BAUPOST LIMITED PARTNERSHIPS

2015 YEAR-END LETTER

"If people knew how hard I had to work to gain my mastery,
it would not seem so wonderful at all."

-- Michelangelo Buonarroti

"The whole problem with the world is that fools and fanatics are always so certain of themselves, and wiser people so full of doubts."

-- Bertrand Russell

"It's déjà vu all over again."

-- Yogi Berra (RIP, 9/23/2015)

The Baupost Group, L.L.C.
10 St. James Avenue, Suite 1700 • Boston, Massachusetts 02116 • Phone: 617-210-8300 • Fax: 617-451-7333

January 20, 2016

Dear Limited Partner,

We are disappointed to post a mid-single-digit decline for the year ended December 31. A detailed breakdown of our full-year investment returns, as well as our largest individual position gains and losses, portfolio allocation, and 10 largest positions, will be available on our website in early February.

2015 In Review

Did we ever mention that investing is hard work – painstaking, relentless, and at times confounding? Separating relevant signal from noise can be especially difficult. Endless patience, great discipline, and steely resolve are required. Nothing you do will guarantee success, though you can tilt the odds significantly in your favor by having the right philosophy, mindset, process, team, clients, and culture. Getting those six things right is just about everything.

Complicating matters further, a successful investor must possess a number of seemingly contradictory qualities. These include the arrogance to act, and act decisively, and the humility to know that you could be wrong. The acuity, flexibility, and willingness to change your mind when you realize you are wrong, and the stubbornness to refuse to do so when you remain justifiably confident in your thesis. The conviction to concentrate your portfolio in your very best ideas, and the common sense to nevertheless diversify your holdings. A healthy skepticism, but not blind contrarianism. A deep respect for the lessons of history balanced by the knowledge that things regularly happen that have never before occurred. And, finally, the integrity to admit mistakes, the fortitude to risk making more of them, and the intellectual honesty not to confuse luck with skill.

In 2015, the U.S. stock market was unusually challenging for those who bought value and maintained discipline, leading to only our third down year in one-third of a century. While our private holdings posted strong results, our public investments lost ground. Simply put, it was hard all year to gain traction as markets sputtered and fundamentals struggled. 2015 was a year of dodging relentlessly falling knives; upon deeper inspection, one superficially tempting investment after another turned out to be worse than they initially appeared. We avoided the great majority of these and were nicked by only a handful. In investing, however, there is no umpire calling balls and strikes, and in retrospect we could have been even more patient at the plate. What had, for many investors, been a growing pool of red ink during the year turned into a bloodbath by year-end. To repurpose Warren Buffett's famous quote about managements and businesses, when a talented investment team confronts an exceptionally challenging market, sometimes the market wins (at least in the short run).

Momentum investing, a strategy that is based on following trends without regard to fundamental value, worked brilliantly in 2015. Buy what's been performing well and watch it go even higher. By contrast, bottom-up bargain hunting – which requires fastidious research, endless patience, pattern-recognition skills derived from hard-won experience, and the application of sound judgment – didn't prove profitable for us last year.

While the S&P 500 Index was slightly ahead for the year (inclusive of the reinvestment of dividends), the average stock declined, making it the worst year for stocks since 2008 and the second-worst year since 1995. The "FANG" stocks (Facebook, Amazon, Netflix, and Google) gained $415 billion of market cap through the end of the year, a 55% jump. Netflix stock surged 134% in 2015; Amazon 118%. Their average price-to-earnings ratio soared from 49 to 120 times, according to Bloomberg. As in the Nifty Fifty era, money managers seem to have decided they'd rather be seen failing conventionally than risk trying to succeed unconventionally. Last year, the 10 largest stocks by market cap in the S&P 500 gained nearly 23%, while the other 490 stocks were down about 3.5% on average. This gap was the largest since 1999, when the internet bubble was nearing its peak. In short, stocks of the sort we own have been dropping; the performance of the top equities in the market has masked the broader pain left in the wake of an astonishingly narrow rally. Indeed, as of mid-December, the average stock was about to enter its own bear market, trading 18% below its 52-week high.

Commodities, energy, healthcare, and biotech were especially hard hit in 2015 and again over the last few weeks. It has been a punishing decline. Through mid-2014, the conventional wisdom was that we had entered a commodities super cycle, an era when energy and metals would benefit from surging demand, particularly from China. Instead, it's truly "commod-ageddon." Energy is now a sector so toxic to investors that almost no one wants to get involved (which may well mean that we are approaching a bottom). Spot oil fell almost 70% in 18 months, from $112 a barrel to $37 at year-end, and recently slumped below $30. Iron ore was down 40% in 2015 alone. An index of prominent energy MLPs fell 33%. Bonds of high cost, highly-leveraged energy companies have fallen as much as 90% as interest coverage evaporated with the fall in energy prices. Copper (down 25% in 2015), aluminum, and steel are all at levels last seen in 2009. In September, there was even fear that commodities powerhouse Glencore was about to become "the next Lehman." While that specific fear has subsided for now, its shares are still down two-thirds from the beginning of 2015 and 80% from its 2011 IPO. Anglo American, the international mining giant, has announced major asset sales, huge layoffs, and the omission of its dividend.

Market liquidity has diminished of late, making trading conditions in 2015 somewhat more difficult but also giving rise to potential opportunity for liquidity providers (like ourselves). Wall Street firms have cut back their market-making activities, and there is probably insufficient investor capital to fill the void. Primary dealer inventories of corporate debt are down 80% from the 2007 peak, even as the outstanding volume of corporate debt has risen by more than 50%. Surprised by tepid demand, underwriters in some recent corporate debt deals were forced to raise coupons substantially to get the bonds sold. Lowly triple-C rated bonds lost more than 15% for the year, and junk bond funds experienced net outflows for the third consecutive year. Many high-yield bonds have become thinly traded, with prices gapping down when sellers appear. In mid-December, the Third Avenue Value Focused Credit Fund blocked investor redemptions, sending shock waves through the high-yield bond market. The fund's assets had fallen from $2.5 billion to $788 million, and investors were rushing to redeem. The fund's NAV had plummeted 27% in 2015 prior to the announcement, and the holdings that could be readily sold already had been. The fund intends to gradually sell off its remaining assets and close.

Many of the hardest hit names in the equity and debt markets continue to fall. The S&P 500 Index, for example, lost a record 6% the first week in January 2016, and another 2.2% last week. The Russell 2000 Index has now plunged 23% from its peak. Consequently, our opportunity set has been expanding, and our Public Investment Group analysts in particular are as busy as they've been in a number of years. We're certainly glad to have ample cash in reserve (41% of the portfolio at year-end), though we've been putting some of it to work recently. We feel fortunate to be in a position where we have been able to add – at increasingly steep discounts – to many of our most compelling positions.

Value investors must be strong and resilient, as well as independent-minded and sometimes contrary. You don't become a value investor for the group hugs. Indeed, one can go long stretches of time with no positive reinforcement whatsoever. Unlike some other fields of endeavor, in investing you can do the same thing as yesterday but achieve completely different reported results. In the long run, the research and analysis you perform should overcome market forces; the fundamentals ultimately matter. But in the short run, markets can trump effort and insight. They move in unpredictable cycles, with investors stampeding this way and that. Businesses quickly come in and out of favor, and the same business can be valued by the market very differently in a matter of days, sometimes on the basis of new facts, but often because of mercurial investor perceptions or simply money flows.

No matter the investment or market environment, Baupost's® process is always the same: the spark of an idea, followed by extensive due diligence, thoughtful analysis, energetic debate, and the application of seasoned judgment. Over the holding period of every investment, we continually re-test our assumptions and scrutinize new information through an impartial lens. Our culture is always supportive but questioning; we regularly challenge each other, which elevates our game. While we will inevitably make some mistakes, we are determined to learn from each one. Last year, we were challenged when short sellers publicly targeted two of our larger stock holdings, Cheniere Energy and Pioneer Natural Resources. In both cases, we carefully considered the short sellers' arguments, re-underwrote and even expanded our analysis, and followed our customary intellectually honest process. In both cases, the additional work confirmed our original thesis.

It is critical for any investment firm to be built to take a pounding – structurally, financially, and psychologically. Investors must have a patient client base that allows for persistence during a bad year (or years), and an approach that limits risk while maintaining an appropriate balance between greed and fear. Greedily throwing caution to the wind is eventually disastrous, but fear-induced paralysis is not a recipe for success either. Investors must employ an investment philosophy and process that serve as a bulwark against a turbulent sea of uncertainty and then navigate through confusing and often conflicting economic signals and market head fakes. Amidst the onslaught of gyrating securities prices, fast and furious corporate developments, and an unprecedented volume of data, it is more important than ever to maintain your bearings. Value investing continues to be the best (and perhaps only) reliable North Star for those who are able to remain patient, long-term oriented, and risk averse.

While value investing is a demonstrated strategy for long-term investment success, it isn't like being handed a treasure map. Rather, the value approach teaches you how to make your own map. And even then, the map doesn't tell you precisely where to dig for treasure: it just points you in the proper direction.

Several years ago, a friend outside the industry asked me to mentor him in Graham and Dodd, and I provided voluminous reading material and coaching. He was intrigued and energized, he said, and declared himself a value investor. Three months later, he informed me that he was giving up. It didn't work, he had determined. It turns out that not everyone has the patience and discipline to follow the one approach that has been demonstrated to deliver excess returns with limited risk over the long run.

Value investors gain clarity by thinking about their investments not as quoted stocks whose prices whip around on a daily basis, but rather as fractional ownership of the underlying businesses. In Benjamin Graham's construct, Mr. Market sometimes becomes greedy, overpaying for *your* shares, and other times fearful, selling you *his* shares at bargain levels. Successful investors must possess the mindset to take advantage of Mr. Market's bipolarity, and even come to appreciate it.

Two extremes of human nature, greed and fear, perpetually drive market inefficiency. Fear is primal, the effect of confronting the apparent loss of what you have. While your shares today still represent fractional ownership of exactly the same business as when they traded higher yesterday, people *en masse* are delivering the verdict that your shares are worth less. It is natural to panic at the possibility of further markdowns. But crucially, you have to find a way not to care or even to relish this eventuality. Warren Buffett has written that one should not invest in stocks at all if uncomfortable with the possibility of a 50% drawdown. The mistake some investors make is to accept the market's immediate verdict as fact and not opinion, and become disappointed, even frustrated. For investment professionals, trepidation over poor performance can morph into fear of job loss. Career risk thus plays a role in their ultimate, and usually untimely, capitulation; even those who wish to be patient may worry that their employer or client will not share their resolve.

Paper losses can cause people to lose their bearings. When your portfolio is marked down sharply, it's natural to fear losing the rest. Thinking about your net worth based on the latest stock quotes may superficially seem appropriate, because if you sold your shares today that's all you would get. But investors must adopt more complex thinking. What you're really worth is not what the market will pay today (that's the erroneous assumption behind the efficient market hypothesis), but rather the true value of the securities you own based on such attributes of the underlying businesses as free cash flows, private market values, liquidation values, downside protection, and growth prospects. This is what Graham and Dodd taught and what we believe at Baupost.

When the market, in the absence of adverse corporate developments, drives an undervalued security down in price to become an even better bargain, that's not reason for panic or even for mild concern but rather for excitement at the prospect of adding to an already great buy. When tempted to sell into a decline, investors must think not only about what they would be getting (the end of pain that accompanies the certainty of cash), but also what they're giving up (a significantly undervalued security which, emotion aside, may be a far better buy than a sell at today's market price). This is why relentless and thorough due diligence and deep fundamental analysis are so important. They give you the justifiable confidence to maintain your bearings – to hold on and consider buying more – even on the worst days in the market.

Greed, too, is deeply rooted within people. It is expressed through the drive to acquire more and more and the related angst felt when others are succeeding while you are not. This is what J.P. Morgan meant when he said "Nothing so undermines your financial judgment as the sight of your neighbor getting rich." Or as Gore Vidal dryly noted, "Whenever a friend succeeds, I die a little." The positive reinforcement from repeated stock market success can be a kill switch for risk aversion in that it tempts people into paying up and then holding on too long. A recent article in Vanity Fair about a looming bubble in Silicon Valley noted, "Collectively these start-ups have helped promote a culture of FOMO – or 'fear of missing out,' in Valley parlance – in which few [venture capitalists], who have their own investors to answer to, can afford to ignore the next big thing."

Fear of missing out, of course, is not fear at all but unbridled greed. The key is to hold your emotions in check with reason, something few are able to do. The markets are often a tease, falsely reinforcing one's confidence as prices rise, and undermining it as they fall. Pundits often speak of the psychology of markets, but in investing it is one's own psychology that can be most dangerous and tenuous.

If investors could know only one thing about greed and fear, they should know this: Over the 30-year period from 1984 to 2013, the Standard & Poor's 500 Index returned an annualized 11.1%. Yet according to Ashvin Chhabra, head of Euclidean Capital and author of "The Aspirational Investor," the average returns earned by investors in equity mutual funds over the same period was "a paltry 3.7% per year, about one-third of the index return." Bond fund investors fared even worse: while the Barclays Aggregate Bond Index returned an annualized 7.7%, investors in these funds "captured just 0.7% (not a misprint!) in annualized returns… That staggering underperformance is the cost that individual investors paid for following their instincts" by adding to and pulling money out of their funds at precisely the wrong times. In short, retail investors, in aggregate, substantially underperformed both the markets and the very funds in which they were invested.

Value investing is, at its core, a risk-averse strategy, and Baupost strives mightily to protect client capital. Buying bargains builds in a margin of safety to counter the inevitable misjudgments or misfortune. We think deeply about risk for every investment we make; we consider it even more intensely for the portfolio as a whole, evaluating not only individual positions, but also concentrations and correlations. In addition, we set up guardrails (such as rejecting the use of recourse leverage on the portfolio and largely avoiding short selling because of its theoretically unlimited downside risk) which provide yet another layer of protection for our portfolios. We regularly spend significant amounts on market and specific investment hedges that provide additional (though usually imperfect) protection against loss. We constantly think about protecting capital, not day-to-day but over a period of years, and not based on quoted securities prices over which we have no control, but instead relying on our own painstaking assessment of underlying value.

Risk is also mitigated through alignment of our interests with yours. Baupost employees, collectively, are the largest client of the firm. Ed Catmull, co-founder of Pixar Animation Studios and author of *Creativity, Inc.*, described the simple idea behind Pixar's creative success – the importance of being your own happy customer – when he expressed his conviction that, "If we made [a movie] that *we* wanted to see, [we thought] others would want to see it, too." Eating home cooking is a cornerstone to our approach. But sometimes, home cooking isn't prepared in a microwave oven but in a Crock Pot. It'll be ready when it's ready.

Discipline isn't something an investor should be turning on and off. There's no point in being disciplined most of the time, only to toss the fruits away in a weak, distracted, or greedy moment. And there's no such thing as being almost disciplined – even one moment of weakness can invite the wolves in, and it can also send a message. If you expect the members of a team to be disciplined, then letting down one's guard on occasion is at first confusing, and then demoralizing, as the benefits from prior discipline are squandered. If excessive risk-taking is rewarded even once, there will quickly be no discipline at all.

In the moment, public market investors have no ability to control investment outcomes, but they can control and improve their own processes. We never shoot for high near-term investment returns. Trying too hard to earn positive results, or assessing performance too frequently, can drive anyone into short-term thinking, herd-like behavior, and incurring higher risk. We do our utmost not to allow this to happen. We believe that by remaining focused on following a well-conceived process, we will make good risk-adjusted, long-term investments. And we know that if we do that, we will indeed earn good returns over time.

No one should invest with Baupost expecting us to change our stripes. We are what we are: value investors who seek to buy bargains and sell what is fully valued. We will wait patiently, for as long as necessary, to identify opportunity, while holding onto cash in the meantime. We will own a smorgasbord of investments across markets, asset classes, and geographies, enabled by our flexible mandate to hunt for the best bargains we can find. A number of these investments will have catalysts for the realization of underlying value. We will concentrate our investments significantly – but not excessively – in our best ideas, always maintaining prudent diversification.

While operating within the constraints of value investing principles, we are determined to look far and wide for opportunity, building our competencies over time based on learning and experience. We must neither be confined by a narrow mindset of what may or may not be undervalued, nor become so aggressive in pursuing opportunity that we deviate far beyond our circles of competence. I tell our team that we wouldn't be doing our jobs if we remained locked in the past, buying only the melting ice cubes of previously good businesses now in decline as though technological change weren't accelerating the obsolescence of entire industries. We would also be remiss if we failed to take advantage of new analytical tools and resources. We must consider new ways of thinking. We must continuously ask ourselves whether any investment under consideration is just too hard to properly assess: Is the fruit too high-hanging? In investing, there are no style points awarded for degree of difficulty. However, the complexity and opacity that may cause others to discard potential opportunities as "too hard" can drive market inefficiencies that result in opportunity for us. In 2015, we took a close look at "big data" technology as a research tool and potential "edge" for Baupost. While there are a number of applications that may be interesting over time, we continue to strongly believe that our investment success will ultimately depend not so much on big data as on big judgment.

Baupost's holdings have varied greatly over the years as a result of the evolution of opportunity. Our flexible mandate necessitates that we operate as much as possible without silos, a choice validated by Gillian Tett's new book *The Silo Effect*, a thoughtful discussion of the downside of narrow specialization. Over time, we have moved beyond Baupost's initial competencies in U.S. distressed debt and equities into new areas including international investments, opportunistic private equity, direct real estate, and mortgage securities and other structured products. We are always seeking to identify or develop new investment edges. We have worked hard over time to build relationships with brokers and operating partners who have us in mind when they spot highly-complex, illiquid, and/or financially distressed situations, and we actively seek out new counterparties and collaborations in the hope of generating future opportunities. We believe our experience in areas including commercial real estate and large liquidating bankruptcies gives us a real edge as those opportunities arise. We have also garnered a reputation for having substantial capital to opportunistically inject into companies.

When this relentless, policy-driven bull market comes to an end, one would expect not a mild retreat but shock, dismay, and tumult. No matter the precautions, hedges, or cash position held, there is risk in being long anything at the top, and further risk to investing cash too soon on the way down. All investors must wrestle regularly with the bull market challenges of rising valuations and a dwindling opportunity set, always absent insight into the magnitude or timeline of any potential reversal. Striking the right balance between action and inaction, between making new investments and holding cash, is extremely challenging. You can't sit on your hands forever waiting for peak opportunity, nor can you ignore the ebullience all around you. While Baupost consistently held on to significant cash balances throughout 2015 (averaging 43% of AUM), our long equity positions significantly underperformed the relevant market indices. While we wish that every month or quarter could be a positive one for Baupost, we know that the price of avoiding all down periods would likely be missing many up markets as well, the result of which would be decidedly lower returns in aggregate over the long term.

As with Pavlov's dogs, in a bull market investors find certain actions repeatedly rewarded; their behavior thus becomes deeply ingrained. Amidst a relentless rally, almost anything you come close to buying but ultimately pass on goes higher, inducing you to be more aggressive. Similarly, anything you sold you probably sold too soon, even if it had met your price objective. In a bull market, focus on downside risk ceases to be shrewd discipline and instead becomes an albatross. Many are seduced into raising their appraisals, because doing so is rewarded. As if missing out on returns weren't itself painful enough for "Type-A" money managers, it also causes underperformance that can frustrate clients and raise career risk. Bull markets don't typically end until most have capitulated, at which point there is almost no one new left to buy.

Bear markets, of course, offer their own false "lessons," but in the opposite direction. As prices fall, anything you previously sold turns out to have been a good sale; anything you bought was premature accumulation. When securities become "value-ish," they at once become too tempting for the value-starved to avoid, yet still potentially toxic to one's financial health. It takes a great deal of fortitude to set the bar at the consistently right place in all market environments. A bar that fluctuates with the tide is, in effect, no bar at all. Trading losses in a down market can turn investors into Mark Twain's proverbial cat who once jumped on a hot stove: to this feline, all future stoves are also assumed to be worth avoiding. We haven't been in a broad-based bear market since early 2009, although numerous sectors now seem to have entered one. We believe that value investing principles, great patience and discipline, a flexible mandate, a time-tested process, and the ability to hold cash, as well as decades of experience in a multitude of market environments, should serve us well in navigating through.

What May Lie Ahead

Baupost doesn't make market or macroeconomic forecasts. We are long-term oriented, bottom-up investors, sorting through opportunities one at a time. We invest based on the micro, although we do worry about the macro. We don't go long when we're optimistic and short when we're not. We're not convinced that anyone can consistently excel at such market timing; we know that we can't. But the stock market's ongoing gains in the face of disappointing economic fundamentals and growing market stresses has us quite nervous. It would be rare for a small number of beloved stocks to lead the market higher indefinitely.

While U.S. equities are not at record valuations today, they are hardly bargain-priced after nearly tripling off of the lows set in the spring of 2009. The major indices hover close to all-time highs. Corporate profit margins remain at record levels in many industries, and, historically, those revert to the mean. It is likely that we will one day experience lower multiples being applied to lower earnings, which would lead to significantly lower equity prices.

The U.S. economic recovery since 2009 has been built on a shaky foundation of epic on- and off-balance sheet federal debt, resulting in a subpar and now tenuous rebound. Debt-to-GDP ratios are now higher for all major sovereigns than they were in 2007. We wouldn't be surprised if the sovereign debt markets in general, and eurozone sovereigns in particular, were ground zero for the next financial crisis.

Countries, businesses, consumers, and markets have been gorging on an all-you-can-eat buffet of low interest rates for the last seven years. This, along with limited opportunities for organic growth, has driven a record wave of corporate mergers and acquisitions. In 2015, the value of mergers worldwide totaled a record $4.7 trillion, with the U.S. accounting for half of that, also a record. European Central Bank President Mario Draghi continues to signal additional eurozone stimulus, pledging to "do what we must to raise inflation as quickly as possible." Central bankers continue to be all-in on policies that, in fact, haven't worked as planned. It's astonishing that even as central bankers try to conjure up inflation, investors now accept it as normal and reasonable for interest rates to be meaningfully negative – not only in seemingly impregnable Germany and Switzerland, but even in Italy and Portugal. Interest rates have never dropped this far below zero; bondholders are not accustomed to paying for the privilege of investing. Today, about €2 trillion in European sovereign bonds have negative yields. Approximately $20 trillion in worldwide government bonds yield under 1%.

We have long believed that the choice to manipulate interest rates to near zero would not be without its consequences; indeed, these are now becoming more apparent. Under quantitative easing (QE), the Fed has purchased an unprecedented 61% of all Treasurys issued while nearly quintupling the size of its balance sheet, raising a legitimate question about the artificiality of today's bond prices. Compounding the problem, near-zero rates have driven a worldwide hunt for yield, and many have found it, or thought they had, in junk bonds, the MLP space, and alternative investments. Each of these areas has, until recently, experienced capital inflows that in aggregate may have been more than could be attractively invested, leading to lower lending standards, eroding credit quality, diminishing returns, and excessive risk taking.

Today, shockwaves are rippling through the debt markets, especially in the bonds of companies in the commodities and energy sectors. Now, other industries are being impacted as well. A recent detailed report by Ellington Management Group noted, "These same hallmarks of the subprime mortgage bubble – outsized lending to riskier borrowers, record low interest rates, dubious underwriting practices and collateral valuation assumptions, misalignment of incentives between managers and investors, and weakening fundamentals – are all present today in high-yield corporate debt markets."

Today's low rates have caused Bo Knudsen of Carnegie Asset Management to proclaim "the end of compounding." The idea that a dollar saved today will grow to be worth more than a dollar tomorrow is one of the most powerful concepts in finance and economics. Albert Einstein once called compound interest the eighth wonder of the world, adding, "He who understands it, earns it... he who doesn't… pays it." But at negative interest rates – such as those prevailing throughout Europe – money saved today would instead be worth less every day going forward. Of course, the perverse goal of many policymakers is to get us to spend now, not to save so that we might spend more in the future; in effect, they're borrowing from future growth to maintain current profligacy. As journalist Jim Grant recently wrote, "[ultra-low interest rates] pull consumption forward in time and push failure backward in time." When this extraordinary period ends, interest rates will be considerably higher. Those who chased yield in the bond market will be poorer. And issuers of this debt will be scrambling to meet looming maturities in the face of considerably more expensive (or non-existent) refinancing options. The impact of "the end of compounding" has yet to be fully understood, but may actually have had a dampening effect on economic activity (rather than the stimulus intended) as the income of savers a number of years ago dwindled to near zero and remained there. Moreover, the eventual end of "the end of compounding" will have its own series of worrisome, volatility-enhancing, and loss-generating implications for investors. A real debacle in credit may lie ahead.

Until the uptick on December 16, the Fed had failed to raise interest rates for nearly a decade. This has left it in the position going forward where it will lack one of the key tools (interest rate reductions) normally at its disposal when it seeks to respond to the next financial emergency. Maybe the Fed has already picked up the last cigar butt of monetary policy and smoked it. There's just nothing left. And it's not just a problem for the U.S.; because of the repressive effect of QE policies in Europe, credit spreads between the strongest and weakest countries there are artificially low. Normal market mechanisms have not been allowed to function, and misleading signals abound, likely leading to growing distortions in economic activity and interest rates. As Jim Grant has said, "Interest rates are prices. Far better that they be discovered in the marketplace than administered from on high."

Grant also recently termed the Fed "America's problem and the world's obsession." Watching it has become a popular spectator sport, with investors constantly sifting through Federal Reserve missives for clues regarding future actions. Oddly, central bankers, in Grant's words, the "bailers-out of markets, suppressors of interest rates and practitioners of money conjuring," think increasingly about the markets. Is there too much speculation? Apparently none that the Fed can see, though they may not be looking too hard. We are in a stare-down, where both investors and the Fed are determined to take the others' actions into account, to the point where no one can separate the behavior from its mirrored influence. As such, today's Federal Reserve tea leaves are unreadable.

We expect market volatility to remain high in 2016. Many economists are now making the case that the world is in a deflationary new normal of excess capacity, underinvestment by governments and businesses, and consumer caution. QE and zero interest rate policies – and the implicit Yellen put on the stock market – have artificially tamped down volatility and supported securities at expensive levels. But this may already be changing. As mentioned, commodities have experienced an 18-month long collapse. Currencies of energy- and commodity-exporting countries have plummeted against the dollar, Swiss franc, and even the euro. The Russian ruble, for example, fell 20% in 2015. Most companies in the space have seen their bonds and share prices collapse.

China is suddenly beset by economic weakness while employing unprecedented policies to support their equity market, which had been exhibiting signs of bubble conditions. While China's economic slowdown is no surprise, an unexpected downturn there would be highly consequential. China, for example, consumed 6.6 billion tons of cement between 2011 and 2013. By contrast, the U.S. used 4.5 billion tons over the entire 20th century. Were China's economic tide to go out, the entire world could find itself swimming naked. China has a looming problem with bad debt, and Chinese stocks began 2016 by plunging 7% (i.e., limit down) twice in the first week of trading.

Another area that has been especially bubbly is venture capital, resulting from highly visible and rapidly growing companies like Uber, now "ubervalued" at $70 billion. A voracious appetite for tech startups has driven prices sky-high, giving rise to the term "unicorn," meaning privately held firms worth $1 billion or more. In today's overheated environment, "unicorns" are no longer a rare breed: there were an estimated 143 extant at year-end, up from 45 two years ago. This constitutes an enormous potential pipeline of future public offerings that could someday overhang the stock market. With investors sitting on large paper gains (the estimated combined value of the unicorns is $513 billion), but having experienced few monetization events, it seems likely that many unicorns will be drawn into the public market zoo. Unicorns also need to be fed, gobbling large amounts of cash as they grow. A change in investor psychology could impair people's willingness to continue to pour in capital at high and growing valuations. Recently there have been downward revisions in the valuations of several of the unicorns held by major mutual funds, a sign, perhaps, that excesses in that sector are in the process of being corrected, that the herd is about to be thinned.

Disruptive forces continue to roll across the global business landscape. Unprecedented changes are taking place as technology advances and entrepreneurs drive creative destruction. Numerous industries, including the behemoth energy, pharmaceutical, automobile, and retailing sectors, are experiencing waves of increased competition and disruption. In many cases, the new competitors simply have a better business model. Andreessen Horowitz co-founder Marc Andreessen has said that "we are in the middle of a dramatic and broad technological and economic shift in which software companies are poised to take over large swathes of the economy. Many of the winners are Silicon Valley-style entrepreneurial technology companies that are invading and overturning established industry structures." Certainly, no investor can blithely assume that what has heretofore been regarded as a "good business" will automatically retain its pre-eminence and, for some, even viable existence.

Geopolitically, the world remains in a precarious position. Dysfunction in Washington has become the status quo. Over the years, gerrymandering has led to a preponderance of "safe" districts. This, in turn, has led to the election of many candidates whose views are at the extremes of their parties. The result is that there is an increasingly sparsely-occupied middle ground, and commensurately diminished ability to reach compromises and get things done (though the recent change in leadership of the House of Representatives may foster a change for the better). Frustration at the lack of progress has evidently increased voters' desire for political outsiders, no matter how improbable, zany, extreme, or divisive, as presidential candidates. Amidst heated rhetoric over wealth inequality and pent-up anger at the big banks and brokerage firms for the 2008 collapse, concern about inequality of opportunity for all is lost. It's difficult not to be concerned about the rising risk of serious social unrest and a political tilt to demagoguery.

A strong and outward-looking America has made the world a safer and more prosperous place for the better part of the last hundred years. One result has been the dollar's standing as the world's reserve currency, providing America with an enormous advantage in the economic arena. Our military strength has gone hand in hand with our prosperity; our strength enhances global stability, which reduces uncertainty and thus creates a positive environment for business, capital markets, and valuations. Our armed forces have no peer, which benefits our friends while confounding our enemies. For the last seven years, however, America's footprint in the world has been significantly reduced, leaving a growing vacuum. We have literally been drawing down our forces: the U.S. Navy is currently the smallest it has been since 1916, while our Army has shrunk to its smallest size since before World War II.

While none of this is necessarily boiling over into crisis as we write in early 2016, the trend lines are unfavorable. Growing entitlement spending, a potentially weaker economy, and another year of a shrinking military under budget sequestration almost ensures that America, after a century as the primary force for order and democratic values in the world, will have a smaller global influence in 2016 and the years beyond. Many in both parties have called America's economic challenges a threat to national security.

In fairness, though, it's easy to rattle off a worry list. Some of these concerns may be resolved simply by the passage of time, either when reasonable heads prevail, or when crises become sufficiently acute. Our country has survived worse. And there is also considerable good news. Living standards have been lifted across the world through the spread of free enterprise. Silicon Valley is unique in the world as the locus of creative destruction, a place where human ingenuity and drive meet entrepreneurial capital and experience. It's another reason to be optimistic about the future. Also, thanks to scientific advances, government-funded research, and targeted philanthropy, human health is also improving globally. Indeed, we seem to be on the brink of a genomic revolution that could precipitate unprecedented breakthroughs for tackling disease and increasing human life expectancies.

It's obviously far better to be alive today than 50 or 100 years ago. But optimism isn't an investment strategy. Growth isn't always profitable growth, and the returns from investments are typically determined more by the price paid than the growth rate. Whether any of these favorable trends are fruitfully investable is unclear. While we may all be better off decades from now, it's reasonable, in light of the numerous concerns discussed earlier, to expect a bumpy ride.

On Being A Fiduciary

I was recently interviewed at a conference honoring one of the world's great fiduciaries, an extraordinary investor and thought leader, Yale University's longtime chief investment officer, David Swensen (who is also a member of Baupost's Advisory Board). As I was considering the topic – what makes someone a good fiduciary – it jumped out at me that this is not something one ought to say about themselves. Who, after all, would admit that they're not a good fiduciary? It is something that only others can fairly say about you, a hard-won mantle based on observed values and behavior over time.

While a fiduciary relationship is founded on trust, trust isn't enough. An effective fiduciary must also be intelligent, wise, and humble. Intelligence is inborn, but wisdom is shaped by experience. Also essential is the self-awareness to avoid behavioral biases, and the adroitness to look around corners and recognize patterns. Fiduciaries must possess the humility to know they could be wrong, and thus to err on the side of prudence and capital preservation. Fiduciaries must have the clarity of mind to identify conflicts of interest, and the character to avoid them as much as possible.

One of Baupost's overriding principles is to put clients first. But what does this really mean? We are devoted to building an exceptional firm, filled with highly-talented, long-tenured people, and a first-rate infrastructure that is capable of generating strong, risk-adjusted returns. We are resolved to charge a fair fee for our efforts, and not necessarily what the market will bear. Indeed, we have taken deliberate action at many points in our history to limit (and twice to shrink) our assets under management. We invest with one philosophy, under a straightforward fund structure, and without a proliferation of investment products. Over our 33 years in operation, we have, hopefully, gained a loyal client base and deep reservoir of goodwill that allows us to invest with a flexible mandate and long-term horizon, which we regard as the key factors that allow us to be successful.

At Baupost, we are rewarded not only from ownership of the business but also from the returns achieved by investing our own capital alongside our clients. Our interests are, thus, closely aligned with those of clients, and we all benefit from building up the firm's capabilities. We long ago decided to remain privately owned by employees rather than go public or sell ownership to outsiders. At any firm's inception, much negotiation goes into the terms that the firm ultimately settles upon with its clients. A deal is struck on fees, liquidity terms, investment restrictions, and the like. When a firm sells out or goes public, this changes the inherent nature of that original bargain. In particular, the agreement was originally one that implicitly promises "if you trust us with your capital, we will focus on investing it well, and at the end of a lengthy period, we will do well for ourselves because we've done well for you." Monetization of a firm has the effect of moving that wealth generation for the money manager forward, while leaving the client totally dependent on the future: "We do well now, while maybe you will do well later."

Also, the manager may be doing something even worse by causing the firm to shift its focus to its own underlying profitability rather than the returns delivered to its clients. This means a firm that goes public may also focus more on what will affect its share price than on what will deliver good long-term investment results for its clients. Going public might, for example, dramatically change incentives, creating a focus on asset gathering or becoming hyper risk-averse (to maintain assets under management) and thereby failing to fully seize opportunities. By enriching current management at the cost of the next generation of the firm's leaders, it also mortgages the future. Going public or selling out dishonors the original deal.

It is easy for ethical transgressions to creep in and distort the thinking or behavior of an investment firm. The investment business is rife with conflicts, and they cannot all be avoided. The challenge for a fiduciary is to set up a client-friendly structure and adopt rules, policies, and procedures that serve to minimize conflicts, and err on the side of clients when they do arise. Fiduciaries must surround themselves with colleagues who share these same values and priorities.

One of the ways we avoid conflicts is by managing our partnerships with a single philosophy. Our evergreen fund structure, tight limitations on personal trading by members of the investment team, and strong encouragement of employees to invest alongside our clients when they are eligible (most choose to invest the vast majority of their liquid net worth at Baupost), serve to align the interests of our clients and team.

I was asked in this interview whether fiduciaries are the product of nature or nurture. My belief is that a person's character is largely determined by their wiring at birth. Not everyone will find it easy to truly put others first. But wiring is not the whole story. A good person ensnared in an unethical environment is likely to lose his or her way. And a person who hasn't spent much time thinking about or caring for others, when placed in the right environment, may well turn out to be a fabulous fiduciary.

Another question I received during the interview involved the margin of safety philosophy. Is that the only possible approach that a fiduciary could take? Or could one pursue another approach that involves greater risk while still fulfilling a fiduciary duty? My view is that fiduciaries must be able to step into a client's shoes. Clients will have different risk tolerances and preferences based on who or what they are: an institution may have a different perspective than an individual; a well-endowed institution is different from one with fewer resources; and a younger individual will have a different investment perspective from a senior citizen.

Our core margin of safety principle also turns out to be more complicated than it may seem on the surface. Individual investments should be made with a margin of safety in mind. But sometimes an investment involves a significant possibility of loss but also a very high probability-adjusted return. Where, exactly, would such an investment fall on the Ben Graham scale?

A fiduciary should think more about the safety of an entire portfolio than about any individual holding. Is Baupost willing to make an investment that has a meaningful, even significant probability of loss, if the expected value – the weighted amount and probability of gain and loss – is hugely positive? The answer is yes. All positions involve a degree of risk; any investment can go sour, and any probability assessment can be wrong. We manage the risk of loss in any single position by sizing appropriately based on historical experience as well as by striving for prudent diversification. Every day, businesses we own are making countless decisions they believe will offer positive expected value to shareholders in excess of their firms' cost of capital. It doesn't make sense to own businesses which do that, yet be unwilling to do it ourselves.

A good fiduciary will have a historical perspective and a risk-averse nature. Responsible investors remain alert and aware of changes in the markets, economy, political process, and society at large as they make decisions. What seems prudent at one moment may not seem at all prudent at another. A wise fiduciary is able to see the full picture of how society's standards and market judgments have evolved over the years and be conscious that they may do so again. They should never allow themselves to be blown by the wind of investment fashion, but instead tack against it when necessary in order to best protect their clients' capital. They should always be guided not by market perception, but by what they truly believe is in the best interest of their clients.

Over time, the centuries old “prudent man rule” has been misapplied. In the 1970’s this rule was interpreted to mean that investments had to meet a certain standard in order to qualify for the “prudent man” list. Stocks not paying a dividend or debt of companies that was below investment grade were automatically rejected for being imprudent. Yet experience shows that the investments regarded by society as most prudent often yield disappointing returns, while the investments seen as imprudent often excel. This is, of course, because price is the main factor in determining risk and return. What is in favor is often overpriced, and what is anathema can be bargain priced. Consider the senior bonds of a company engaged in a restructuring process that are trading at a steep discount from par. These often entail considerably less risk than the equity of a cyclical or volatile business where the company’s fortunes can dramatically ebb and flow. The stigmatized bankrupt bond is subject less to market forces and more to the rigors of a multi-year process, where an investor can actually help determine his or her own fate by becoming involved in the restructuring.

In a responsible investment firm, being a fiduciary must be deeply rooted in the culture. At Baupost, we strive to recognize not only talent in our people but also good character, and aim to promote only those who possess both. It is a given that the people chosen to be partners at Baupost are strong fiduciaries, putting clients, the firm, and their fellow employees ahead of their own personal interests. One friend refers to this as being morally inflexible. My partner Jim Mooney frequently reflects that “clients would be so proud to have their money invested here if they had just been in that meeting and heard our discussion.” The notion of our clients being in the room with us at all times is extraordinarily powerful as a governor on behavior and thinking. I noted earlier that it doesn’t make sense to be disciplined “most of the time.” Well, you can’t be a good fiduciary most of the time either. You either are all the time or you’re not at all.

We know that we might not get every judgment right, but we wrestle with all the details, and ask ourselves whether we are making each investment decision for the right reasons and with the right process. We don’t ask whether something we are considering will personally earn us more money or make us look good. Our focus remains solely on whether each investment decision is in the best long-term interest of our clients.

The Baupost Team

Across the firm, we have a deep team of exceptional contributors. Led by our partners in the Public and Private Investment Groups, our investment teams worked harder than ever in 2015 to navigate challenging market conditions, seize on opportunities to monetize existing investments, and energetically source and analyze new ones. Our investment teams’ talent and passion for investing continues to shine through as we pursue opportunities across diverse asset classes and volatile markets. Despite disappointing overall results, our teams demonstrated patience, discipline, determination, focus, and teamwork in finding some truly compelling bargains and exiting some very successful investments.

Jim Mooney, a partner and a member of our Management Committee, continues to ably lead our Public Investment Group. Jim's efforts regularly raise everyone else's game, both in the Public Investment Group and throughout the firm. Jim continues to drive the steady improvement of our investment process. Along with Jim, partners Greg Ciongoli, Mike DeMichele, and Josh Greenhill remain key contributors to our public markets investment effort, working closely with our analysts in sourcing, researching, and analyzing investment ideas. Rob Bralower, who took on the leadership of our Portfolio Risk Committee two years ago, is a key thought partner for all of us. His knowledge of markets and sound thinking around risk and hedging help the Public and Private Investment Groups identify specific hedges for individual investments, and he coordinates closely with me, Jim Mooney, and the rest of the Portfolio Risk Committee on portfolio hedges as well. Rich Carona, a managing director in our Public Group, plays a senior role in our London office pursuing public equity, debt, and private investments throughout Europe. Effective January 1, 2016, Rob Bralower was promoted to partner in the firm. James David and Michael Sperling were promoted to managing director, and Bryce Albin was promoted to principal. As discussed in our third-quarter letter, Brian Spector, partner in the Public Investment Group, retired from the firm at year-end to focus on family and personal philanthropy.

Tom Blumenthal, who is focused on international real estate and private investments, and George Rizk, who is focused on U.S. real estate, serve as co-heads of our Private Investment Group. Both are partners in the firm, and Tom is a member of our Management Committee. Their team, which maintains a global focus on all types of real estate as well as opportunistic private equity investments, was a significant profit contributor again in 2015.

Under Tom and George, the Private Investment Group continues to energetically add new operating partners to our roster while sourcing interesting transactions throughout the U.S., Europe, and beyond. Sam Plimpton, partner emeritus, continued in his role of sourcing opportunities, training analysts, and mentoring the team. Ably supporting Tom and George are the managing directors on the private team: Bob Berlin (Private Corporate Investments), Mark Tsocanos (Real Estate), and Brian Zilla (Asset Management). Effective January 1, 2016, Nick Azrack and Hunt Doering were promoted to managing director and Casey Nelson to principal of the firm.

Our London office remains a hub of investment sourcing, relationship building, and research, as well as an epicenter of coordination among the various groups within Baupost under the joint leadership of Josh (public investments) and Tom (private investments). We have strived to ensure cultural synergies and consistencies between Baupost London and Baupost Boston. The London office again drove a number of new investment opportunities in 2015, and the significant European pipeline involves both public and private investments.

During 2015, one new analyst joined the Public Investment Group and five joined the Private Investment Group, enhancing our already deep, talented, and hardworking team. We believe our ability to recruit exceptional people remains a significant competitive advantage for the firm.

Our investment efforts are supported and facilitated by our Investment Execution teams. Our Trading Group, led by executive director Scott Haig, efficiently executes buying and selling decisions, which have become more global and increasingly complex over time.

Our new general counsel and partner, Fred Fogel, manages our newly consolidated legal and compliance functions and reports to me. We are pleased to have his experience and expertise on board. Directly reporting to Fred are chief compliance officer and regulatory counsel Scott Stone, assistant general counsel Rosemary McCormack, investment counsel Collin Beecroft, and tax counsel John Harvey; overall, 14 people work across our legal teams. Donna Ryan, tax consultant, retired from her full time position at year-end after 11 years at Baupost, but she will continue to serve as a consultant to Baupost on a part time basis in 2016. Baupost has always been deeply committed to maintaining the strongest possible culture of compliance; we continue to build this function and expand our focus amid an increasingly complex regulatory environment.

Our exceptional operations team is led by Elaine Mann, chief operating officer, and Barbara O'Connor, chief financial officer, both partners and members of the Management Committee.

Our highly complex investment portfolio places significant demands on the firms' Operations departments. We are fortunate to have a talented and committed group of leaders under Elaine and Barbara who work with their teams to pursue operational excellence. Our department leaders are: James Conz, Information Technology; Diana DeSocio, Corporate Communications; Beth Mills, Investor Services; David Morris, Middle Office; Jason Price, Accounting and Valuation; Frank Seyboth, Tax Reporting; Lucy Tshuka, Human Resources and Administrative Services; Johanna Ward, Financial Reporting; Adam Halpern, Private Investment Operations; and Linda Hoyt, Special Projects Manager.

Around year-end, we hold a company breakfast to honor those employees who have achieved milestone anniversaries. For each employee who reaches his or her 10th anniversary with Baupost, we commission a professionally drawn caricature to display on the wall of our lunchroom here in Boston. This year, we added four new caricatures, bringing the grand total to 28, and four current employees have clocked more than 20 years at Baupost!

I am immensely proud of our firm's culture, which attracts exceptional people, many of whom choose to build their careers at Baupost. We believe it serves the interests of our clients as well as our employees to remain tightly focused on the long-term perpetuation of the firm. Accordingly, two interdependent goals are paramount: first, to be a great investment manager for many generations to come; and second, to be a great employer.

We know how fortunate we are to work in a business that offers the potential for substantial remuneration for our skills, and we believe that those who do well in society have a strong moral obligation to help others who are less fortunate. Our values lead us to strongly support local community endeavors through our volunteerism and philanthropy, both as a company and individually.

We remain aware of the inherent fragility of investment organizations, and we are determined not to fall victim to the arrogance, hubris, or complacency that sometimes bring firms down. We will tirelessly strive to improve. We will also maintain our commitment to intellectual honesty in the service of building the best investment firm we possibly can for the long-term benefit of clients and employees. We intend to be around for a very long time.

With Our Appreciation

We continue to benefit from the wise counsel of Baupost's Advisory Board: Baupost Founders Bill Poorvu and Howard Stevenson; Jay Light, dean emeritus of Harvard Business School; David Swensen, chief investment officer of the Yale University Endowment Fund; Jane Mendillo, retired president and chief executive officer of Harvard Management Company; Bill Helman, partner at Greylock Partners; and Paul Gannon, former chief operating officer of Baupost. The board has a wealth of experience, and the insights of its members regarding investment and business matters continue to benefit Baupost and its clients.

We also appreciate the ongoing long-term relationships that Baupost enjoys with Ropes & Gray LLP, our corporate counsel; and Ernst & Young LLP, our auditors and tax professionals; and with organizational consultants from Podia Consulting and the Center for Applied Research who have worked with me and a number of our partners and senior leaders over the past several years.

One of the greatest privileges for us at Baupost is to serve as stewards for the assets of a limited number of fine families and esteemed institutions. Our valued limited partners are truly long-term oriented. Were you not, it would be nearly impossible for us to maintain the kind of investment horizon that we think is required to capture good risk-adjusted investment returns, especially in today's challenging environment. Your trust and steadfastness strengthen our resolve and enhance our ability to make the very best decisions. For this, you have our sincere gratitude.

We hope you have a healthy and prosperous new year. We greatly appreciate your confidence and support. Please let us know if you have any questions or comments.

Very truly yours,

Seth A. Klarman
President and CEO

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