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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