

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,

A handwritten signature in black ink, appearing to read 'Michael J. Burry', written in a cursive style.

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.