# 2000

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

## Annual Letter

Scion Capital, LLC
Private Investment Management

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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