseas -- primarily from Europe and Latin America and away from the North American meltdown. Dot-com exposure is less than 2%. Moreover, their developing expertise in wireless, from working with **Ericsson** (ERICY, news, msgs) in Europe, will prove quite handy when wireless eventually takes off here in the United States.

Wireless is one area of telecom that continues to hold promise. Many of the biggest carriers worldwide have already spent billions on licenses that have not been developed. These carriers will not be able to delay long purchasing the consulting services needed to realize a return on such a large investment. DiamondCluster is very well-positioned in that area.

The balance sheet is pristine, with more than $150 million cash (over $5/share) and no debt. In fact, the stock has some history, having been punished severely during the October 1998 meltdown, only to rebound twenty-fold before crashing once again. This is a stock that is fundamentally illiquid and tends to provide opportunities within its tremendous price ranges.

Management continues to maintain a no-layoffs policy, and tends to promote from within. These features are unique in the industry and foster stability within the company that can only benefit it in relation to its peers. The competitive landscape includes **IBM** (IBM, news, msgs), a formidable e-services competitor. However, DiamondCluster has demonstrated an ability to win many of the biggest clients and is in the process of developing a branded reputation as well. Success with big clients is the biggest selling point when speaking with other big clients. The human-relations culture fostered at DiamondCluster (industry-low turnover is just 11%), the blue-chip client base, and the fundamental cash return on investment mindset that management constantly evokes all set it far apart from many of its weaker, struggling competitors. Unlike commodity staffing, high-level business consulting is very susceptible to branding, and DiamondCluster has been making the right moves to create an effective brand.

In any consultancy, human resources management is key. By not laying off consultants, management is signaling to the highest quality candidates out there that DiamondCluster offers stability and financial strength. This lowers turnover as well as costs, and helps DiamondCluster to the best margins in the industry. This also allows DiamondCluster to be most ready when the economy revs up once again and competitors are once again scrambling for talent.

Backing out the excess cash, DiamondCluster trades for around 10-times newly lowered estimates. It reached cash profitability at a lower revenue threshold than any of its competitors, and it will remain solidly profitable despite the current downturn. As a value investor, I am quite used to buying cyclicals as the downturn looks most dire -- but before the actual bottom is hit. Traditionally, cyclical stocks begin their bull rally well in advance of the actual business bottom. I believe that DiamondCluster is poised for such a rally.

There is some price risk here. Other high-tech consultancy stocks have plummeted to levels approximating their cash holdings, and DiamondCluster may in fact do that too. To date, the quality of the business has actually provided DiamondCluster stock some price protection relative to its lesser peers. But what I believe we are seeing is a short-term catharsis from the lack of visibility for recovery. The illiquidity of the stock as well as the momentum shareholder base simply aggravates the fall. Most value investors would not touch something called DiamondCluster, and hence price support is vanishing. I have seen the stock fall as much as 5% on a few hundred shares, only to see others follow and dump thousands of shares because the stock fell 5%.

The stock is hence something of a falling knife rapidly accelerating its descent. Technically speaking, the only support flows from the bottom of a channel uptrend extending back to early 1997 and a recent bounce off $14 1/2.

Fundamentally, the metrics look good. The company has been able to maintain revenues per billable of about $350,000 -- over 50% higher than several prominent comparables. Expect a cyclical lull in this figure as the company refuses to cut headcount during the downturn, but as mentioned before long-term investors should welcome this attitude.

However, the intrinsic value of this company is double current levels even using conservative long-term growth estimates well below those provided by the company. A key factor in these sorts of companies is management, and in this case management is reacting exactly how I would like them to -- as owners interested in the long-term prosperity of the business. The stock is now priced as if earnings will grow only 10% annually for the next 10 years, before falling to about 6% growth. A share buyback is underway, as it should be. Whenever a company has an opportunity to purchase $1 dollar of intrinsic value for 50 cents, it should do so. The company has ample cash to amplify the buyback, and ought to do so when the current allotment is completed.

For the record, management continues to target annual 30% revenue growth long-term, and earnings per share growth approximating 25%. They are looking across the valley. Intelligent investors would never take these growth rates, extrapolate a value from them, and call out "margin of safety." But intelligent investors should be able to also look across the valley and see an opportunity for capital appreciation in a long-term hold from these levels.

The industry may see some consolidation. Anecdotal reports are that foreign firms looking to snap up American technology expertise are already scouting out various targets among the e-business consulting walking dead and wounded. Proxicom seems particularly susceptible here. I am not expecting DiamondCluster to sell out, but depressed shares composed 1/3 of cash are generally attractive targets. Buy 500 shares at 14 3/4 limit, good until cancelled.

Other buys
Also, buy 1,400 shares of **GTSI** (GTSI, news, msgs) at 4 3/4 limit, good until cancelled. This stock is a holdover from last round. A supplier of technology equipment to the government, it remains a net net (selling at a discount to net working capital less all liabilities) despite a tremendous change in the business for the better, with expected earnings in excess of $1 per share.

Buy 800 shares of **Senior Housing Properties Trust** (SNH, news, msgs) at 10 limit, good until cancelled. This is another holdover from last round. A high dividend payout on this health-care REIT and an improving regulatory and financial climate due to recent budget changes continue to make the stock attractive. Warren Buffett bought stock in **HRPT Properties** (HRP, news, msgs), which has the same management as Senior Housing and which is also Senior Housing's largest shareholder.

Buy 10,000 shares of **Criimi Mae** (CMM, news, msgs) at a 75-cents limit, good until cancelled. This is a stock of a finance company coming out of bankruptcy soon and worth at least $1.25/share and with only slightly different assumptions a little over $2/share. This is one of the slightly innocent bystanders forced into bankruptcy by the Long Term Capital Management crisis of 1998. This one's complicated and has recently been under selling pressure from a convertible preferred issue that has been converting. Penny stock is a pejorative term that happily makes people not want to look deeper, but the market cap is greater than GTSI, which trades above $5 regularly, and the enterprise value is much greater still.

Buy 1,000 shares of **London Pacific Group** (LDP, news, msgs) at $6.65 limit, good until cancelled. This is an ADR representing an ownership stake in a London insurance company and asset manager that uses its float in part for venture capital activities. The company has had a tremendous track record, and many of its companies not taken public have been acquired, resulting in large stakes in companies like **Siebel Systems** (SEBL, news, msgs). The extensive list of companies it has helped fund include **LSI Logic** (LSI, news, msgs), **Atmel** (ATML, news, msgs), **Linear Technology** (LLTC, news, msgs), **Oracle** (ORCL, news, msgs), **AOL Time Warner** (AOL, news, msgs) and **Altera** (ALTR, news, msgs), among others. Currently trading at a substantial discount to the net asset value, the stock should in fact mirror the value of its public and private holdings plus the value of its $5 billion asset management operations. It is also important to realize that a soft IPO market does not result in losses -- the company simply must keep its private companies private a little longer. Similarly, mark-to-market losses on public securities are simply paper losses until realized.

Journal: March 16, 2001

- **Change the outstanding limit order on GTSI Corp. (GTSI, news, msgs) to buy 1,500 at 4 7/8**

limit, good until canceled.

- **Change the outstanding limit order on Criimi Mae (CMM, news, msgs) to buy 10,000 at an 80-cent limit, good until canceled.**

- **Change the outstanding limit order on Senior Housing Properties Trust (SNH, news, msgs) to buy 700 shares at $10.10 limit, good until canceled.**

- **Buy 1,500 shares of Grubb & Ellis (GBE, news, msgs) at 5 limit, good until canceled.**

- **Buy 2,000 shares of Huttig Building Products (HBP, news, msgs) at $4.10 limit, good until canceled.**

- **Buy 2,000 shares of ValueClick (VCLK, news, msgs) at 3 5/8 limit, good until canceled.**

Two out-of-favor choices
First, let's adjust a few unexecuted trades. Change the outstanding limit order on **GTSI Corp.** (GTSI, news, msgs) to buy 1500 at 4 7/8 limit, good until canceled. Change the outstanding limit order on **Criimi Mae** (CMM, news, msgs) to buy 10,000 at an 80-cent limit, good until canceled. Change the outstanding limit order on **Senior Housing Properties Trust** (SNH, news, msgs) to buy 700 shares at $10.10 limit, good until canceled.

Now, today's new names:

I'll buy 1,500 shares of **Grubb & Ellis** (GBE, news, msgs) at 5 limit, good until canceled. A real-estate services firm, one would imagine that this company would be out of favor right now. It sure is. **CB Richard Ellis** (CBG, news, msgs), a competitor, is being taken private by management at an enterprise value/ EBITDA multiple of 6.2. Currently, Grubb & Ellis trades at a multiple of about 3. Warburg Pincus and **Goldman Sachs Group** (GS, news, msgs) are the majority owners of the firm. The stock has been languishing, and Warburg is looking for a way out. They've been shopping the firm around, but found no takers for uncertain reasons – possibly the price was too high. GE Capital and Insignia Financial Group have taken a peek.

The firm recently completed a fully subscribed self-tender for about 35% of the outstanding shares at a price of $7 -- undoubtedly a way for Warburg and Goldman to liquidate a portion of their position in light of the fact that there is no ready buyer. The company released the CEO last May and neglected to search for a new one. This company is, quite simply, on the block and as yet there are no takers.

In the meantime, it is very cheap. Cash on hand at the end of the year is inflated by deferred commission expense, and this is a cyclical industry headed into a downturn. But if CB Richard Ellis is worth a 6 multiple on peak EBITDA, surely the Grubb & Ellis share price is awfully low. Other comparables trade at a 6 multiple on EBITDA as well.

I'll add in a buy 2,000 shares of **Huttig Building Products** (HBP, news, msgs) at $4.10 limit, good until canceled. A holdover from last round, this building-products distributor with a nifty value-added door manufacturing operation trades at low valuation and has been out of favor since its spin-off from **Crane** (CR, news, msgs) in late 1999. It recently pre-announced this quarter, seasonally its most difficult. Over the decades, however, this firm has managed to stay profitable through thick and thin. It is executing a plan to de-leverage its balance sheet and has found cost synergies in a major acquisition last year that will bloom this year. A comparable company, Cameron Ashley, was taken private by management last year at a valuation multiple that implies Huttig deserves a share price in the $10-$15 range. The largest outside shareholder wants out and may find the easiest way is to instigate for a buyout. The second largest shareholder is the Crane Fund, an affiliate of Crane, and Crane's CEO is Huttig's Chairman. Without a takeout, the company trades at low multiple of free cash flow, has management focused on return on capital hurdles, and makes a good hold.

Buy 2,000 shares of **ValueClick** (VCLK, news, msgs) at 3 5/8 limit, good until canceled. ValueClick is a pay-for-performance (or cost-per-click) Internet advertiser. Again, tremendously out of favor right now. What this company has going for it is a hefty cash load as well as shares in an overseas subsidiary, ValueClick Japan, that together are worth significantly more than the current share price. Operations have been roughly cash-flow neutral, and certainly things are not getting worse. Because of pooling transactions rules, ValueClick's management claims it cannot institute a share buyback of any size.

Intuitively, one would expect that the cost-per-click or pay-per-conversion model would start to make sense to more and more advertisers as traditional revenue models requiring payment simply for the presentation of a banner prove futile. Financial companies such as credit card vendors are starting to see the light here. Japan remains a stronger market for ValueClick, which got into the market earlier and hence is participating more fully in the de facto advertising standards that developed there. ValueClick has also acquired assets in areas such as opt-in e-mail campaigns and software measuring return on investment.

DoubleClick (DCLK, news, msgs) owns a stake in ValueClick and has representation on the board. If nothing else, this company seems a takeout waiting to happen. Most downside is priced in at this point – after all, the business has a negative valuation – and there is a decent upside.

Journal: March 28, 2001

- **Place order to buy 1,000 shares of Spherion (SFN, news, msgs) at 7.85 limit, day order only.**

- **Place order to short 300 shares of Standard Pacific (SPF, news, msgs) at 22 or higher, good until canceled.**

- **Place order to short 100 shares of Adobe (ADBE, news, msgs) at 36.50 or higher, day order only.**

The recovery mirage

A prominent newspaper recently published one of the least informed articles I've ever seen. I believe it speaks volumes about where the stock market might be headed. The title was "Why High Tech Can Weather the Slowdown." The newspaper, unfortunately, was the San Jose Mercury news. Hometown shame.

Here's some choice wisdom:

- (caption for photo of Yahoo's new headquarters): "Yahoo's new headquarters in Moffett Park is an ironic lesson in the New Economy: Silicon Valley can avoid a recession like the one 10 years ago because it has diversified beyond defense contracts, chips, and hardware." My comment: Internet advertising is a tool for diversification against an economic slowdown? Quick, someone tell **The Washington Post** (WPO, news, msgs)...
- "A broad spectrum of tech companies hedges against slumps in any particular sector at a given moment. Although all the tech companies are linked in a food chain, some will probably suffer less during the IT spending slowdown, the economists say. "They're holding hands, but they're cartoon characters, and their arms can stretch," said Mike Palma, principal IT analyst at Gartner Dataquest." My comment: Oh, they're cartoon characters all right ...
- "I don't think there's anything out there that would lead us to anything even approaching the early-1990's experience," said Ted Gibson, chief economist at the state Department of Finance. Silicon Valley economics guru Stephen Levy, co-founder of the Center for the Continuing Study of the California Economy agreed. "Everyone knows that it's temporary," he said of the tech slump. My comment: "The Silly Putty guru levied a temporary study of the continuing"... Wait, no... "The joint economy of a continuing center of Sili. Valley gurus and government intelligence"... wait, no... "We're from the government-and he's an economist-and we are all known for being very very right most of the time"... ah, much better ...
- This time it will be different because "California is slowing from an extraordinarily red-hot economy" and "In 1990, California was coming off a building binge" and "Monetary policy is different" and, wait, this is great-"Venture capital has matured as an industry, fueling business innovations in a broader way than before." My comment: Yeah, those VC's

> really refined that "dump it on the gullible public" strategy. Thank God the VC's will be there with their newfound expertise to help us pull through these rough times.

But the market has already fallen so far. Could it really fall further? Sure. As long as everyone is asking, "Is this the bottom?", I doubt that it is. When people truly capitulate, no one will be asking if there's capitulation. Capitulation will be defined by a loss of interest in capitulation.

I'm not trying to divine market direction from popular behaviors. In fact, I really am not proclaiming anything about market direction. But the valuations justify a bottom about as much as the behavioral indicators do, which is to say not at all. So here goes my essay, titled "Why High Tech Stocks Cannot Weather the Slowdown."

The stock-options shell game

I'm going to outline a problem that a lot of tech companies face -- and that makes their stocks in general overvalued. Unlike nearly every other industry, tech companies compensate their employees in a manner that hides much of the expense of the compensation from the income statement. Of course, I'm talking about options.

With the most prevalent type of option -- called "nonqualified stock options" -- the difference between the price of the stock and the price of the options when exercised accrues to the employee as income that must be taxed because it is considered compensation. Not according to Generally Accepted Accounting Principles (GAAP), but according to the IRS. So the IRS gives companies a break and allows them, for tax purposes, to deduct this options expense that employees receive as income. The net result is an income-tax benefit to the company of roughly 35% of the sum total difference between the exercise price of the company's nonqualified options during a given year and the market price of the stock at the time of exercise.

Since GAAP does not recognize this in the income statement -- for whatever reason, I'm not sure -- the cash flow statements record this "net income tax benefit from employee stock compensation" in operating cash flow as a positive adjustment to net income. After all, the company included neither the cost of the options nor the income tax benefit on the income statement. Hence, the correction to cash flow.

Great, right? So net income is understated, right? Wrong. When evaluating U.S. companies, investors ought to assume that if the IRS can tax something, then it is a real profit. And if they allow one to deduct something, then it is a real cost. For instance, goodwill amortization cannot be deducted for taxes, but that's another topic for another day.

For many tech companies, options compensation is a big issue. In a rising market, the net income tax benefit can be quite large -- but it only reflects 35% of the actual cost of paying employees with options. How does it cost the company? Because the company must either issue new stock or buy back stock for issuance to employees in order for the employees to obtain this stock at a discount. The cost is borne by shareholders. The per share numbers worsen, while the absolute numbers improve (after all, issuing stock at any price is a positive event for cash flow if not shareholders).

Adobe (ADBE, news, msgs), for instance, is widely regarded as a good company with a franchise. A bit cyclical maybe, but a member of the Nasdaq 100 ($OEX) and the S&P 500 ($INX). It's been around the block. And its shareholders have been taken for a ride.

Looking at its recently filed form 10K for 2000, one sees that the income-tax benefit for options supplied $125 million, or roughly 28% of operating cash flow. Fair enough. Let's move to the income statement. Based on a corporate tax rate of around 35%, that $125 million represents $357 million in employee compensation that the IRS recognizes Adobe paid, but that does not appear on the income statement.

Plugging it into the income statement drops the operating income -- less investment gains and interest -- from $408 million to $51 million. Tax that and you get net income somewhere around $33 million -- and an abnormally small tax payment to the IRS. That $33 million is roughly the amount of net income that public shareholders get after the company's senior management and employees feed at the trough.

For this $33 million – roughly a tenth of the reported EPS-shareholders are paying $8.7 billion. Adjusting the price/earnings ratio (PE) for what I just described jumps the PE well into the triple digits.

This is why I call a lot of technology companies private companies in the public domain -- existing for themselves, not for their shareholder owners. Of course, it is a shell game. A prolonged depressed stock price -- for whatever reason, including a bear market -- would cause a lot of options to become worthless, and would likely require the company to either start paying more in salary or often worse, to start repricing options at lower prices.

In a coldly calculating market rather than a speculative one, the stocks of companies that have been doing this to shareholders will suffer. It is not limited to Adobe. **Cisco** (CSCO, news, msgs), **Intel** (INTC, news, msgs), **Microsoft** (MSFT, news, msgs) and many of the greatest tech "wealth creators" of the last decade are in the same boat. When shares are bought back in massive amounts and the share count keeps rising, that's a clue. And in a true bear market, even cold calculations are barely worth the screens they're punched up on. As much as this market overshot to the upside, expect an overshoot to the downside.

And now for the trades
We're in the midst of a bear market rally, so I'm not anxious to buy much yet -- I like to buy when things are more gloomy. I will resurrect a short from last round, though. Short 300 shares of **Standard Pacific** (SPF, news, msgs) at 22 or higher, good until canceled. A homebuilder heavily exposed to California's difficulties, with insider selling. Sentiment surrounding the homebuilders remains wrong-headedly perky. I wrote about this last round and will update my analysis soon.

Here goes one buy now because a catalyst is in the offering: **Spherion** (SFN, news, msgs) is a human resources/temporary services firm now floating a subsidiary on the London exchange for more cash than the entire market capitalization of Spherion. The proceeds will be used to pay off debt and buy back shares. The upside could be variable, especially in the near-term, but using very conservative assumptions, it appears the downside to the valuation is still about 18% above the current price. And to the extent the share price remains depressed as Spherion starts buying back stock, intrinsic value per share will rise. Buy 1,000 shares at 7.85 limit, day order only.

Journal: March 29, 2001
- **Place order to sell position in London Pacific Group (LDP, news, msgs) at the market.**

- **Place order to sell position in Spherion (SFN, news, msgs) at the market.**

- **Place order to buy 500 shares of GTSI Corp. (GTSI, news, msgs) at 4 7/8 limit, good until canceled.**

Real stocks, real profit, real value
My short of **Adobe** (ADBE, news, msgs) was not triggered. But I do recommend rereading my argument for doing so. I am not short Adobe in real life either, but the same logic applies to many, many of the tech stocks out there. I do not believe we are near a bottom yet because in the cold light of a bear market these types of things -- such as dilutive options compensation and hiding mistakes with charge-offs --matter. The greater fool theory no longer rules. What a relief

Now, maybe, finally, we have a time for rational stock picking. If the market begins the first multi-decade sideways run of the new century (there were two such runs last century – both times after extreme valuation bubbles), then the surest way to profit will be to buy stocks of incontrovertible value. Stocks of profitable companies that can be bought for their level of earnings per share five to 10 years out meet this criterion. In this vein, buy 500 more shares of **GTSI Corp.** (GTSI, news, msgs). This is one of the cheapest stocks in my universe, with the best story. They distribute technology products to the military, the IRS and others. Over $650 million in sales and a $35 million market cap. No debt. Net net value (net working capital less all liabilities) is north of $6. And they will earn over a buck a share this year. They earned a buck a share last year, but that was with a tax loss shelter from the era before new management took over. They have seen steady gross margin improvement, and even with full taxation this year, they expect earnings to beat last year's untaxed income. Because of the contractual nature of the business, there is some visibility, and yes, there's growth.

The company just won a dispute over a large contract to supply products and services to the government. While awards within the contract are still open to competition between the company and **IBM** (IBM, news, msgs), GTSI should do well. This is a relationships business, and GTSI competes well because they have the relationships with the government decision makers and the willingness to get into all the government paperwork. It is a low, low margin business in which the largest portion of capital is usually tied up in working capital. To the extent that new technologies help them squeeze working capital, cash will be freed up for other uses. The company is looking to do its first-ever road trip and broadcast the better business practices that now hold sway over all that revenue.

Insiders were buying at lower levels, as was I. For a few years it was a lock of a trade from 2 5/8 to about 4. Lacy Linwood, the largest shareholder, has been buying in the open market and was one of the founders of **Ingram Micro** (IM, news, msgs). Having a large, non-management shareholder with a large, illiquid stake is catalyst waiting to happen, though without guarantees. His background confirms that Ingram and its ilk are not the competitive threats here, as one might think.

Undoing some mistakes
Investment managers are bound to be wrong many, many times in their lives. This is a business of managing emotion as much as managing money, and taking one's lumps is the surest path to a more erudite view. So it is time to own up to a few mistakes. In my last entry, I outlined my pessimistic outlook for technology shares based on the devious, unfriendly manner in which many tech managers try to hide the truth from shareholders. Two of my holdings do not reflect that pessimism.

DiamondCluster (DTPI, news, msgs) and **London Pacific Group** (LDP, news, msgs) were very big timing mistakes. The same mistakes I made at the beginning of the last round -- being overly optimistic as a new round gets under way, and under some self-imposed pressure to make some moves. Optimism in such cases is rarely warranted. Nearly without fail, egg will befall one's face. With stocks in freefall, I thought, "Well, these two are interesting situations and we have at least six months." Unfortunately, every time I think like that I become cavalier in my timing. The fact of the matter is I should always wait for my rules to kick in – and that includes waiting for falling knives to lay motionless on the floor before trying to pick them up. I violated these rules, and now I've lost two fingers to a couple of very sharp blades. There is value in these companies at current levels, however, and I'll hold DiamondCluster for now.

I am selling London Pacific Group at the market open because of something I call the "5 to 3" effect. Illiquid stocks falling beneath 5 often fall much further because of margin calls that kick in in the 3-5 price range. Forced selling in illiquid stocks is a recipe for price risk, so I have found it prudent to get out of stocks as they cross below 5. It is a very rare case that I pay attention to absolute share prices, but this is one of them.

I should note that DiamondCluster is about to lose significant European business because of **Ericsson's** (ERICY, news, msgs) cost-cutting and the European slowdown. This non-U.S. business had shielded DiamondCluster from some of the rampant devaluation in the e-consultancy sector. Not anymore. Nevertheless, I expect both layoffs and quite significant cash drain over the coming quarters at DiamondCluster. At current prices, however, this pessimism is largely discounted. Whether DiamondCluster will recover before the end of the Strategy Lab round is a matter in serious doubt. Moreover, DiamondCluster has a big options compensation problem, much as I described with Adobe. Nevertheless, the value five years or so out should be greater than it is now, and the company has become an attractive acquisition target with a load of cash on the balance sheet. The earnings power in good times is roughly about 33% of the current share price net of cash, with no debt and a resilient business model.

An event play, sans the event
Sell **Spherion** (SFN, news, msgs) at the market open. This was an event-driven value play, and the event occurred after I submitted the story. In this case, the event did not look like I thought it would look. Too late to cancel the story, so the order went through and I bought a position. One more reason I say learn what you can from me, but don't imitate me. Now I'm selling it because in event-driven investment if the event does not turn out as predicted, the only prudent thing to do is to exit the position. Spherion is likely to announce horrendous numbers, and there is price risk in the stock. A good argument can be made that it is only fairly valued in the 7's, not undervalued. To justify a sell I must only be able to make such an argument.

What happened? As this was an event-driven value trade, for the investment to work we had to have the event go off nearly as planned. In this case, the event -- a float of subsidiary Michael Page in London -- did not go off nearly as planned. Actually, the pricing still hit the bottom of my model, so there was some safety in the price I paid given the information I had.

The circumstantial evidence points to some skullduggery, however. Michael Page's officers had some incentive to have the offering priced low. Now any options that they get -- and that they can use to incentivize employees -- will be priced low. Moreover, they had incentive to do an offering rather than to sell to others in a private transaction worth as much as 25% more. The incentive involved the fact that Page management was getting 6% of the company and there was a large 12% overallotment for the underwriters. Unfortunately, there was every incentive, except fiduciary responsibility to the shareholders, to price this offering low. Michael Page is a good buy now over on the London exchange. I doubt that it will stay under 200p long.

Also, it appears that Ray Marcy, the CEO of Spherion, now wishes to use the proceeds to pay off some debt and then hold cash for the downturn. This is opposed to the previous statement "pay down all debt and buy back stock." The two statements imply drastically different levels of confidence in the business. One potential catalyst -- again, this was an event-driven trade/special situation -- was that the company would at least support its stock in the market. That would be relatively easy to do given the stock's illiquidity. A buyback of 30% to 40% of the capital stock could even push the moderately higher, and with some more optimistic projections, build more intrinsic value per share. It is not to be.

A board member who was selling large chunks of stock in Spherion during the months leading up to the offering could be a target of shareholder scorn. The prevalent idea was that this was distressed selling for him because of personal financial difficulties. Even if true, he engaged in massive dumping of large blocks in the months leading up to some very bad news. Spherion has never been the best-managed company, but the degree of funny business here is illuminating as to what management will do with future cash flows.

Event-driven trades occasionally don't work out in the short-term, but what you want is a fundamental floor to your valuation in the worst possible case. I think we have that here, and it is around the mid 7's. But I'm not hanging around for the questionable appreciation potential and sure-fire bad news that management will announce regarding earnings within the next two or three weeks.

Also, before Michael Page, the company had significant difficulties producing free cash flow. If they just sold off all their free cash flow production, the situation could deteriorate, and we can't know this for certain yet. This situation would have been mitigated if they had received $300 million more in the offering, as we were recently told to expect. Instead, we are left with the image of a desperate seller in need of much more shareholder-friendly management and a better economic outlook.

Journal: April 2, 2001

- **Place order to buy 1,000 shares of ValueClick (VCLK, news, msgs) at a 3 1/32 limit, good until canceled.**

What price repricing?
Where's the insider buying?

Cisco (CSCO, news, msgs), **Intel** (INTC, news, msgs), **Microsoft** (MSFT, news, msgs), **Sun** (SUNW, news, msgs)? Of course, I could probably count off hundreds, and it is a little unfair to single out these companies. Only a little. It is not that management is not prescient. In most cases, they knew to sell heavily at the top -- or at least as heavy as they could without seeming improper. These are individuals who have made millions if not billions, and yet they are not buying back their company stock in this time of need. In fact, many chose opportune times during the January bear market rally to give gifts of stock -- thereby maximizing the tax benefit while the going was good. Good thing they didn't wait. (Microsoft is the parent of MSN MoneyCentral)

Another controversial aspect of all this is that many of these companies have been executing massive share buybacks with funds from corporate coffers as these executives and founding shareholders have sold off their shares. Shareholder cash providing liquidity for their officers to dump stock? Sure. Happens all the time, especially in the tech industry, where the phenomenon of private companies existing in the public domain in order to take advantage of the public is rampant. This is not a new problem, but the venture capitalist mindset of the last decade has exacerbated it.

Shareholders ought not expect insider buys to start anytime soon. Aside from the general lack of value, most corporate officers and employees have just had options repriced, and others are considering it. Why pay for something you can just take? Options repricing is one of the most blatant forms of theft from shareholders that corporate officers have at their disposal. The larger the company, the greater the degree of theft. If Cisco reprices -- as has been rumored -- it very well may be the greatest single theft from shareholders in history.

Moreover, portfolio manager James Clarke of Brandywine Asset Management suggests that options that can be repriced are worth a whole heck of a lot more than Black-Scholes or the company's annual report would have you to believe. I know Clarke, a good friend of mine, to have at least thrice-daily original thoughts, and this one was an excellent one.

Here's how it works. Be aware that this part, however, is my extrapolation of his insight. If an employee has been given a call option to buy stock at certain price, one can potentially calculate the value of the option because there is risk if the stock price falls and there is gain if the stock price increases. If the option can be reissued or repriced so as to eliminate or mitigate risk if the stock price falls, how does one value the option? Well, you are basically putting something akin to zero in the denominator of the reward/risk tradeoff, which uncaps the value of the option. If a company were to pay cash in lieu of such options of such high value, what would the cash amount be? Would it be infinity? No, but it would be very high, and that's not good for stockowners, most of whom are OPMIs (Outside Passive Minority Investors), in the parlance of Third Avenue's Marty Whitman.

So let's recap.

- Per my journal entry last Tuesday, many tech companies are drastically overreporting cash earnings per share -- by a factor of 10 or more -- by relying on options compensation that does not appear on the profit/loss statement. Example:**Siebel** (SEBL, news, msgs), which would have massively negative per share cash earnings if it paid in salary what it paid its employees in options last year.
- With few exceptions, insiders are not stepping up to buy shares yet, even though they are fat with profits from selling the same shares at much higher prices, possibly aided by massive share buybacks using shareholder money. Example:**Exodus** (EXDS, news, msgs), which saw its executive officers sell down their holdings to near-nil last summer. There is still selling occurring. And dare I mention Microsoft? Witness VPs galore locking in

their fortunes and now holding only token amounts of shares.

- The rampant practice of repricing and reissuing options after a stock price fall in effect is like paying employees with items of near-limitless value, which raises the question of whether we should deduct near-limitless expense from the income statement. Examples: Too many. One or two examples wouldn't do this justice. But watch for Cisco to reprice its options. They've shelved the plans for now but are considering it.

Which brings me to my original thesis. When these stocks were going up, greater fools worldwide made millions. Many kudos to those non-insiders who were able to take advantage of it without rolling the money into yet another foolish idea. Now the zero-sum nature of growing companies that consistently dilute out and take advantage of their status is crystallizing in the nation's pocketbooks. Yet I cannot begin to tell you how common a question "So, has Cisco bottomed?" is whenever people discover my occupation. So whether any of these issues are crystallizing in anyone's mind is another matter.

Now that the bubble is pricked, tech stocks will face scrutiny they never faced before. It is a good time to start picking prices based on a solid understanding of the fundamentals behind these companies. Whether we have a bear rally or not, greater bargains are sure to come, and some "wish list" prices may come into view on the truly great, shareholder-friendly companies with permanent competitive advantages. For now, I remain unexcited by the prices I see in general in the market, and I'm happy to keep some powder dry for better values later.

ValueClick (VCLK, news, msgs), a current holding in the portfolio, was knocked down no doubt by some window-dressing at the end of the quarter. Who or what would want to show ValueClick, an Internet advertising firm, as quarter-end holding? Hopefully this will draw in more sellers. The company has north of $5 a share in cash and securities and is trading at $3 and small change. I should be clear, however, that management are acting foolish. They've been buying companies with their 60-cent dollars, i.e., their shares, and that is just nonsensical and wasteful. A buyback would work wonders for investor confidence and maybe even allow people to think that $5 in their hands is worth at least $5.

Journal: April 12, 2001

- **Sell entire position in DiamondCluster International (DTPI, news, msgs) at the open.**

- **Sell entire position in Criimi Mae (CMM, news, msgs) at the open.**

- **Sell short 75 shares of Kohl's (KSS, news, msgs) at the market.**

Preparing for more bad news
I'm selling my entire **Criimi Mae** (CMM, news, msgs) and **DiamondCluster International** (DTPI, news, msgs) positions at the market open.

A significant worsening in the commercial real estate market could undo the former, and on the latter, I am just taking advantage of a mindless bear-market rally in tech.

Also, I expect that DiamondCluster stock will not hold up well in the face of as-yet unannounced news of significant weakening in Europe. Its largest client there is **Ericsson** (ERICY, news, msgs), which is of course having some trouble. Word is that Ericsson's consultants are getting the ax, and DiamondCluster would be in that group.

I'll also short 75 shares of **Kohl's** (KSS, news, msgs) at the market. Same-store sales growth is cited widely as far and above the best in the industry. OK. But this growth overstates true organic growth. Sales per square foot has been tracking in the very low single digits. The company is turning to debt to finance the expansion, and Kohl's has been priced much too high for a while now.

Also, Kohl's has the same options-compensation problem that I have discussed previously with regard to technology stocks. Last year, nearly $270 million in options compensation was handed to employees, which largely dilutes much of last year's income.

Journal: April 13, 2001

- **Sell short 100 shares of General Electric (GE, news, msgs) at a limit of 44.**

- **Sell short 100 shares of Krispy Kreme (KREM, news, msgs) at a limit of 36.**

- **Buy 600 shares of Delphi Automotive (DPH, news, msgs) at a limit of 11.**

GE: bringing good things to earnings?
First, let me just re-emphasize that my trades here in fake-money land should not be followed verbatim. Yesterday I sold some shares of **Criimi Mae** (CMM, news, msgs) at the market open. The stock gapped down nearly 20% before rallying nearly 30%. Illiquid, low-priced stocks are subject to extreme swings. Because I often invest in such securities, I always use limit orders, and I never enter trades the night before in real life. I like to get a look at the market before I start maneuvering for a best-price execution. Here in Strategy Lab, I tend to be a little flippant with my trades – since they are often not securities in which I really have positions. Also, to write something up and never get executed – well, that has happened to me too much here, so I entered market orders

Similarly, I'd been meaning to put "short Kohl's" up here for at least a week or so. I finally got around to it -- and the timing was both fortuitous and unfortunate. The stock fell significantly at the open on an announcement that fits my thesis quite perfectly. Yet because I entered a market at open order, the trade executed on the gap down. Again, not something I would do in real life, but this isn't real life and market orders are often the best way not to waste words. Given the unfortunate results of my market orders in this forum, I will go back to potentially wasting words (and using limit orders).

Short 100 shares **General Electric** (GE, news, msgs) at 44 limit, good until cancelled. GE has been bringing good things to earnings for a long time now. Unfortunately, those earnings aren't what they are cracked up to be. Everybody knows this, but everybody lets it slide because those earnings are so danged consistent. What happens to these kinds of stocks when those earnings show any sign of strain? GE will bring every ounce of its substantial resources to manage earnings such that GE does not miss while Jack Welch is still in power. Yet the economy will hit GE, despite Jack Welch's claims to the contrary. The stock should be at least 50% cheaper. They overpaid for Honeywell, an acquisition which will prove to be quite unfortunate. And the fact that they have a retiring legend in the CEO spot, well, fairy tales are no good without the handsome prince.

Short 100 shares of **Krispy Kreme** (KREM, news, msgs) at 36 limit, good until cancelled. This is not Starbucks. No one is really addicted to these confections. Donuts are an expendable item coming out of at least semi-discretionary spending. But that's almost beside the point, and the point is not that Starbucks has had some difficulty creating shareholder value even with an addictive product and cool concept. No, the point is that Krispy Kreme's $17 million in net income pales next to its nearly $1 billion valuation. The net income also stopped navigating the cash flow statement during the last nine months. Free cash flow is in the single digits. And stock is being issued in abundance. There is a lock-up expiration to deal with. Oh, the list goes on and on.

And, to finish off the trades, buy **Delphi Automotive** (DPH, news, msgs) at 11 limit, good until cancelled. If this executes, I'll give reasons why.

Journal: April 17, 2001
Don't be distracted. Cisco is in far worse shape than even the dismal forecast it presents.

Hidden in Cisco's bad news, more bad news
Cisco Systems (CSCO, news, msgs) is writing off well over 60% of its inventory! They are trying to use the one-time write-off sneak-a-roo to great effect here. That is, "Hey, we've got bad news on the earnings front, so let's take billions in charges to write off all the parts of the business we know we managed poorly. And then let's say we'll actually be profitable this quarter before the charges!"

Do you buy it? I don't. This is a company that suffers from a tremendous lack of shareholder-orientation. A private company in the public domain, existing to take advantage of shareholders, not to benefit shareholders. While

John Chambers, the CEO, states that the hardest thing he has had to do is lay off these thousands of workers, well, that's only because he and his IR crew let only trusted "friendly" analysts in on the quarterly conference calls.

Let's look at what Cisco is doing:

- **Workforce reduction charge.** Cisco is taking at least a $300 million charge to lay off more than 8,500 people. That approaches one-quarter of the work force and tells us that this is not by any means a temporary lull in business. In fact, this tells us that Cisco really does not know whether or not the long-term growth rate can even approach 30%-50%, despite its assertions to the contrary. If Cisco really believed this, they would plan for it. And a 25% work-force reduction isn't planning for it.
- **Consolidation of excess facilities.** Here's another $500 million out the door and another sign that 30%-50% growth "long-term" is a pipedream. Cisco was to build a brand-spanking new campus about a mile and a half from my house here in south San Jose. Portions of it were supposed to be modeled after snooty Palo Alto's downtown area. Plans on hold indefinitely, now. Poor Cisco. They couldn't even build their very own trophy campus like all the other flash-in-the-pan never-can-fail growth stories got to do before they went bust. How unfair!
- **Asset impairment charges.** Bye-bye to $300 million or so. This is a goodwill write-off, which means, "We overpaid at least $300 million for acquisitions over the last few years." Honestly, this number seems low. Expect more where this came from -- only tremendous mind-over-matter denial is keeping Cisco from puking yet again and in greater volumes.

Oops, did I almost forget the $2.5 billion charge for inventory write-offs? Cisco would like me to, but Cisco's dreaming again. Read the press release: "Cisco expects to take a restructuring charge of $800 million to $1.2 billion" -- and then lists out the three components of the charge, as I did above. And then it puts an "also" in there. As in, "Oh, by the way, there's another $2.5 billion coming out of inventory, but don't pay too much attention to that."

That is over 60% of inventory vaporized with a simple charge. That is very real money out the door -- costs that Cisco experienced but will never recoup.

To put in more real terms, remember those $3.7 billion in profits Cisco said it earned over 1995-1998? Well, Cisco has gotten so big that it can now take a one-time charge to eliminate 1995-1998 from the record books. Impressive, huh?

Actually, it gets more impressive. If one accounts for the shareholder dilution from massive options compensation abuses, you could potentially add total income from 1991-1994 to the write-off.

Oh, numbers to warm a shareholder's heart...Now, we await the repricing of options, or shall I say, "sheer ecstasy waiting in the wings."

Journal: April 18, 2001

- **Hold all positions. Intel is much more difficult to tear apart than Cisco Systems, but I'll try.**

Deciphering Intel's news
Now it's Intel's turn. First thing one notices is that the press release is not structured to hide much. That's because **Intel** (INTC, news, msgs) beat its lowered guidance, and is indicating its microprocessor business has stabilized. No need to hide good news

And to be perfectly honest, Intel is much more difficult to tear apart than **Cisco Systems** (CSCO, news, msgs). The abuses are simply not as egregious. I'll give it a college try, however.

One big number that stands out is the $23.2 billion that Intel has spent since 1990 buying back shares. Pretty impressive. Unfortunately, there is roughly the same number of shares, adjusted for splits, outstanding now as back then. In fact, there may be even a few tens of millions more shares. Was that entire $23.2 billion diluted out of existence by options programs and stock issuances for employees and management under the GAAP table? Almost.

When the employee executes a $2 option and turns around to sell the stock at $30, the company gets that $2 plus a tax benefit, both of which are offset by dilution of the common shareholder. Over the last decade, Intel has realized about $8 billion in cash inflows from these options exercises and from the associated tax benefits. So if the share count stays about even over the decade, the absolute dollar amount of dilution to shareholders is roughly $23 billion minus $8 billion, which equals $15 billion.

That $15 billion is only roughly one-third of the $46 billion in net income Intel reported from 1991-2000. Over the long-term, this is how much Intel's options compensation and stock compensation policies dilute shareholders, and hence a rule of thumb might be to dock Intel's reported earnings numbers by a about one-third when trying to figure out value. If Intel demonstrates a penchant for re-pricing -- a practice that is just sheer theft from shareholders, in my opinion -- then earnings get docked a lot more.

Another aspect of Intel's earnings reports is that it reports earnings before goodwill write-offs, amortization and in-process R&D charges. If you are going to add back goodwill charges to earnings, then you have to add back the goodwill amortization and charge-offs to the balance sheet. Intel charged off $660 million this past quarter, $1.7 billion in 2000, and $803 million in 1999. These are significant amounts of cash out the door. So while they are non-cash charges now, it is important to remember that all these charges are only money spent by Intel in the past finally making its way through the income statement.

I am a big fan of the proposal to eliminate the amortization of goodwill. Let the goodwill stay on the balance sheet for all to see. This way we can tell exactly how much money the company has wasted in the past by simply looking at what the company is earning now and looking at what the company has invested to get to the now. Goodwill amortization hides mistakes. When the goodwill amortization doesn't hide mistakes fast enough, you see extra charge-offs, as we saw with Cisco earlier this week. Shareholders should not want mistakes hidden.

As for inventory concerns, nowhere did you see in Intel's report anything close to the horrendous wipeout of 60%+ of inventory that Cisco reported the day before. Cisco wrote that inventory off and then said they expect to increase inventory turnover. I would hope so! All in all, that sort of big bath accounting/funny business is not in Intel's quarterly statement. It is clues like these that lead me to have much more trust in what Intel is telling me than what Cisco is telling me.

Not all is rosy in inventory-land at Intel, though. I see inventories jumped over 29% during the quarter even as revenues fell 23% sequentially. When you are in a business that sets the gold standard for planned obsolescence, such an inventory bloat is not generally good. It also hits operating cash flow. In fact, the $411 million jump in inventory nearly obliterates the $485 million in first quarter net income.

Last year, with business picking up, inventories jumped only 5.7%. Could there be an inventory writeoff in the future? Sure. In fact, we should expect it. But I don't expect Intel to claim anything about improving inventory turns when they do.

By the way, it was reported in the Bay Area that Intel would not build any more plants here due to the high costs of doing business. Smart. Cisco, meanwhile, was plowing ahead with plans for the new campus in my neighborhood. Not smart.

By and large, I don't think success went to the head of Intel as much as it did Cisco. And so it is not surprising that scathing commentary on Intel is not so easy to write as it was for Cisco. Companies that manage themselves to please some Wall Street bogey are bound to say and do stupid things when they can no longer please Wall Street.

But just because Intel is relatively better doesn't mean it is absolutely good. For the reasons given above, I do not believe that Intel's current valuation is justified, the after-hours 10% pop in the share price notwithstanding.

Journal: April 25, 2001

- **Cover short position in Standard Pacific (SPF,**

news, msgs) at 16.25 limit.

- **Place order to buy 1,000 shares of American Physicians Capital (ACAP, news, msgs) at 16.50 limit.**

- **Place order to buy 400 shares of IBP Inc . (IBP, news, msgs) at 15.25 limit.**

Two buys with upside to spare
Cover the entire **Standard Pacific** (SPF, news, msgs) short position at 16.25 limit, good until canceled. Earnings will be released after the close, and I cannot ask for much more from this short. If you remember, I started this short last round with an initial short around 30. I re-entered the short this round substantially in the low 20's. Now with the price flirting around book value, the stock no longer violates one of my most successful rules of thumb: Public homebuilders should not trade much above book value. Presently, Standard Pacific doesn't.

This is not a buy recommendation, though. I anticipate that Standard Pacific will warn going forward and that it may have to write down some of its book value. But certainly the easy money has been made on the short side, and hence it is time to cover.

Buy 1,000 shares of **American Physicians Capital** (ACAP, news, msgs) at 16.50 limit, good until canceled. A mutual insurance company that demutualized in an IPO this past December, American Physicians is a terribly cheap stock. Book value is north of 30 a share, and a share buyback will only increase the per share book value. The company underwrites low-limit medical malpractice policies as well as some workers compensation insurance. The ratios are headed in the right direction, and the company is quite profitable as well as tremendously overcapitalized. At the very least, this stock should be trading at a more modest discount to book value.

Buy 400 shares of **IBP Inc.** (IBP, news, msgs) at the 15.25 limit, good until canceled. IBP is the gargantuan $17 billion sales beef and pork processor. After a bidding war that involved a management group and **Smithfield Foods** (SFD, news, msgs), Tyson won the right to buy IBP for 30 a share. Tyson Foods got heat from its shareholders over straying so drastically from chicken. After all, many portfolio managers had bought Tyson as one to benefit from the mad cow scare, not as one to suffer from it. In any case Tyson found a reason to back out and did. So IBP has fallen all the way down to 15 -- half the winning buyout offer and at about 65% of the initial buyout offer from the management group. IBP is no great shakes in terms of its business economics, but it is worth substantially more than 15 a share. In time, I expect Smithfield to make a substantially reduced offer at a substantial premium to the current price. The downside here is fairly limited.

Journal: April 27, 2001

- **Place a buy stop on previous position in Krispy Kreme (KREM, news, msgs) at 46, good until canceled.**

- **Place a buy stop on previous position in Standard Pacific (SPF, news, msgs) at 22, good until canceled.**

- **Place a buy stop on previous position in Kohl's (KSS, news, msgs) at 62, good until canceled.**

- **Place a buy stop on the previous position in General Electric (GE, news, msgs) at 51, good until canceled.**

- **Place order to sell 1,500 shares of ValueClick (VCLK, news, msgs) at 4 limit, good until canceled.**

When things go wrong
Considering I've had four shorts go the wrong way lately, I can't be too upset with my position in the Strategy Lab. Shorting things like **GE** (GE, news, msgs), **Krispy Kreme** (KREM, news, msgs) and **Kohl's** (KSS, news, msgs) in the face of one of the fiercest bear market rallies in history could have left me in much worse shape

As it is, I tried to get out of my **Standard Pacific** (SPF, news, msgs) short before they released results. I anticipated a typically promotional press release, and got it. Earnings, revenue, backlog all up. Unfortunately, so are inventories -- well in excess of sales -- and debt, and cash is way down.

No cash flow statement provided. And just as unfortunately, no sooner did I enter my order than it rallied 21% in two days on short covering – gapping its way out of reach of my limit order. An example of a limit order working out the wrong way. I would much rather have covered earlier, but with no opportunity to alter the order in the wake of the new housing numbers -- we're on a 24 hour delay here -- it wasn't possible. I'll put in a buy stop at 22, good until canceled.

The Kohl's short, a position I entered on a market order that went off quite badly, has been similarly unfortunate. My thesis remains intact there. I will put a buy stop at 62, good until canceled, however. No need to lose my shirt if the market goes haywire to the upside. Kohl's is a great short at 62, but it's also a better short at 70. No need to lose 8 on the way to the better short.

General Electric is a stock I am convinced will trade substantially lower in the wake of Jack Welch's retirement and the Honeywell acquisition. Its collective powers to manage earnings are considerable, but a slowing economy will showcase GE's weaknesses. Notably, absent the 110% surge in profit at GE Power, GE would have shown a 25% decline in operating profit this past quarter. Those kinds of surges will not be an ongoing event at GE Power. At this point, given its recent strength and tendency to rally hard with the market, I will place a buy stop on the position at 51, good until canceled.

Krispy Kreme trades in a manner decoupled from any reasonable fundamental valuation, much like the internet stocks of 1999-2000. In such cases, the stock floats on sentiment alone. My thesis remains intact -- the stock is worth at best 1/3 current levels, and eventually sentiment will correct its error. Actually, I'm being generous – 1/3 current levels approximates the IPO price, which was surely a bit high. In the interim, there can certainly be wild swings to the upside as shorts rush to cover on any change in general market sentiment, as has happened recently. Hence the stock has tremendous short-term upside risk. Given that Strategy Lab is a short-term activity and the current trend seems to be higher, I'll place a buy stop at 46, good until canceled.

In real life, I never enter market orders, nor do I enter limit orders with good until canceled features. I look at stocks I want to buy and short, set target prices, and watch the market action -- along with my trader -- for the best price in light of market conditions and recent news. When I attack, I attack with intraday limit orders. But such orders are not practical here. I've had a few fits and starts here in Strategy Lab trying to find the optimum mix of market orders and limit orders, and I'm not sure I've found a satisfactory method yet in light of the delay. As a practical matter, the amount of control I have in real life will never be attainable here in Strategy Lab, so I must make do. Attempting to cover a housing short with a limit order the night before national new homes data is released is not a good way to go about things. Noted.

ValueClick is a good example. Today **ValueClick** (VCLK, news, msgs) releases earnings, and a good part of my decision on what to do with that position will depend on what the earnings release reveals – and especially how the balance sheet looks, since this is to a large degree an asset play. I figure the stock is worth at least 4.30 as a stand-alone entity accounting for recent share dilution. To a strategic buyer like **DoubleClick** (DCLK, news, msgs), ValueClick could be worth much more. But without knowing what today's news will reveal, I'll make a conservative move that will likely result in a non-event. Sell 1,500 shares of ValueClick at 4 limit, good until canceled.

I had previously bought stock in **DiamondCluster** (DTPI, news, msgs) this round at 14 per share or so (and subsequently offloaded it at 10 or so, thinking I could buy it back cheaper later). My thesis was that DiamondCluster was worth about twice the price I paid and would make a nice acquisition. In that same entry, I brought up **Proxicom** (PXCM, news, msgs) as an alternative to DiamondCluster. Yesterday, **Compaq Computer** (CPQ, news, msgs) announced it was buying Proxicom for 5.75 per share cash. Normalizing various multiples over to DiamondCluster based on this new standard for valuing e-business consultants, and adjusting for the higher margins and better cash production at DiamondCluster, one finds DiamondCluster to be worth about 21.50.

This is a bit lower than my original estimate of value, and no doubt reflects the distressed future facing many of these firms as stand-alone entities. DiamondCluster had the best shot, in my opinion, of remaining profitably independent, and because of this it might deserve a higher valuation. As for the opportunity to buy DiamondCluster back cheaper later, I doubt that opportunity will occur now. No investor has a 1.000 batting average, but every mistake deserves scrutiny and this one will get it.

I will note that it seems likely that there was a leak in the Proxicom deal with Compaq. Proxicom stock has been leaping in a manner out of proportion to its brethren in the industry-over two days late last week the stock jumped 158%. That was about the time this deal was probably starting to come together. Hence, someone knew something -- and many people traded on that knowledge, since volume was up to five times higher than normal. Security regulators will probably never investigate, but investors should be outraged at this transfer of wealth based on what looks on the surface to be inside information.

Journal: May 23, 2001

- **Place order to buy 700 shares of Wellsford Real Properties (WRP, news, msgs) at 16.40 limit, order good until canceled.**

A cheap piece of real estate
I waited a few days to post this here, and so this stock has run up a bit. The phrase "cheapest piece of real estate on the stock exchange" is bandied about quite frequently, so I won't use that hyperbole here. Nevertheless, I can make a good case for net real asset value here over $30/share, and it has been basing around $16 for the last four years

What has changed is that **Wellsford Real Properties** (WRP, news, msgs) is liquidating its most visible investment -- a joint venture with Goldman Sachs. This joint venture specialized in rehabilitating office buildings -- turnarounds. So the book value underestimates true asset value. A recent sale went for a 25% premium to book value.

The chairman of this New York real estate investment trust is dedicated to buying back stock, and the company has retired 20% of its shares in the past two years. Wellsford invests in commercial real estate mostly around the Northeast.

But at this point, I've let others do the waiting for me long enough. Time to take a position.

Journal: May 30, 2001

- **Sell the entire ValueClick (VCLK, news, msgs) position at a limit of 3.20.**

- **Increase the limit buy price on Wellsford Real Properties (WRP, news, msgs) to 16.45.**

Watch for return to April lows and lower
The last few trading days notwithstanding, chances are that you feel as if every stock you look at has moved up recently. You would be correct in that feeling. The recent rally has been incredibly broad, with over 80% of NYSE stocks participating almost regardless of market cap or sector. The problem is, very few people actually bought the April lows. Hence, chances are you have also watched several of your favorite or most wanted stocks creep (or leap) steadily upward without you. It's a fateful and frustrating experience, no doubt. But it does give some insight into what professional managers are feeling

Yes, the phenomenon is no different for professional investors -- they missed the early April lows en masse and have had to deal with tremendous lags in performance ever since. The difference? Professionals by and large were not fully invested when the turn came, while the indices by definition were. You have seen the results of this phenomenon here in the Strategy Lab, where all the players received $100,000 as the market entered one of the steepest four-week dives in history only to rebound within two and a half weeks of hitting its lows.

Of course, with each passing day of the rally, a few (hundred) more institutional holdouts crossed the line and started buying. After all, mutual fund investors never did pull money out of mutual funds altogether. It went to the money market funds, not to the mattresses. That money came rushing back with the ease of a click or a phone call, compounding the cash-on-hand problem. Hence, we got a "can't miss" rally, as in "can't miss the next bull market." Yet, the indices inched achingly ahead of the institutions' performance nonetheless. Which of course begets even fiercer buying. The aggressive ones are using leverage, if they are able, to catch up.

I can only conclude that it is quite possible we have not yet seen the bottom. Speculative booms like the 1920s and the 1960s were followed not only by steep stock declines, but also by stocks falling to absurd values. The aftermath of the speculative boom of the 1990s has seen ostensibly severe stock declines, but never during the April lows did I find stocks, generally speaking, go on sale. There was no sale in tech, but neither was there a sale in the financials, consumer products companies, cyclicals, etc. Gilt-edged brand names like **Coca-Cola** (KO, news, msgs) and **Gillette** (G, news, msgs) have seen their valuations reduced slightly, but they remain quite highly priced.

Indeed, by my calculations -- taking into account the massive corporate governance abuses borne of the bull market -- many of the biggest tech names and some of the biggest non-tech names that did fall fell only to fair value at worst. No fire sale in a fundamental sense at all. What is fair value? I use an annual 10% return to shareholders after dilution, slings and arrows.

Conventional wisdom says that either we've seen the bottom, or that there will be one more leg down, creating a W-shaped bottom. It is possible, even likely, that conventional wisdom will be proven wrong, and that the only alternative to these two options will instead occur. That is, the April lows will not only be tested, but pierced.

Bull markets: gifts that keep on giving
This is not a common viewpoint, but you shouldn't expect it to be. Such a viewpoint would imply we don't know where or when the bottom will be hit. But surely, "I don't know" does not sell. It doesn't sell advertising, generate commissions, generate deals or attract investors.

Thus, everyone from CNBC to any broker, sell-side analyst, market maven or personal finance magazine has a vested interest in advancing confident-sounding market prognostication. And the bias, of course, is for a bull market, not a bear. Bull markets are simply the gifts that keep on giving.

Meanwhile, several if not most CEOs of our greatest corporations are by and large blowing the proverbial sunshine...well, you get the idea. To the degree they can attempt to talk consumer confidence and capital spending up, they will all do their darndest. After all, when Jack Welch speaks, people listen. No matter that he's simply cheerleading his own exit. Think of management as a car salesman desperate to please. It's an overreaching metaphor, but it puts one in the correct defensive mind frame when listening to such charismatic characters. It is quite likely that the glimmers of hope we are hearing from such sources are simply just that -- glimmers, easily explained away in the future as never having been certain in the past.

So, I will go on record right now as saying that this is a time of tremendous uncertainty about market direction -- but no more so than at any time in the past. I continue to believe the prudent view is no market view. Rather, I will remain content in the certainty that popular predictions are less likely to come to pass than is believed and that absurd individual stock values will come along every once in a while regardless of what the market does.

Trade updates
I'm moving the limit price on my outstanding order to sell the **ValueClick** (VCLK, news, msgs) position down to 3.20. This stock was a case of good assets, bad business, bad management. The result was certainly predictable, and hence this was a mistake on my part. By and large I was looking for a fluctuation upward to net asset value. Looking at this conservatively, that's where we are now. The target came down to meet us, and hence it is time to minimize the impact of this trade to a small loss.

I will also raise the limit a nickel on the **Wellsford Real Properties** (WRP, news, msgs) buy. The limit buy price should now be 16.45.

Journal: June 13, 2001
- **Place order to sell 500 shares of American**

Physicians Capital (ACAP, news, msgs) at a limit of 20.40.

• Place order to buy 900 shares of Cascade Corp. (CAE, news, msgs) at 9.00 limit.

• Increase the limit buy price on Wellsford Real Properties (WRP, news, msgs) to 16.45; change order to 600 shares.

A nickel between me and break-even

Still pushing to get back to break-even. I'd have achieved that goal by now if I had been a nickel more generous with my limit buy on **Wellsford Real Properties** (WRP, news, msgs). Wellsford just bought back 24% of its shares at a huge discount to intrinsic value. Hence, intrinsic value per share just jumped at least $3 per share. The shares moved up to reflect this accretive action by management, but now they're soft again. It's not often that I'll raise my initial buy price on a stock (usually, I let missed opportunities be), but in this case 18.50 now is cheaper than 16.45 was back before the buyback. Increase the limit buy price on Wellsford to 18.50, but reduce the number of shares to 600.

Also, sell 500 shares of the **American Physicians Capital** (ACAP, news, msgs) position at 20.40 limit, good until canceled. I took advantage of a no-brainer price when I took such a large position, but at this price I'll scale it back to a still large but more average-sized position. I continue to be quite bullish on American Physicians, with the biggest risk being a dumb acquisition by management.

Back to basics

With only a couple of months until the end of Strategy Lab, I have to say I'm quite disappointed with my performance thus far. As I did during my first Strategy Lab last round, I kicked off the round buying several stocks that possessed a lot of short-term price risk. Optimism (associated with the beginning of a new round) and a wad of cash (fake, granted by MSN MoneyCentral) make for toxic twins in the world of investing. I should have been smarter, even if it is only fake money. And once having bought such securities with near-term price risk, I should never have sold them simply because they fell in the near term. Had I simply held all the stocks I bought this round rather than selling some of them, I'd be much better off. This was largely true last round as well. Ok, two strikes. Will MoneyCentral give me a third chance?

It is not in my nature to scramble for excess short-term return by taking on extra risk. Hence, you will not see me take massive stock positions or leveraged options positions simply to try to shoot the lights out in these last few months. As I did last round, I'll try to recover by going back to basics.

Start off with a new order to buy 900 shares of **Cascade Corp.** (CAE, news, msgs) at 9.00 limit, good until canceled. Cascade, a maker of forklift parts with significant branding and market share, was the subject of a management-led buyout offer earlier this spring. The offer put Cascade in play, and after a well-run bidding process that included more than 10 parties, an outside group offered to buy the company out for 17.25. Management came back with a late 17.50 offer that was properly rejected by the board.

The buyout fell through when the outside group encountered some skittishness on the part of lenders. Not surprising; several deals have been scuttled because of weak debt markets. What is surprising is that there was a final offer from the group -- $15.75 a share -- that was rejected by the board as well. In other words, a leveraged buyout can be done at prices 50% to 100% greater than the current price, and sharks are circling.

Recently **CB Richard Ellis'** (CBG, news, msgs) going-private transaction got a shot in the arm when it successfully placed junk debt in an oversubscribed offering. This is a good sign that with lower interest rates offsetting the economic risk, the junk markets are attempting a comeback. I expect Cascade to be taken out in a reasonable time frame. This illiquid stock, which was transferred from the hands of long-term owners to arbitrageurs during the bidding process, was unceremoniously dumped by those arbitrageurs when the deal fell apart. Now approaching half the price bid just a few months ago, the shares of this old economy diehard appear a bargain at 4.3 times trailing nonpeak EBITDA (earnings before interest, taxes, depreciation and amortization) with significant free cash production. The stock is at about three times peak EBITDA. No doubt the company faces rougher economic times ahead, but with a trio of bidders willing to pay over $16 a share just a few months ago, there is a margin of safety here.

Journal: June 20, 2001

- **Sell the entire position in IBP Inc. (IBP, news, msgs) at the market.**

Taking the easy trade

Buy stocks cheap enough and the news is bound to be good. As the deal for **Tyson Foods** (TSN, news, msgs) to buy **IBP Inc.** (IBP, news, msgs) blew up in late April and went to the courts, IBP stock fell to around $15, despite the fact that competitive bidding for the company less than six months earlier had priced the company at $30 to $32 a share. Moreover, $15 represented a 50% gain back to the $22.50 price at which a management-led group had offered to buy the company. And finally, $15 meant that if the deal went through as planned -- roughly 50% stock, 50% cash -- then you were getting Tyson stock for free. If the deal did not go through, one was getting a significant cash-generating business at less than book value. In short, at $15, one could argue that any news was going to be good news

IBP won its fight to have the merger agreement stand, and so now I sit on appreciated shares of IBP. If Tyson's current share price holds and the previously negotiated merger agreement stands, then IBP will be bought for a sum total of about $25.40 per share. IBP closed at $23.52 Tuesday.

So the natural question is, "What now?"

Risk arbitrageurs would now buy IBP stock and short a pro rata amount of Tyson stock in an effort to obtain the difference between that $25.40 and the $23.52. That's an 8% spread, which, if realized in a reasonable time frame, represents a good return. Risks for these arbitrageurs include that the deal price is reduced or that the deal does not pass antitrust muster. In such a case, Tyson's stock would rise and IBP's would fall. On the arbitrageurs' side is a court order mandating Tyson do the deal and Tyson's statement that it would not likely appeal.

I am not a risk arbitrageur. I believe that risk arbitrage is a quite overcapitalized field and, by and large, not currently a very profitable endeavor unless one has significant access to borderline inside information. Because there are only a few months left in this round of Strategy Lab, the only logical option for me is to sell IBP now and take the gain.

Those with a longer-term horizon could make a good argument for holding onto IBP and taking delivery of the $15 per share plus Tyson stock when the deal closes. Indeed, selling IBP now is equivalent to selling the Tyson stock at $7.16 per share before even receiving it. The key to remember is that the value of the deal is not the same thing as the short-term compensation to be received by IBP shareholders. That is, the value of Tyson stock is not necessarily that which the market is now quoting, as the stock is under intense short pressure from risk arbitrageurs. Longer-term holders who feel they can correctly judge the underlying value of Tyson stock as possibly $11 or greater would find the implied price of the Tyson shares embedded in their current IBP stock to be quite a bargain.

With respect to IBP, I'm a bit late here in Strategy Lab -- the news was announced Friday after the deadline for submissions for Monday trades. Making myself even more late, I did not submit an entry on Monday. Hence, my "automatic sell" of IBP is on time-delay and it has cost me a buck or so. Two days late and maybe a buck and a half short.

Journal: June 22, 2001

- **Sell the entire Grubb & Ellis (GBE, news, msgs) position at a 6.25 limit, good until cancelled.**

How to get even

An outsider might think find investors' thinking odd. Presented with new money to invest, most set goals of growing that money. They set targets of 20%, 30% or sometimes much more. And they set off fully intending to do so. Not so odd, yet.

However, once having lost money, investors tend to set a seemingly conservative new goal: breakeven. The irony is that breakeven math is one of life's crueler realities. That is, breakeven requires a percentage gain in excess of the percentage loss incurred. Not so conservative.

Moreover, losses are the ultimate slippery slope. If one has lost 20%, then one requires a 25% gain to break even. If one has lost 50%, one requires a 100% gain to break even.

As a result, the goal of breakeven is often much more aggressive than one's initial investment assumption. In an attempt to get back to breakeven, most investors simply ratchet up the risks they take. Of course this usually just ratchets up the losses – and increases the required return back to even. Talk about a death spiral.

My experience is that when one has losses that look other than temporary, there is usually a reason. The appropriate corrective action is to investigate the reason for the loss. More often than not, I find that I have strayed from the consistent method of investment that has served me so well for so long. Indeed, this finding often needs no investigation – I knew at the onset of the investment operation that I was straying, yet foolishly plowed ahead anyway.

All investors stumble. Usually some stubborn insistence plays a role. But fools will not be suffered lightly in a bear market. The risk of ruin is real. As investors, we must continually guard against the missteps that might lead to losses – and react rationally if we find ourselves down. Acting like a fool after the fact will only compound the error.

Portfolio updates
Senior Housing (SNH, news, msgs) is acting beautifully and pays a nice dividend. I would not be a buyer here, and I do not expect fireworks for the remainder of the round. The stock was a steal at 10 or below, and fair value is between 15 and 17. The upper end of that range may be reached as the payment situation in senior living improves even more. The dividend certainly enhances the return for long-term holders.

Huttig Building Products (HBP, news, msgs) remains significantly undervalued. I value this stock north of 10. $30 million could be squeezed out of the real estate acquired from Rugby (and on the books for nearly zero) by just rearranging some properties. I continue to anticipate a buyout or some other value-realizing activity, as this is a company that does not need to be public.

American Physicians (ACAP, news, msgs) was a no-brainer at 13.50, which is the price at which it demutualized last fall. Below 17, I'm a buyer. This company is overcapitalized with tons of excess cash and hence I view the move from 17 to 20 as more of a move from 5 to 8. That's why I'm willing to reduce the size of this hefty position in the 20.50 range. The biggest risk is that management carries out a dumb acquisition. Tremendous value could be created by just buying back the shares, which carry an intrinsic value north of 26.

Grubb & Ellis (GBE, news, msgs) under 5 is a decent buy, but there are structural ownership issues that limit the upside. Meanwhile, a new CEO has taken over and will want to make a mark even as the commercial real estate industry is entering a funk. I continue to believe that my long-term downside risk is that the company gets bought at a 40% premium to what I paid. In the near-term, this illiquid stock can bounce quite low. But I won't worry about that. Last quarter, some big institutional investors dressed up the stock at the end of the quarter in order to enhance their returns. That may happen again. In anticipation, I'll enter an order to sell the entire position at 6.25 limit, good until cancelled.

GTSI (GTSI, news, msgs) is prepping a blowout for last half of the year. Operational changes and a couple of contract wins have boosted business at this government technology products distributor, which sells at a multiple of around 5 on this year's earnings. The business is much less cyclical than the stock price, which bounces around a lot. The stock is finding its way into stronger hands, however. I believe the stock is worth at least 8 and probably more.

So that's it. With my previous sale of **IBP** (IBP, news, msgs), I have only five positions left. When I sell half of the American Physicians position, another slot will be open. I am being patient for the end-of-quarter selling that often occurs in downtrodden names as institutions rush to window dress their portfolios. In the meantime, my standing order to buy **Wellsford Real Properties** (WRP, news, msgs) at $18.50 might execute.

Journal: August 10, 2001

• Buy 1000 shares of Mesaba Holdings (MAIR, news, msgs) at 8.80 limit, good until canceled.

To own or not to own Cisco

Cisco Systems, market capitalization $141 billion, reported combined earnings for the last two years of $1.66 billion, and it is uncertain how or when Cisco will grow again. Moreover, it is possible and maybe probable that Cisco will write off $1.66 billion as a one-time charge sometime in the next few years. As usual, details regarding Cisco's options compensation programs are scarce.

So, which is the bigger risk: owning Cisco or not owning Cisco? One need not be short Cisco to experience the risk of not owning Cisco. For professionals, performance is benchmarked. That is, performance is relative. In the relative performance game, one is effectively short every stock not in one's portfolio that is nevertheless a part of the benchmark. To illustrate, a 100% cash position benchmarked against the S&P 500 Index is 100% short the index in the relative performance game. If the S&P 500 rises 10%, then in the relative performance arena the cash portfolio is down 10%. This is how Wall Street works.

So who in their right mind would short Cisco now? Virtually no one. Despite mustering every ounce of confidence possible, most analysts, portfolio managers, economists and corporate executives have no clue as to when either the economy or Cisco will again rebound. And on the off chance that the rebound occurs next month, well, better not be short Cisco.

What we have here is greed overruling fear, despite the fact that for a financial buyer -- a buyer that does not think strategically but rather thinks in terms of pure proven cash flows -- the public stock market offers precious few opportunities. And almost none of them are in big caps. Cisco does not qualify. I have given some reasons why in previous journal entries.

This lack of value should be troubling to thoughtful investors. Tremendous liquidity continues to grace the stock market. Hence, when investors flee from growth, they rush to value. Any big publicly traded company with a low price/earnings ratio or low price/book ratio and without obvious warts has seen its stock have a big run recently. Indeed, the bull run for value that started last fall has continued right up into the present. Now, however, most stocks are at least fairly valued. I would argue most remain overvalued.

Given the current valuation scenario across the market -- and evident in my daily reviews of anything and everything that looks either undervalued or overvalued -- investors would do well to start replacing fear of missing a rally with fear of further capital loss. Before the bear goes back into hibernation, the time will come when fear overrules greed. We are not there yet. Though we may soon be.

With little doubt, this round has been a disappointment. Now that I'm a short-timer, it seems hazardous to enter a position now, knowing that it is only a guess where the price will be in a few weeks when the totals are recorded for eternity. Nevertheless, the spirit of the Strategy Lab is not to remain idle. So here goes.

Hoping for a Mesaba takeoff

Buy 1000 shares of **Mesaba Holdings** (MAIR, news, msgs) at 8.80 limit, good until cancelled. Mesaba is a regional airline that was recently dumped at the altar by Northwest, which is also minority shareholder in Mesaba. Mesaba's primary business is to be an operator in the Northwest Airlink system.

Mesaba is the cheapest domestic airline. It gets paid by the capacity it makes available rather than the number of passengers it carries. It also has a favorable long-term fuel contract that buffers it from fuel cost fluctuations. Currently, one of its largest cost centers is the training of pilots. That will become less of an issue when Mesaba opens its new domestic pilot training center inside of a year from now.

The other potential catalyst is the winning of additional routes and jets from Northwest. Mesaba primarily competes with Express Air, a wholly owned subsidiary of Northwest. Therefore it follows that Mesaba will not get the majority of the new business from the recently announced large purchase of regional jets by Northwest. It is this lack of near-term growth that really turns off most analysts.

Mesaba will get some of those routes, however, and growth isn't terribly necessary given the valuation. With approximately $5 a share in cash, no debt and $2.31 a share in trailing EBITDA, $9 seems a cheap price for the stock. And it is. Book value per share checks in at around $8, and it is growing at a nice clip. A rational valuation is probably in the mid-teens, all aspects of this investment considered. Northwest turned away from buying Mesaba at $13 after an industry pilot strike resolution made the deal unfavorable for Northwest. Nevertheless, Northwest was not the only company interested in buying Mesaba. Last fall, another airline group made an inquiry to the board regarding purchasing the company and was rebuffed in favor of the Northwest deal.

If one looks at the valuations accorded peers such as **Mesa Air** (MESA, news, msgs), **SkyWest** (SKYW, news, msgs), and **Atlantic Coast Airlines** (ACAI, news, msgs) and adjusts for the lease structure at each, one would find Mesaba worth $16 a share or more. For now, it is just an illiquid stock knocked down by arbitrageurs rushing for the exits after the Northwest deal blew up. It has yet to recover, and it probably won't recover within the next month. Near-term downside may be as much as 12% to 15%, but such downside would be far from permanent.

Journal: Dec. 3, 2001

- **Don't worry about indexes. Worry about your stocks.**

Brace for yet another new paradigm
Welcome to Round 7 of Strategy Lab. The strategy entry pieces together outtakes from the quarterly letters I write to Scion Capital's investors

The cumulative return of my picks over the previous two discontinuous rounds has been just over 23%. Over the same 14-month span, the S&P 500 ($INX) returned a cumulative -22%, and the Nasdaq ($COMPX) returned a cumulative -58%. While the relative performance looks respectable, I am not happy with the absolute performance. It is not generally true that my portfolios correlate with the various indices anyway, and I know I could have done better with my stock picking here within Strategy Lab. Last round's performance was particularly harmed by my special situation airline and hotel holdings. I will attempt to do better here this round.

A good friend and portfolio manager recently related a conversation he had with a sell-side analyst. "Never in history have we seen interest rate cuts like this," the analyst waxed, surely prophetic in his own mind, "and not seen the economy and the stock market recover quickly."

My friend's response? "Unless you're Japanese."

You never see a bubble until it pops
The standard argument against a Japan 2000 scenario here in the United States is that we never had the real estate bubble like Japan did. For us it was just stocks. Or so the story goes. Of course, most people don't recognize bubbles until they've burst, while precious few seem quite capable of recognizing asset bubbles even while they are still intact. Good portfolio managers -- of which there are precious few, by no small coincidence -- belong to the latter camp. And good portfolio managers ought realize that the U.S. real estate bubble is simply not yet popped.

Another standard argument against a prolonged recession or depression is that the U.S. markets are freer, allowing quicker adjustments. However, if by adjustments, such pundits mean hurricane-force layoffs, greased-lightning monetary policy and the great disappearing act that is the federal budget surplus, I am at a loss. After all, none of this will change the fact that the economy is mired in a sea of stranded costs -- courtesy of about five years of moronic capital investment strategies. The country simply neither wants nor needs much more of what additional capital investment might produce. After all, when was the last time a new computer actually seemed faster than the old computer?

Moreover, there is a downside to a low interest rate policy in a nation of ever-expanding seniors. That is, lower rates mean lower income for the growing fixed-income population. Which means less spending if not crisis in certain quarters. Unlike stimulation of capital investment, this consequence of lower interest rates is both certain to occur and generally ignored. I have already had several of my own investors inquire as to sources of higher yield.

The yield chase
The need for yield has been apparent in the new issue bond markets of late. The **Ford** (F, news, msgs) deal was doubled in size even as Ford made it clear that the company would be lending out at 0% that which it borrows. Stocks don't pay dividends anymore, savings and money market accounts yield too little. The remaining option is bonds. To the degree the need for yield results in a mass panic for yield, however, the consequences will be dire. While earnings yields on equities are commonly mispriced, bond yields are much less commonly mispriced. So what is my recommendation to those who approach me in search of higher yields? Caveat emptor. In other words, work hard not to be seduced when a too-good-to-be-true higher yield investment comes along.

Moreover, should deflation become a factor, the tremendous debt burden under which many U.S. companies and consumers operate will become much more of a burden, even as consumers hold off on consumption as they wait for lower prices.

Paradigms are continually turned upon their heads. This how the United States as a country progresses. We ought brace for yet another new paradigm -- one that few if any pundits including me -- can predict. Regardless of what the future holds, intelligent investment in common stocks offer a solid route for a reasonable return on investment going forward. When I say this, I do not mean that the S&P 500, the Nasdaq Composite or the market broadly defined will necessarily do well. In fact, I leave the dogma on market direction to others. What I rather expect is that the out-of-favor and sometimes obscure common stock situations in which I choose to invest ought to do well. They will not generally track the market, but I view this as a favorable characteristic.

Journal: Dec. 14, 2001

- **Don't worry about missing a rally. Worry about losing your money.**

Why I'm all cash – for now
Cash seems quite conservative, quite boring. Yet the typical professional investor finds cash a little too hot to handle, and therefore high cash balances become the too-frequent prelude to forced investments and poor results. As this round started, the market roared ahead before most of us Strategy Lab players had acquainted ourselves. Indeed, the market was just continuing a massive rally from September lows. And then there we were, each with $100,000 cash. Absent the ability to short or use options, I chose, as a strategic decision, not to invest the cash, and I continue to choose not to invest the cash. This is by no means a permanent decision.

continue to avoid forecasting either market or economic direction. Rather, I simply attempt to keep both eyes and mind open to the inputs that influence the prevailing market environment. I use any resulting insights to help target areas of potentially lucrative investment. Currently, I am finding most opportunity in investments that would not be appropriate for posting here in Strategy Lab. Below, I describe my view of the current investing environment.

The equity ethic continues to circumscribe American investment philosophy. That is, America's taste for stocks is not yet diminished, and tremendous cash liquidity exists, ready to race to the next hot or quality or safe sector. Yet some basics of investing go unhindered, not the least of which is valuation.

When I speak of overvaluation, I do not refer to aggregate price-to-earnings ratios. Rather, I survey common stocks across all market capitalization ranges and find that the market continues to find ignorance bliss. That is, off-balance sheet and off-income statement items are ignored even as complex pro forma accounting obscures on-balance sheet and on-income statement items. Insider related-party dealings, despicable corporate governance and other such issues continue to take a back seat to an intense focus on expected growth rates. Greed continues to conquer fear.

Don't try to dig your way out
A key phenomenon driving the recent stock

market advance is the need for so many fund managers to catch up. Having had discouraging years through the end of September, many professional investors took on increased risk in order to dig themselves out of a hole. I warned against this tendency during the last Strategy Lab round. The math of investing requires a 50% gain to wipe out a 33% loss, and the only catch-up tool most professional investors have at their disposal is to take on increased risk.

Moreover, the year-end represents a nail-biting finish to a very grand one-year performance derby. The winners of the derby reap massive rewards. For most, missing a year-end rally would be fatal to such aspirations. Hence, just as happened twice earlier this year, Wall Street has climbed the wrong wall of fear; the common fear has been of missing the next bull market, not of further stock market losses. Fundamental valuations have been cast aside in the scramble. And once again, in the short run, mob rules.

One argument that has been used to sell and to sustain this rally as the real thing is the idea that the stock market rallies 25% or so 4-6 months in advance of an economic recovery. Therefore, as a rally reaches those proportions, predictions of a recovery 4-6 months out become ever more confident and full of bluster. Yet, to borrow a phrasing, the market has predicted two of the last zero economic recoveries in 2001 alone! Circular logic remains an oxymoron.

Of course, even if we have economic stabilization or recovery, it would be wrong to assume that this would be a boon for stocks in general. Indeed, for most investors, it would be better to watch interest rates. Interest rate changes become more significant in stock valuation when valuations are very high. That is, investment in a stock with a price/cash earnings multiple of 25 will be much more sensitive to interest rates than investment in a stock with a price/cash earnings multiple of 5. Rising rates paired to a richly valued stock market ought not result in a significant new bull market, despite an expanding economy. To put this in other terms, most widely held stocks have already (over)priced in a substantial economic and earnings recovery – even as they sit far below their highs of yesteryear.

Contrary to the somewhat absurd notion that all we have to really fear is missing a rally, I truly only fear permanent and absolute capital loss. Over the course of this round, I will place my investments as very good opportunities arise.

Journal: Dec. 28, 2001

- **Short 100 shares of Magma Design Automation (LAVA, news, msgs) at $29.50 or higher.**

Magma is one of a handful of companies that supply the semiconductor industry with the software to design semiconductor chips. Two other 2001 IPOs in this industry have performed decently.

Magma also has the meteoric price rise, up over 120% from its offering price. The stock has broken free from any rational valuation and now seems to go up simply because it is going up. And the offering price of $13 was a heck of a stretch in the first place.

True to its heritage, Magma's appeal suffers when one peeks under the hood. Here are the basics, culled from the company's own prospectus, news coverage and my own due diligence, including conversations with top management and insiders in the industry.

The company is not profitable. In fact, it has been losing tens of millions of dollars a year. Earlier this year, Magma laid off a significant portion of its workforce even as several of its competitors were doing very good, even record, business.

Also earlier this year, after filing in May for a public offering, the company found itself the subject of intense criticism as industry pundits noted that the filing revealed Magma's precarious financial position. The filing also helped heave doubt on the veracity of Magma's prior claims as to the size of its backlog and market share. This followed reports that Magma had been actively shopping itself to its four biggest competitors in the electronic design automation industry and that all had said no quite quickly. The IPO was thus delayed.

The delay created stress on the cash-hungry business, and in August Magma required a bridge loan of $25 million for working capital. The interesting terms of this loan included giving the creditor the right to convert the loan into stock at 67% of the IPO offering price. Indeed, this is what ended up happening, as Magma went public amid renewed investor appetite for risk on Nov. 20.

Primping for the public
What did Magma itself do to spruce up for its debut? Plenty, its filings show, and it is not pretty. First, starting in April, Magma imposed on its sales staff new rules: Commissions would no longer be paid upon the initial sale, but rather would be paid in installments over time. By spreading out the commissions expense, Magma delays cash outflows as well as near-term expenses.

While Magma acted to make expenses appear less than they really are, it also acted to make revenues appear greater than they really are. During the quarter ending Sept. 30, the company changed its sales model to emphasize perpetual sales over subscription sales. This has the effect of allowing greater revenue recognition in the near term at expense of revenue recognition down the road.

The net result of these two actions was to delay short-run expenses while boosting short-run revenue. The company also acted to beautify the cash-flow statement, reducing the capital expenditure run-rate to less than 50% of historical levels.

All this should give investors pause. Clearly, the last thing investors need is yet another management team with tendencies toward aggressive accounting. And investors ought keep in mind the reason for all these maneuvers was to look good enough to pawn the company off on the public at an IPO price that values the company at roughly $375 million. Magma discloses that the small portion of this that goes to company coffers allows only about 12 months of operations at current levels.

Over the next 12 months, other issues will arise. Magma specializes in an area of electronic design automation that has historically been the lair of embattled **Avant!** (AVNT, news, msgs). In fact, Magma has benefited from Avant!'s legal troubles with industry leader **Cadence Design Systems** (CDN, news, msgs) and from the associated marketing headwind that Avant! faces. After Magma's IPO, it was announced that the widely respected **Synopsys** (SNPS, news, msgs) is acquiring Avant!. The resultant Synopsys/Avant! combination is going to be a powerful one for several reasons that I will not detail here. The net effect on Magma, however, is that one of Magma's reasons for being has been severely weakened even as the resources of its largest competitors just doubled at minimum.

An exit for early investors
As well, of the nearly 30 million shares outstanding, some 24 million or so will come out of lock-up during the first half of 2002. The high percentage of shares in the hands of pre-IPO investors is reflective of the tremendous venture capital support this company required, and without a doubt one key reason for this IPO was to provide an exit for early investors. In time, this will bring selling pressure even as it multiplies the float available to buyers. Engineering tiny floats was a key tool in achieving rapid run-ups of IPOs during 1999.

In the short run, I also expect that the effective float has been made temporarily even smaller, as purchasers over the last month nearly all have gains, and a good portion may be unwilling to realize those taxable gains before year-end. It is possible that early January could see some of those buyers move to lock in these gains.

The three main underwriters of Magma's IPO have had their research arms come out with thoroughly unimpressive 'Buy' ratings on the stock. Other aspects to consider include that short covering may be driving a good part of the recent rally. There is also speculation that Cadence might be forced to acquire Magma in response to the Synopsys/Avant! combination. This is hard to imagine at Magma's current valuation, however.

I saved the valuation for last. It will be hard to nail the price of this security one day in advance. In the last half hour or so, the stock has risen another 7% or so and appears ready to crack $30 a share.

Valuation is out of whack

Valuation is a bit difficult for other reasons. After all, it has the requisite 1999-era quality of massive cash losses paired to no reasonable expectation for actual profit in the foreseeable future. Still, I'll take a shot. At $30 a share, Magma approaches a $900 million market capitalization. That represents about 36 times its (inflated) trailing revenues, although I'm being a bit overprecise here in assigning more than one significant digit to either this volatile stock or the uncertain business underlying it. Its strongest comparables across all market caps trade for between 3 and 6 times revenue – and are generally plenty profitable.

We also can look to a recent deal to help clarify valuation. Synopsys is paying an all-things-considered price of about 3 times revenues for Avant!, which generates tremendous free cash flow and has the best margins in the business.

Realize that this IPO occurred for two main reasons: to provide an exit for venture investors and to provide cash to allow Magma to survive a bit longer. My feeling is that insiders would sell like mad at $30 a share if they could. As Strategy Lab just loosened the rules to allow shorting, I will short 100 shares of Magma at $29.50 limit, good until canceled

Journal: Feb. 8, 2002

- **Buy 800 shares of Elan (ELN, news, msgs) at $12.70 or lower.**

- **Buy 200 shares of Kindred Healthcare (KIND, news, msgs) at $36.25 or lower.**

- **Buy 1,000 shares of Industrias Bachoco (IBA, news, msgs) at $8.50 or lower.**

- **Short 400 shares of Magma Design Automation (LAVA, news, msgs) at $25.00 or higher.**

Amid 'Enronitis' scare, three Buys and one Short

Those of you that have been reading my journal entries here for a while know that I've been a fairly vehement critic of accounting shenanigans. In the past, I've whacked **Cisco Systems** (CSCO, news, msgs) over the head, dissed **WorldCom** (WCOM, news, msgs), and I've had a few choice words in general for the way the professional stock market works to take advantage of the amateur stock market

I of course still believe that companies, in the long run, will not be able to fool anyone. Either value is created, or it is not, and the share price ultimately reflects this. Sometimes, and maybe even most of the time, a company that has been involved in scandal will be overly punished in the marketplace. What's more, as long as the company has the cash flow and the balance sheet such that it does not need access to capital markets, and as long as its customers don't care about the stock price, a company can have a very decent shot at long-term redemption.

The real Elan

Take **Elan** (ELN, news, msgs). This is a real company. Real shenanigans. Real debt. Real cash and real cash flow. Real drugs. Real pipeline. Real customers. Real value. Drug companies don't generally trade to 9-10% free cash flow yields. Remember folks, this is the pharmaceutical industry.

There are plenty of strategic buyers for Elan, and now it has fallen to a financial buyer's price range. Such circumstances usually don't last long. Ethically-tainted, scandal-plagued companies trading at real financial buyer multiples in an industry full of potential strategic buyers -- well, such situations usually deserve another look.

Kindred's spirit

Kindred Healthcare (KIND, news, msgs), a nursing home and long-term acute care operator, emerged from bankruptcy early last year. Very few are watching this as it drifts lower over worries that two key pieces of legislation benefiting Medicare revenues will essentially be reversed. I won't get into the specifics, but only half of what is feared might actually come true. The other half is 50-50, but for once I'm rooting for Tom Daschle.

This too is trading down at a roughly double-digit free cash flow yield, and has a net cash position. The downside in the event of a bad legislative outcome is maybe a 20% fall from current levels, and maybe even just stabilization at current levels. The upside to a good legislative outcome is a near doubling of the share price from here.

Poultry profits
Industrias Bachoco (IBA, news, msgs) is a Mexican chicken products producer. No. 1 in the country, trading at about a 20% free cash flow yield and at half book value. Enterprise value/EBITDA multiple is just over 2.5X. Economic trends vary, but this company has been around for the last 50 years, and in the last several years it paid off, out of free cash flow, an acquisition of the No. 4 player in the industry.

Nos. 2 and 3 in the industry are associated with **Pilgrim's Pride** (CHX, news, msgs) and**Tyson** (TSN, news, msgs). I admit -- this is not a great business. Maybe just worth book value. OK, double the share price and give me book for my shares.

Unlocking short value
Finally, if **Magma Design Automation** (LAVA, news, msgs) ever gets near 25 again, short the heck out of it. I believe I've already provided my rationale. In light of their earnings announcement reporting a one penny per share profit, investors should just realize that the company booked a fairly significant perpetual license order late in the quarter. They disclosed this on the conference call. Perpetual orders allow for significant revenue recognition up front, as opposed to revenue from time-based licenses, which are recognized ratably over time.

Also, we should realize that during the conference call management did not describe the non-cash stock compensation charges as non-recurring, but excludes them from its pro-forma profit calculation anyway. Management did say it was "hopeful" that these charges would eventually decline.

Lock-up expiration is just a few short months away, and then we find out what all the insiders really feel the stock is worth

Journal: Feb. 15, 2002

• Place order to buy 200 shares of Reuters Group (RTRSY, news, msgs) at $46 or lower.

• Place order to buy 1,000 shares of National Service Industries (NSI, news, msgs) at $6.75 or lower.

• Buy an additional 200 shares of Elan (ELN, news, msgs) at $13.25 or lower.

• Change previous order to short Magma Design Automation (LAVA, news, msgs) to 300 shares at $22.50 or higher.

Two stocks that look cheap
Coming up on the deadline, so I'll make this quick. **Reuters Group** (RTRSY, news, msgs) looks cheap. A cash-flow machine with significant brand equity and a solid balance sheet, the business is in the midst of a turnaround at the hands of a new American-for-the-first-time CEO. The company owns sizable stakes in **Instinet** (INET, news, msgs) and **Tibco** (TIBX, news, msgs), and it has a significant venture portfolio. It recently bought Bridge Information Systems assets out of bankruptcy. Buy 200 shares at $46 or lower

National Service Industries (NSI, news, msgs) is a cigar butt trading at a deep discount to tangible book. The reason: asbestos. The company has also been the subject of a recent restructuring and reverse stock split. None of this looks very appetizing to nearly any institution, and so the shares have been getting dumped lately. It takes some work to understand the true earnings power of the business, not to mention the asbestos liability. After doing this work, I've concluded the stock should be trading at levels at least twice the current level based on a variety of measures. Buy 1,000 shares at $6.75 or lower.

Also, reviewing prior picks, buy another 200 shares of **Elan** (ELN, news, msgs) at $13.25 or lower, and change my order on **Magma Design Automation** (LAVA, news, msgs) to short 300 shares at $22.50 or higher.

Journal: Feb. 18, 2002

• Sell position in Elan (ELN, news, msgs) at the market and cancel all outstanding trades.

• Change previous order to short Magma Design Automation (LAVA, news, msgs) to 400 shares at $22 or higher.

• Change previous order to buy National Service Industries (NSI, news, msgs) to 1,500 shares at $6.85 or lower.

Whoops. Elan doesn't look so hot
Time for a mea culpa. I am selling the entire **Elan** (ELN, news, msgs) position at market and will cancel all outstanding orders regarding this security. The accounting here is pretty tricky, as the world knows, and it takes some creativity on the analyst's side to interpret the numbers presented. I believe I made several errors in judging the safety of this common stock investment, and so I will unload the position.

After further review of historical filings and after discussing my concerns with the company, I feel the net issue here is that the company has put itself in a more precarious financial position than was prudent. It has leveraged itself in order to ramp its pipeline as fast as possible, and has been capitalizing much of the expense of doing so. I find it very difficult to foot the valuation from a financial buyer's perspective. In my world, it is primarily the financial buyer's perspective that is meaningful, even if the strategic value to a corporate buyer might be somewhat higher.

With that lead-in, I'll emphasize that common stock is the most precarious portion of the various layers of capital structure. In a bankruptcy preceding, it is most likely that the common stock is canceled altogether. Therefore when assessing the safety of a common stock investment, one must also evaluate the probability of bankruptcy at some point in the future.

The simplest way to look this is to examine capital flows. If a company does not earn its cost of capital, then it will have to access capital markets periodically. If the hope of earning its cost of capital is perceived to be fading, the capital markets will become less accessible for the company. In such cases, bankruptcy will ensue, with the associated destruction of stockholders' equity.

In the interest of not wasting some previous picks, I'll change some trades so that they are more likely to get executed fairly soon here in Strategy Lab. **National Service Industries** (NSI, news, msgs) -- change the order to buy 1,500 shares at 6.85 or lower. **Magma Design Automation** (LAVA, news, msgs) -- change the order to short 400 shares at 22 or higher.

Journal: Feb. 21, 2002

• Place order to buy 100 shares of Reuters (RTRSY, news, msgs) at $42, good until canceled.

• Place order to buy 100 shares of Reuters (RTRSY, news, msgs) at $40, good until canceled.

• Place order to buy 100 shares of Reuters (RTRSY, news, msgs) at $38, good until canceled.

• Change my order for National Service Industries (NSI, news, msgs) to buy 1,000 shares at $7 or lower, good until canceled.

• Place order to buy 200 shares of Canadian Natural Resources (CED, news, msgs) at $26.75 limit, good until canceled.

Magma still has room to fall
Since I shorted **Magma Design Automation** (LAVA, news, msgs) common, the stock is down considerably. I do not feel the need to cover the position at recent prices. The company recently filed its form 10 with the SEC. This filing reveals, as I suspected, that the company is not showing a cash profit in line with its pro forma profit claim. Rather, the company continues to produce negative operating cash flow. The filing also reveals an interesting relationship with a large customer that received 100,000 Magma options in November in exchange for 'advisory services.' I am attempting to clarify that relationship, as well as several stock repurchase agreements Magma has with its founders. These, too, were disclosed in the 10Q. Any individual who is long or short the stock ought to be looking at these things -- all the disclosure in the world will not help those who do not read the filings. In any event, the

stock is not worth even double digits, so I will not cover here in the high teens. I expect another 50% gain or so from recent levels, possibly even during this Strategy Lab round

Reuters (RTRSY, news, msgs) stock has been in a free fall. The value is higher than the current price by a large degree, however, and therefore falling prices are beneficial. The company produces a prodigious amount of free cash flow -- my estimates are that the recent share price will reflect less 10% free cash flow yields during 2002 and less than 12% in 2003. For these estimates, I assume top-line growth will be flat in the face of a sluggish world economy. The shareholder base is likely turning over as we speak – overanxious growth investors selling to patient value-oriented investors. Several other factors are contributing to the depressed share price, but none contributes more to the low valuation than the myopic views of investors in general. I should note that this is a very volatile stock, so I have no illusion that I've found the near-term bottom here. In the event that I'm not watching closely when it happens, place an order to buy another 100 shares at $42, an order to buy another 100 shares at $40, and an order to buy another 100 shares at $38, all good until canceled. I do not necessarily expect that this position will recover before the end of the round.

National Service Industries (NSI, news, msgs) keeps squirting higher. I won't pay more than $7 per share, and I will change my order to just that: buy 1,000 shares at 7 or lower, good until canceled. Maybe one of these days I'll get some in the portfolio here. I'm expecting a horrible quarterly report, so maybe that will do it.

Canadian Natural Resources (CED, news, msgs) is a boring favorite of mine. One of the largest Canadian exploration and production companies, with among the best returns on invested capital in the sector, Canadian Natural has thus far missed out on the mergers and acquisitions binge involving North American exploration and production companies. The recent acquisition of Canada's Alberta Energy gives another decent comp for valuation purposes. All signs point to Canadian Natural being worth over $35 share, although it might be as much predator as prey. It is relatively illiquid for such a big market capitalization, so I'll set a low limit price in hopes of taking advantage of the volatility. Buy 200 shares at $26.75 limit, good until canceled.

Journal: Feb. 25, 2002

• Place order to buy an additional 250 shares of Industrias Bachoco (IBA, news, msgs) at 9 or lower.

• Cover short position in Magma Design Automation (LAVA, news, msgs) at 9 or lower.

• Cancel outstanding orders in Reuters (RTRSY, news, msgs).

Playing chicken

Industrias Bachoco (IBA, news, msgs), a current portfolio holding, took a hit Friday as it released earnings. However, the valuation remains very compelling.

The market capitalization of the stock is $450 million as I write this. The company has just $33 million in debt paired to $128 million in cash, for an enterprise value of $355 million. Earnings before interest, taxes, depreciation and amortization (EBITDA) was $145 million during 2001. Free cash flow was $100 million. The trailing enterprise value: EBITDA ratio is therefore 2.45, and the free cash flow yield is 22%. The company continues to trade at just over half book value, and it paid a dividend during 2001 amounting to 7.7%. The price/earnings ratio is just under 4. All these numbers are not so bad at all, especially when one considers that 2001 was a difficult year for the industry, as the economy softened along with pricing. In all probability, the sell-off occurred because of the recent run-up -- a sell-on-the-news phenomenon.

As I noted before, the company is the leading producer of poultry products in Mexico, where chicken is the No. 1 meat. **Pilgrim's Pride** (CHX, news, msgs) and **Tyson Foods** (TSN, news, msgs) lag Bachoco in Mexico, where fresh chicken products are much more broadly accepted than processed chicken products. Bachoco, having been in the Mexican chicken business for decades, has a natural advantage that can be exploited if the company is run well, and it does seem to be run well. Regardless of the recent run-up in the share price, I continue to target a

$15 or greater share price for Bachoco. As time goes by, shareholders equity will continue to grow and dividends will be paid. This should be a solid total return investment. I'm not asking for an extravagant valuation; 8-9 times earnings and par with book value would provide tremendous price appreciation from the current level, especially when paired with the dividend. If it falls to 9 or lower, buy another 250 shares.

Regarding **Magma Design Automation** (LAVA, news, msgs), the position is working out pretty well – a roughly 50% gain on this too-small short position. Just in case it has a midday meltdown followed by some short-covering, I'll enter an order to cover the entire position at 9 or lower. Sounds ridiculous to enter such an order, but while I did not expect the stock to fall as fast as it did, I do not see any reason that the stock doesn't crash the $10 level soon as well. Any rallies in this stock are likely to be short-covering rallies as shorts lock in their quick gains.

GTSI Corp(GTSI) - $5.00 on Mar 28, 2001

A debt-free net net stock, now showing earnings growth and consistency for the first time. Known for its trading range, with the highs in the range usually produced by some bit of good news paired to low float, but there are some changes afoot that should set it free to the upside.

GTSI distributes technology products to the military, the IRS and others. Bsically, a B2G distributor. Market Cap at 40 mill, sales over $650 mill. Low margin stuff. As like any distributor, they have to have hot hands, and by and large they do. Located just outside D.C. New management arrived 4 years ago and has started turning around a money-losing operation. Now, working capital is not overly bloated, they turn inventory well (12 turns/year), and AR increases match AP increases well. They were profitable for the third straight full year new management has been in place, and GTSI is starting to see gross margin enhancement from hawkish working capital management, cost controls, more favorable contracts, and increased sales. The result: $1.15 in diluted earnings last year, but that was with residual tax losses creating a tailwind.

Management has given guidance, however, that they will beat last year's earnings per share even after full taxes are paid this year. So right off the bat we have an honest PE less than 5, no debt, and an improving business with capable management and increasing contract wins.

Management has bought the stock aggressively up to just under 4, and there is a large outside shareholder in Lacy Linwood, one of the founders of Ingram. Linwood has also been acquiring shares in the open market - he's the one providing all that support around 3 the past few years - and now ones over 25% of the shs out. Employees are participating in the employee stock plan but many are also buying lesser amounts of stock in the open market.

In addition to the obvious advantages of having a large outside shareholder with an illiquid stake, Linwood also provides some alleviation to the fear that Ingram or its ilk would jump in and compete GTSI out. If anything, his actions seem to indicate GTSI makes a good takeout for such a company (his stake is very very illiquid in terms of public market exit strategies yet he buys more).

In fact, knowing the business means knowing that such competition isn't much of a risk anyway. As with a lot of government vendor stuff, this is a relationships business. GTSI is well-ingrained into the procurement system, and has expertise in getting the right forms in the right hands at the right time.

GTSI just won the MMAD contract for over $857 million in technology products to be supplied to the military, IRS, and other branches of government over 5 years. The news of this award sent the stock skyrocketing last year. A protest was lodged, which was resolved in GTSI's favor. The poor stock market has helped stifle any positive reaction in the stock. But the win is indeed real, and the company isn't sure why the stock didn't react like it has in the past to such announcements. Indeed, in the 4 hours or so after the news was announced, only 7,000 shares traded hands.

GTSI will compete with IBM for bids to supply various projects under the MMAD contract. GTSI is confident of getting the majority of the money from this contract because historically they have done so when competing against big name suppliers. Why? Basically GTSI is willing to pay more attention to the process and get down and dirty in the whole government procurement area. They make money for the same reason plumbers get paid well. As well, they have the longstanding relationships on their side.

The trading strategy with this stock has always been to buy just under 3 and wait for a spike - there have been a few - and sell it. The last two spikes have occurred after the last two quarters produced blowout earnings. The stock is starting to stick at higher prices though, as the more permanent nature of the positive changes in the company is getting noticed. For the first time, true fundamental change for the better is starting to gain traction in sustainably higher stock prices. A nice trend to join early.

Also, because the buyer here is the government, there is a tremendous built-in backlog of demand. The computer equipment at the IRS, for instance, was legendary a decade ago. And the demand is seasonal (government is a procrastinator, rushing to buy a lot at the end of contract terms and at the end of years, therefore making contracts more profitable later in the cycle and years more profitable as the quarters wear on), but not cyclical. Moreover, obsolescence is less an issue because the government doesn't demand the latest and greatest. Management is taking advantage of the advantages of working with the government while minimizing the disadvantages.

There is a lot of operating leverage in the business that is just starting to be realized on the positive side (they lost over $2/share before new management came in), and with few shares outstanding, it would not be surprising if pre-tax income starts to approximate the share price myself and others paid back in the $3 range last year. Like Buffett's WPO, though on a much, much smaller scale. I'm still accumulating the stock.

A risk is a takeunder. I wouldn't get too extended in my buys from the price the large shareholder and management have paid (which ranges up to 3.75). I'm buying up to 5. Buying at 6 and waiting 3 years to be bought out at 7 wouldn't be very fun.

As a side note, on the last conference call, a private investor called in and ID'd herself as an employee of GTSI. This was an error, though I know a few investors whose initial reaction was that something stunk. I was one of them.

Catalyst

Gross margin improvement, better management's effects being felt and recognized, first-ever road show coming up in next few months showcasing new COO (comes from the Executive Office of the President with a lot of government contacts and know-how), expected strong stock price reaction to developing trend of consistently good earnings (40% upside from here just to get to net net value), acquisition target/buyout target, outside shareholder with illiquid, large minority stake and uncertain agenda/exit strategy

Huttig Building Products(HBP) - $4.3125 on Aug 27, 2000

I just finished entering a bunch of data such as trailing EPS and revenues. Throw it all out the window. Huttig Building Products may be one of the most ignored, misunderstood stocks on the market, and a big reason is that superficial analysis with readily available data is, well, too superficial. Huttig Building Products (NYSE: HBP), spun-off from Crane (NYSE: CR) last year, is a leading distributor of building products such as doors, windows and trim. Value investors may recognize the opportunity that so often occurs with spin-offs. In this case, simultaneous with the spin-off, Huttig issued 6.5 million shares to acquire Rugby USA from Rugby Group PLC. The net is that even the proxy for the spin-off was worthless because it wouldn't account for the acquisition. As a spin-off from an S&P 500 company, Huttig was guaranteed hot potato status anyway. But factor in confusing offering documents and an admittedly poor marketing job, and the stock simply could not avoid the doghouse.

The beneath-the-surface numbers follow. The leader in its very fragmented industry, Huttig has a market share of just 8% and will earn revenues topping $1.2 billion. Razor-thin margins are offset by industry-leading working capital management. In fact, the company has been profitable since the Civil War. This year, the company will see about $60 million in EBITDA plus a substantial one-time gain, yet carries an enterprise value ($89 market capitalization plus $122 million debt less $6 million cash) just about $205 million.

As the industry's most efficient operator (with management firmly ensconced in a shareholder-friendly EVA compensation model straight out of Stern & Stewart), Huttig is ahead of plan to squeeze $15 million in synergies out of Rugby as well as bring Rugby's poor working capital management more in line with Huttig's other operations. Expect another $20 million to drip out of working capital within the next year. Because of these savings, Huttig in effect paid just $40 million for Rugby's $30 million in annual EBITDA.

While Huttig's management should get credit, some of it must be shared with the motivated seller. Rugby Group PLC is not the world's best-managed company, to put it lightly.

Going forward, Huttig will have tremendous free cash flow. Free cash flow averaged $21 million per year for the three years before the acquisition of Rugby. Now, EBITDA jumps to at least $60 million, and free cash flow jumps to at least $35 million. Plus, in the short term, we get the $20 million or so that comes out of Rugby's working capital. As a result of this, during calendar 2000 Huttig is well on track to bring its $122 million in debt down to $82 million. Management's reasons for the debt-reduction? Reduced interest expense and expanded ability to pursue acquisitions. So what we are looking at is an enterprise trading at just 3.1 times EBITDA, and only about 5.1 times free cash flow. Remember – 130 years of continuous profitability.

Management follows strict return-on-investment criteria according to Stern Stewart's EVA theory and model's operations on GE's Six Sigma program. The Chairman comes from Crane and is known to be a shareholder advocate.

Catalyst

Sheer value is something of a catalyst here, but there are other key aspects to consider. Rugby Group PLC holds nearly a third of Huttig's share and is a price-insensitive seller on the market. This introduces price risk but not business risk. The shares are not liquid, and Seth Klarman is said to have bought up to 20% of Huttig's shares. If so, consider those shares locked up. Klarman is known as an extremely disciplined deep value investor. Once the Rugby Group shares are on the market, look for a buyout of Huttig. The buyout could come from inside (management) and a private market valuation based on recent activity places the shares at a worth over $12-15/share. Again, the Chairman is a shareholder steward - Crane investment arm still has an investment in Huttig - and would not let the takeout go through much lower than private market value. I'm looking for action within the next year. In the meantime, a large distributor of wholesale doors left the business. Huttig is expanding to meet the demand. Because of this, sales may rise over the next year or two even if, as seems probable, the homebuilding market turns south. Finally, spin-offs often reach a price nadir about one-year after the spin-off date; it takes that long for the knee-jerk sales to stop. By early 2001, the nadir should be behind us.

Industrias Bachoco is the $1 Billion sales leading poultry producer in Mexico, where chicken is the number one meat. IBA is a NYSE-listed ADR that is as cheap as ever. Bachoco is the giant in an ultra-fragmented industry.

Summary financials (in US $) and ratios as of their most recent earnings release 10/24/02 (not carried on Yahoo news):

Market Cap $426 million
Total Cash $186 million
Total Debt $ 24 million
Enterprise Value $264 million

9 mos Net Income $104 million
9 mos OCF $127 million
9 mos Depreciation $ 23 million

* FCF roughly approximates Net income, and 2002 NI will be about $130-$140 million.
* The company has been pouring its cash flow into debt paydown after its 1999 acquisition of the industry #4 (which smartly provided both horizontal and vertical integration benefits), and is now nearly debt-free.
* The payout is around 25% of net income - so the dividend yield will be in the upper single digits.

Put in perspective, net income trends:
1998: 92.9
1999: 85.8
2000: 126.8
2001: 117.6
2002: roughly 130-140

* Nominal PE (Market Cap/NI) is 3.2
* EV/2001 EBITDA (will be higher this year) is 264/164 = 1.6
* Adj for net cash and related net interest, adj P/E is 264/125 = 2.1

Shareholders' Equity is $871 million, nearly all of which is tangible.
So P/B is ~ .50

Over last 5 yrs, ROE has been between 12 and 17% despite growing cash drag.
Return on Assets has been ranging 10-15%.
IBA's net profit margins are in the low double digits.

Comparatively, TSN and CHX, both of which have a validating presence in the Mexican market but rank behind Bachoco, carry relative valuations 3-5X higher than IBA despite profit margins less than 2% and poor ROE's. Labor and costs are one major advantage at IBA, which continues to improve its operating margin - now 11.96%.

Risks:
1) A recent Hurricane damaged production at a small portion of IBA's farms. This is a minor, temporary issue, but appeared to hurt the stock.
2) The company is dealing with reduced protection by tariffs, which were cut in half on Jan 1 2002 and will be phased out completely in 2003. 2002 was supposed to be difficult because of this -helping to depress the share price - but the company has been faring much better than anyone expected. Pilgrim's Pride was supposed to be a big threat here, but they keep stumbling over themselves and have a weak balance sheet. This issue cuts the other way in a couple years ways when IBA gets to access feed at cheaper prices thanks to NAFTA. IBA may also be able to leverage its low costs into an export business into the US, per the CEO.
3) There is the potential that the company will lose a favored tax status, though it is unclear that this would disadvantage it significantly in relation to competitors facing similar issues. Apparently the tax would be a VAT, which would increase the prices consumers pay. This has been hanging over the company for some time, also depressing the share price.

Summary: 2X free cash flow; leading market position; large scale; tremendous financial strength with no net debt; big dividend while you wait; a statistical anomaly of a valuation

Catalyst

Resolution of tax issue, resolution of hurricane fear, and continued good cash production through tariff relief are potential catalysts. Mainly, security just needs some serious consideration by a few smart investors (most of whom won't give a Mexican chicken company the time of day). At this 2X free cash flow valuation, the share price should track cash accumulation - over $2/year - no matter whether multiple expansion occurs or not.

Pillowtex(PWTX) - $3.20 on Sep 20, 2002

Pillowtex makes pillows, blankets, comforters, sheets under the Royal Velvet, Fieldcrest, Cannon, Charisma brand names. PWTX emerged from Ch 11 late spring 2002, having erased nearly 900 million in acquisition-related debt, closed a baker's dozen plants, and laid off 4500 fewer employees. Also has 533MM in NOLs.

The current stock quote is 3.20, down from 6 at emergence and down from 9 within a month or so of emergence. Roughly 20 mill shares out give a 64 mill market cap.

POR projections, assuming no growth in the industry and stable economic conditions, projected reaching a 3.5% net margin, 7.3% op margin on 1.07 bill sales by 2004. This trajectory would provide 28 mill net income in 2003 (1.40/sh), 37 mill net income in 2004 (1.85/sh). Normalizing working capital (thanks to normalizing vendor, retailer relationships) would provide a boost to free cash flow, which would be around 35-40 mill/year before principal payments on debt.

So based on POR projections, the stock is trading at less than 3X 2003 earnings, less than 2X 2004 earnings, and at about 1.5X free projected free cash flow. Post-reorg/fresh start book value is around 200 mill, so at 64 mill we're at .32X book and at around 6% of sales.

Clearly the market doesn't believe the projections. The market is actually pricing in a catastrophic miss, and a high risk of ch 22. I don't believe the projections either - although I do believe they are attainable on a lengthened timeline, and I certainly don't take the market's view of the equity.

Of course, the market isn't entirely rational right now. All stocks have had a rough go, but reorganized equities are getting slammed especially hard as distressed securities funds find themselves in some distress courtesy of all the 2nd, 3rd, 4th, and 5th foot dropping going on in WCOM, KM, etc. PWTX is in a Buffett-certified 'bad business' and as I've heard, no price is too low for some of the sellers in the stock. As well, Westpoint Stephens' situation is worsening, spooking watchers of the sector.

The stock was distributed to bank debt holders, including vultures. Oaktree owns 20%. Lehman and BofA ended up with multi-million share chunks too. Share volumes are double counted, so it's been in distribution essentially since it emerged. A lot of it is coming through CRT in case you want to buy in volume. Just today I cleaned out a guy at 3.20 that had received stock in the distribution. A Nasdaq listing is hoped for by the end of the year, although we can't expect wide sponsorship.

A crucial point is that the company has hired new management that is widely respected. Pre-reorg management was simply horrid and attracted short sellers in droves - many of the savviest hedgies know PWTX as a great short from a few years ago. Things are different now though. Dave Perdue comes from Reebok where he has a big background in buying everything, making nothing. His position at Reebok focused on international vendor relationships. He recently replaced the restructuring-era COO with a guy who worked with Dave at Sara Lee, where they oversaw significant growth in the underwear division. Sources in the textiles industry view these hires as very good hires. I would hope and expect the addition of more talent in the executive suite.

The strategy of the new management is emphasizing branding vs. manufacturing. They are actively seeking relationships with overseas manufacturers, and I would expect that they have some success with this, given the CEO and COO's backgrounds at places that outsourced everything. They are searching in particular for one large vendor in order to have greater control over quality.

The risks in the story are primarily in management execution of the branding over manufacturing strategy. As well, the strength of the consumer is an issue, as PWTX in present form is subject to tremendous operating leverage. PWTX, while leveraged, is not over-leveraged and has the cleanest balance sheet in the industry at present.

A good comp is Springs Industries, which was taken private by management and Heartland, advised by CRT, in late 2001. Taken private at 1.24 bill by financial buyers in a 5:1 recap. Management controlled 71% of the voting, exerting pressure on the price extracted. At that price, Springs traded at an 11.7X forward PE, 12.7X trailing PE, EV/EBITDA 5.2X, EV/EBIT 9.4X, EV/Sales .57. Springs had 3.1% net margins, 11% EBITDA margins, 2.3 bill sales. Revenues were in decline, and Wal-Mart was a big customer at 27% of sales, not unlike PWTX. The brands at Springs include Wamsutta, Springmaid, Regal, Dundee, all of which generally have slightly lower price points than PWTX's better brands. Putting any of these numbers on PWTX gets PWTX's common stock price well over $10/share - indeed, nearer $15/share. Again I'd note that the buyer of Springs was financial and the transaction was well-levered.

Other comps are relatively poor because WXS has a different mix of business, scary capital structure. DRF is lower end/different mix of biz. Springs is really the best comp, though 2X as large as PWTX. PWTX at 1 bill plus in sales is no small potato though.

Catalyst

Completion of distribution and securing of stock in stronger post-reorg, non-distressed, stock-guy hands. Appreciation potential on cessation of dumping is tremendous. Jumped 35% in one day when the sellers disappeared at the onset of the July rally. 7-8 in next 6 months are pure technical rebound is possible, with operational improvements account for remainder of appreciation to 10+.

Quipp, Inc(QUIP) - $19.85 on Apr 20, 2001

A stock that can be played multiple ways for value realization, Quipp designs, manufactures, installs, and services post-press material handling equipment for newspapers. Equipment goes by names like Bottomwrapper, Newspaper Stacker, Automatic Cart Loading System, Newspaper Gripper and Conveyorm, Automatic Palletizer, etc. They service and sell spare parts for the equipment after market as well. A neat little cyclical but growing business, with 10%/year revenue growth over the last ten years, during which they have increased earnings from 100K to $5 million. Has generated gobs of cash which does come back to shareholders.

The stock is at 19.85, and the company has announced a Dutch auction self-tender for a little over 1/3 the float, or over 1/4 total shares outstanding, at 20-23, to commence any day now. It was announced two weeks ago. So there is an arbitrage opportunity, though it is very possible that the offer will be oversubscribed, resulting in pro-rata cash out.

That's not the only special aspect of this situation, though. The Dutch auction came about after a buyout fell through on financing and the deteriorating economy. During the time the legal documents were drawn up the stock was trading in the mid-high 20's. It is likely the buyout offer would have been for $30 or higher. There has been a string of MBOs and LBOs that have fallen apart on financing since last fall, and it is becoming a common story (and a ripe field for finding value, IMO). It doesn't change that there was a private financial buyer willing to pay a significant premium to the current price. A strategic buyer would pay more, though one doesn't seem readily available.

The valuation is fairly compelling. With 1.9 million shares out, the market cap sits around $38 million. There is about $17 million in cash and securities, the result of slowing capital expense, and no significant debt. 2000 EBITDA ex-cap ex and ex-interest income was $6.5 million.

Free cash generation has been great relative to market cap. Total cap ex the last three years was only about $1 million, and Total operating cash flows the last three years were $14.4 million. With EV at just over $20 million, that's pretty cheap. Two years ago, the company paid a $7/share special dividend because of the cash build up. Book value rebounded to near pre-dividend levels in just two years, and the share price recovered within 1 1/2 years. Margins are good, and ROA, ROE and ROIC have all been trending strongly higher with increased scale economies, offset by economic slowing.

So you have a stock in a company that generates lots of cash and does not reinvest it in the business to any great length (R&D at 2% of sales, cap ex at just a few hundred thousand - nearly all maintenance). So every few years a sizable cash and investment portfolio accumulates. Two years ago it paid the $7/sh special dividend, and this year it is buying back 1/3 the shares in a Dutch auction. Over the years the stock has been steadily appreciating. In recent years, cash flow has really jumped, and it has not been reflected in the share price.

The fall-off in operating performance at newspapers has had an effect. No single newspaper accounted for more than 10% of sales, though Gannet and Knight Ridder were 18% and 12% of sales last year. That concentration is down from 1998, when Gannett was 32% of sales. Also, foreign sales are at 13%. At year end, backlog was $1.5 million higher than last year, but the incoming orders have slowed as much as 50% in the first quarter. International avenues for growth are being pursued, but its two biggest competitors worldwide are Swiss and German in origin. Given the company's small size and low-tech, brandable product line, growth should nevertheless be good through cycles and in excess of the industry trends.

The stock sold off after the buyout fell through - the stock is fundamentally illiquid and those hoping for a quick buyout were natural sellers when it fell through. This is a readily overlooked stock, and buyers didn't materialize to catch the shares. The Dutch auction is meant to shake out remaining weak holders without wreaking havoc on the share price. Management have not been buyers recently (not a surprise since legally they couldn't be), and they own about 21%. The buyer was a financial one - strategically, it is not clear that there is a shoe-in for a potential buyer, but the industry for newspaper equipment is relatively stagnant to shrinking, which is spurring consolidation. There is some evidence that there is a brand here with a good reputation.

There is some logic in not tendering shares here and just awaiting or instigating for value realization. After the tender, assuming it goes off at about 21 or so, you'll still have a stock bought at $19.85 with $4/sh cash and history of value creation for shareholders as well as strong free cash flow averaging $3.30/share the last three years. So market cap/ avg FCF (over last three years) is around 6. Back out the cash and it falls to less than 5. Don't need growth or even less-than dramatic long-term revenue shrinkage to make that attractive. EV/EBITDA (ex-cap ex, ex interest income) is 15.85/4.81= 3.3X on last year's strong (but not all-time peak) numbers. It is not terribly hard to buy shares, as the largest shareholder has been steady liquidator and to my knowledge a disintrested wholesaler has a large block ready to go at 19.80-19.85.

Catalyst

Low tech, cash-generating business offers several catalysts 1) Arbitrage with Dutch auction 2) Ultimate sale of company at a nice premium from current price once economy turns/debt markets recover 3) Await realization of value in market. 4) Not really a catlyst, but ultimately, if one wants a control situation, management are not majority owners here, and the cash flow could substantially eclipse purchase price over next 5+ years. Two largest shareholders are non-management, which provides some undefinable but real catalyst as well. To the extent one wants out, as seems to be the case, it also creates additional pressure on an illiquid stock that will not last forever.

ValueClick, Inc.(VCLK) - $4.4375 on Nov 6, 2000

ValueClick is an internet asset play trading below cash and equivalents, with no debt and with an expectation of positive operating earnings by the end of the next fiscal first quarter. Join the crowd, right? There's more, but please do read the disclaimer at the bottom of this entry.

Most intriguing is a 53% ownership stake in ValueClick Japan valued at about $135M. This is largely in addition to $117M in cash and about $10M in Doubleclick (DCLK) shares, but you won't find it glaring at you on the balance sheet, since the operations are reported together. There is about $25M on the Japan side that you don't want to double count. Nevertheless, add these things up and with a $124M market cap, we're being paid a pretty penny to take the US and non-Asian business. ValueClick took in a little over $1M in cash last quarter by selling just 17 shares of ValueClick Japan, so the stake is very real - and there are over 8000 more shares where those came from. In recent years, these situations have been limited mainly to apparel retailers loaded with inventory, so net current assets was next to meaningless. Here, though, the assets are quite real, and there is no inventory to verify.

There are reasons to believe the natural price level for the business - and the shares - should be higher. Therefore I see a margin of safety in the current price even without playing the obvious arbitrage.

The business is in transition but still growing. What is the business? An internet advertising network whereby advertisers pay ValueClick, and ValueClick in turn pays the publisher, only when a web surfer clicks on the advertiser’s banner. They are pruning their customers, taking it from 82% dot coms to 72% dot coms, while maintaining their absolute numbers. Overseas contribution will be 50% by the end of next year, and revs should hit $63M. Advantageous is that ValueClick has been able to maintain its pricing and streamline operations on the cost side, resulting in gross margin growth even as the general market for internet advertising gets hit - thanks to the performance-based model, which is more attractive in times of uncertain effectiveness of internet advertising.

VCLK is acquiring competitor ClickAgents with stock. This seems like the bonehead move of the century. The stated reason is that the deal was negotiated with the stock up at $10+, and they would have had to pay more in cash. Still, sheesh, I say buy with cash, and I admit I do not buy the CFO's reasoning. Advertising.com is a private competitor with similar revenues, but with worse profitability measures relative to ValueClick, or so I understand.

Doubleclick owns 28% of ValueClick, with rights to buy up to 45% at nearly $22/share. There is a significant lock-up on these shares that takes us well past 2001.

Founding investors and insiders had margined themselves somewhat heavily on this stock, and had to sell as it fell below five. The general lock-up on shares ended in September, precipitating a fall as well. Together, these things caused a pretty serious spike down to the 3 5/8 range, from which the stock has yet to really recover. Hence, I believe it is in a rather artifactual trading range caused by massive margin calls and abandonment by the growth and momentum fiends. Clearly it will take some time for the value guys to embrace an internet play, but the ValueClick Japan factor should make it relatively easy once open minds prevail.

Already management is starting to hear less inquiries from investors about click-through rates (they're stable) and more inquiries regarding quality of accounts receivable (relatively small and high-quality, or so I'm told). I don't expect the value guys to take too long to catch on. I'll try to answer a few questions if they come up, but I must admit I won't support this idea as much as I did Huttig - my time pressures are greater now than then [not to say that they are greater than yours ;)]

DISCLAIMER: I benefit from this stock's appreciation, and have acquired it at a price significantly below the current one. I do not have a specific exit price in mind at this point, and make no promises that I will notify people here when I sell. I therefore prescribe two grains of salt and a ton of due diligence. You never know my motives, although I will say that I am just trying to put a second idea up in accord with the requirements of VIC, and in good faith.

Catalyst

I feel value makes a great catalyst, but in this case you have artifactual trading pressures due to margin calls, tax-loss selling, and insider lock-up expiration. All of these pressures, once released, may provide catalysts for near-term price appreciation as we move into 2001. Doubleclick owns a bunch of the stock, and it would not be terribly surprising to see a takeout, although I have not investigated this aspect very thoroughly yet. The industry is consolidating, and we're talking at the most expensive a free business here. Positive net income next year will likely put the operations on the valuation map, which could take the shares to $10 with only the slightest change in perception.

Wellsford Real Properties(WRP) - $16.60 on Jun 1, 2001

WRP is an opportunity to buy real estate at as little as 50 cents on the dollar (and at most 61 cents on the dollar), with a plan for value realization in place and virtually no downside. Wellsford Real Properties is a real estate operating company (REOC) and as such its value is in wealth creation rather than earnings distribution. Third Avenue (Whitman's group) has a nice dissertation on why REOC's can be superior to REITs in its latest semi-annual. Third Avenue's also been accumulating this stock.

The stock's at $16.50. Book value is $26.93 and understates true net asset value. For four years others have done the waiting for me (and are likely to sell now in pure disgust), and now I do believe the next couple years will see value realization - and hence a nice return/risk ratio. Here's why:

Wellsford is an incomplete liquidation story now divided operationally into three strategic units:

1) Wellsford Commercial ($10/share book value, liquidating, no recourse debt) - primary asset is a 39% interest in Wellsford/Whitehall, a joint venture with Goldman, valued at 86 million at March 31st. This value will continue to increase. W/W has been in the business of buying up turnaround properties and putting some sweat equity into them, then filling them. This naturally causes book value to drastically understate net asset value. This is important because Wellsford/Whitehall is being liquidated on a 3 year plan at Wellsford Real Properties' insistence. Two recent properties sold at 25% and 40% premiums to book, respectively. Today, the Parsippany announcement - a 43 million book value property sold for 61 million. There was $582 million in assets on W/W's books (213 mill in equity) at last report - but the realizable value is higher.

Just looking at the Parsippany sale, equity in W/W pre-tax will jump over $18M - that's nearly 8 mill to Wellsford. Wellsford only has 8.35 million shares, so that's a pre-tax gain of roughly 84 cents/share on the sale of just one property representing just 6.9% of the JV's assets. With the stock at 16 1/2 and book at 27, you can see where this is headed.

Management certainly considers the $582 million number to understate the true asset value in Wellsford/Whitehall. I've heard management laugh at that number. A 25% premium to book realized on the liquidation of these assets would jump Wellsford's book value nearly $6/share to $33/share. The most recent Parsippany sale went at a 40% premium, and another recent sale went at roughly a 25% premium. Obviously not all will go at such great prices, but it's a good trend. Management told me earlier the 25% premium they fetched earlier was on one of their average properties, and implied there was better stuff to come. Today's 40% premium with the Parsippany sale is consistent, and certainly doesn't make management a liar.

Why liquidate W/W? According the Chairman, "I know real estate. I have fundamental way of analyzing this, and we're in the 9th year of a 7 year boom" and hence he thought it was a good time to start liquidating the Goldman JV. Goldman disagreed. Both offered to buy the other out (Goldman first), but both bid low and neither accepted. So, an arrangement was worked out where WRP sent its employees working on the JV to Goldman and Goldman's man manages it with a newly created company. Goldman has since decided it too doesn't want to expand this business anymore given the stage of the real estate boom. So now, essentially, they're presiding over the liquidation of the JV. Expect good news to come out of this liquidation (like today), with more readily identifiable cash assets appearing on the balance sheet. To be clear, the liquidation is occuring primarily because it is the smart thing to do given the cycle, and a secondary effect is it will make the value more obvious to those reading the balance sheet.

Commercial ADJUSTMENT to book get to NAV: + $3 to $7/share; but again, we've already got a big discount to book, so the key is that there is a liquidation ongoing.

2) Wellsford Capital ($12/share book value; continuing; no recourse debt) -As the real estate market peaks, the Chairman wants to get out of equity, but sees future potential for buying real estate debt on the cheap as things turn sour. So Capital is an ongoing operation with more to come in the future. Management is quite dismissive of "S&L's on steroids," mortgage REITs, and the structure of entities such as CMM. They feel they can be much safer and smarter than using those strategies, and yet by buying smart earn great returns despite not taking on substantial risk.
a) $35.4 mill direct investment in 11.5% meezzanine loand, 277 Park Avenue (DLJ's building, well known to some of you I'm sure 'hedge fund hotel')
b) 51% interest in Second Holding, LLC, another JV that invests in real estate debt. They have been ramping this up. Carried at equity method and equity in Second Holding is roughly $27 mill. That's the limit of their liability. Debt/equity in Second Holding at 12X but of course debt within the JV is non-recourse to WRP. This is the current main vehicle for investment in debt, and it has recently raised several hundred million, which for now is just sitting, earning slightly more than its cost. How this will be used is an unknown, but presumably they'll be smart about it. The stock hasn't been recognized, but management has been creating value, and Capital is a bet they ought to be able to in the future. Again, the equity value at risk herre is only a little over $3/share.
c) $7 mill investment in REIS, a real estate information services company - I write this down simply because there's a family relation behind this investment, but it is possible the 6.9 million may even underrepresent the value of that asset.
d) VLP is being liquidated - another $11 million or so to come.

Capital ADJUSTMENT to book to get to NAV: -1 buck for the nepotistic investment in REIS, though it might work out. One only need look at Homestore.com to see that real estate e-commerce ventures have not been the terrible bombs so characteristic of the .com genre. REIS is not infrequently cited in respectable press, and may have a niche.

3) Wellsford Development ($4/share book value; liquidation?; $99 mill mortgage debt) - 86% interest in an JV with Equity Residential (EQR) which is an 1800 unit multifamily development in a nice area south of Denver. 760 units being rented. Converting 264 more units to condos, and first sales have gone well at nearly $200K/pop (they cost about $166K/pop to build). Sold a 344 apartment project for 22.5 mill last year, for a gain of 3.5 million. Totalling up the value of the various pieces here and I get a small premium to book value. The key is that portions of it are being liquidated at a slight premium.

Development ADJUSTMENT to book to get to NAV: none, maybe +1 buck/share on the upside. Chairman talks this one up as a "no-brainer" but I'm unwilling to give much credit yet.

That's it; because of the nature of the turnaround properties, I don't anticipate much long-term downside there from the book level. Potential losses in Capital are maybe $3/share in book value. Face value of a $25 mill convertible preferred is more than offset by cash on hand. As time goes by, earnings will add about $1.25 to $1.50 per share to book value each year as well.

The company has been buying back shares when blocks become available, retiring 2 million shares in this fashion in the last couple of years. The Chairman vows to continue doing so, claiming the illiquidity of the stock is the greatest impediment - he doesn't want to run it up. BTW, a strong advocate of share buybacks in undervalued securities, I have never found myself on the receiving end of a management lecture on why buying back stock is such a good idea. That's what I got from this Chairman. "Look, I know what I got..." He gets points for mentioning Berkshire Hathaway in his annual letter, too: "Our business strategy model, based on the Berkshire Hathaway model of net asset value growth being reflected in share price, has thus far not been transferable to the real estate industry."

The history of Wellsford is that management presided over Wellsford Residential Property Trust - of which WRP was a subsidiary - from 1992-1997. The Trust merged with Equity Residential Properties at a price that gave a 23% annualized return since inception to shareholders. The stock had done nothing for years and then ran up for the buyout. Still, that's a source of pride for the Chairman, who points to the annualized return rather than the long stagnation, and I don't believe he is adverse to selling out again so he can have a similar "achievement" here. He is not comfortable with the lack of recognition in the public markets. In any case, WRP was a subsidiary of the Trust, and was spun off immediately prior to the merger. A private placement for 6,000,000 shares at book value ensued the next month. And the stock hasn't done anything since, even though value has been created.

Franklin Mutual (Beacon, Qualified) owns 24% of the common from the initial private placement, and Morgan Stanley owns 17% of the common from the same. Neither have been buyers recently. MJ Whitman Advisors upped its position 25% during the 1st Q.

A decent sized seller (probably Fleet or Advisory Research or both) has been offering shares whenever a decent-sized order comes up to buy, so in my experience at least the illiquidity is less a problem than it appears.

Catalyst

Liquidation of real estate per plan with $200 million in properties being marketed for sale right now; possible sale of whole company; commitment to share buyback at deep discont to intrinsic value; dollar on sale for 50-60 cents with no significant downside; possible Russell 2000 inclusion on June 30th but is one of the few such candidates that hasn't really moved yet.

Reading Michael Burry

I finally got around to reading a good chunk of the Michael Burry archive that still resides on the old Silicon Investor forums. It's a highly informative read that shows the evolution of Michael Burry from an enthusiast, to an investor with a unique style and philosophy. Here are a few interesting highlights that I came across.

Initially, Burry cut his teeth on traditional Ben Graham-type stocks that traded below book value. Below, he discusses the Tejon Ranch Company (TRC), a stock with strong downside protection due to the 270,000 acres that it owned.

> Looks like TRC is fairly valued on an asset basis if these prices are the case. When reviewing these ads, note that Tehachapi area locations are similar in terrain to the Tejon ranch, but closer to Bakersfield.
>
> The excitement comes from the fact that management has taken an interest in developing some of these 270,000 acres. As noted above, land in developed areas can go for $15k to $30k/acre. So not all of the Tejon Ranch needs to be developed. ANY development should justify the current price, and may lead to significant gains down the road.

What's also remarkable, was that Burry was getting solicited by certain "high ranking" investors since early 1997.

> As you say, I agree that "high-ranking" investors lurk here, since I get e-mail from them every so often

While it's clear that Burry was aware of the mania (and indeed derided many investors expectations) for Dot-Com stocks, he saw Apple for what it was in 1999, a value stock with any future growth being essentially thrown in for free. He also scolds himself for selling it too soon after a 30% run-up. Most importantly though, it was with stocks like Apple that Burry began to appreciate the power of branding, marketing and management, the sort of intangible factors that Buffett is so perceptive in recognising.

> I bought it as a Buffett pick. And then I sold it after a quick 25-30% run-up. Shame shame. But I make no excuses. The run-up to me seemed flimsy. It traded back to the low 20′s then jumped on its internet strategy announcement. I got out. But I sorely want back in. I would like to buy in the low 20′s again, and I will. But at the time I needed money to buy some other stocks that were becoming much more acutely undervalued (my AAPL, APCC, FIC) with IMO possibly better-positioned and better-managed businesses. So far this bet is paying off, but for it to really pay off on both ends I'd be able to buy MAT at 22 1/8 again. And Callaway Golf at 10 and change again, since I sold my Buffett soul and got out of that one too.
>
> BTW, really, no one is crediting Apple, but to me it has the markings of a value stock and potential Buffett-like stock. A real cash machine of late, trading at a mid-single digit multiple of cash flow, with a great recovery in terms of operating efficiency. A great brand name with proprietary advantages and mindshare. Subtract out the cash and it was recently trading at about 10 times earnings. A good holding for an 8 year old. Buy her a blueberry iMac and give her some stock I bought it as a long-term holding but it's run up too. This problem of ultra-quick 30% gains despite Buffetesque intent is vexing, but not unpleasant.
>
> Re: Apple, boy, everyone is living in the past on this one. Management is now great. The

product is now very good, but even more importantly the marketing is now great. The "win rate" for new PC buyers here and especially Japan has gone through the roof. And there's a future dividend that comes with that. It wasn't $15 just a few months ago. In fact, now it has $15 in cash generated primarily from operations. It's been bouncing between the mid 40′s and low 30′s for many months, and is now right where it's been since 1988 (for a reason – every time it gets to this level people sell),except for the dip to the teens when everyone misjudged the power of the brand. This successful emergence from trial by fire is new information about the durability of the brand, and successful investors it seems to me should be able to absorb it quickly rather than belatedly.

In an early post, he chips in with some thoughts on an overvalued market with a quote that I love.

Buy and hold becomes mantra at the end of a bull market.
Buy and hold becomes anathema at the end of a bear market.
Thanks to the raging bull for those 10 years, everyone is preaching buy, hold, patience. However, if you had invested in the market in 1969, you would be at a significant loss in 1983, especially given the high
inflation of the times and the down market. In the early 50′s, the common logic was that stocks simply don't go up, thanks to the doldrums market from the mid 30′s to the mid 50′s. Why can't this market conceivably crash from these levels and not recover for 20 years? I guess I am just a bit of a contrarian.

As for how Burry chooses stocks, he states it on this thread, also revealing that price is the key determinant in whether to invest, or not.

The screen that worked the best for me? Scanning the S&P MidCap 400 guide – eyeing the lower right hand page for high and consistent ROE.

Then, moving up the page, comparing capital expenditures to cash flows, then moving up to equity and observing that its growth validates the ROE numbers.

Then, still moving up the page, looking at the last 10 years of earnings consistency and growth – at least doubling in 10 years, without more than one down year.

Then look for the low payout ratio and conservative debt.

Then look at the current price and figure out your buy price and wait. You'll hit a few.

If you do this with the 1997 S&P MidCap 400 Guide, two companies jump out at you – Dairy Queen and Flight Safety, both
Buffett buys.

I used this to find Medusa and BMC Industries, both of which I bought. Medusa was taken out by Southdown at a 50% premium to my price in just a few months. BMC had significant insider buying and now sits about 13% above my price. Of course, by virture of their businesses, neither meets all of Buffett's criteria.

Re: his picks, I'll have to take a closer look. Some of them have come up in my reviews over the last 6 months. I should say that I have gone through all the stocks covered by S&P in its three major guides, and the pickings are slim, and will remain so without a major correction.

I've said it before, and I'll say it again – finding Buffett companies now isn't so hard. Finding

> them at reasonable prices is dang near impossible.

Finally, here are a few book recommendations from Burry.

> My bias is value investing, and I highly recommend Janet Lowe's Value Investing Made Easy as a primer. I'd follow that book with Why Stocks Go Up (and Down) by William Pike. Other books have been discussed here i.e. Superstocks by Ken Fisher, etc. You can get any of these — even obscure ones –from www.amazon.com very easily and cheaply. When you think you've got it all figured out, try Sense and Nonsense in Corporate Finance.