BAUPOST LIMITED PARTNERSHIPS

2021 YEAR-END LETTER

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"Disinformation does not mean false information. It means misleading information—misplaced, irrelevant, fragmented or superficial information—information that creates the illusion of knowing something but which in fact leads one away from knowing."

– NEIL POSTMAN

"We forget all too soon the things we thought we could never forget."

– JOAN DIDION

"As long as I have known the World I have observ'd that Wrong is always growing more Wrong till there is no bearing it, and that right however oppos'd, comes right at last."

– BENJAMIN FRANKLIN

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In Memoriam

This year's letter is dedicated to the memory of David Swensen, who passed away in May 2021. He was an extraordinary investor, a valued advisor, and a dear friend. His impact on the field of investment management will be felt for decades. We will miss his passion for investing, his great integrity, his thought leadership, and his personal warmth. We will always honor his memory.

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January __, 2022

Dear Limited Partner,

[redacted] A detailed report on our investment results will be available on our website in early February along with additional detail on the 10 largest positions at December 31, top gains and losses on individual positions, as well as year-end allocations to various asset classes.

2021 in Review

COVID-19 dominated life in 2021. It occupied our thoughts, drove our anxieties, restricted our lifestyles, determined economic winners and losers, and cast a bright light, as nothing has before, on the gaping inequality inherent in American society. In response to the ongoing economic crisis caused by COVID-19, Congress passed a third round of stimulus payments and extended both the Paycheck Protection Program and unemployment benefits, while the Fed continued its bond buying and low interest rate policies pretty much throughout the year.

Because of less than universal acceptance of vaccinations, the pandemic continued to take lives, weigh on care providers, and disrupt everyday activity. As a result of the ongoing spread, offices were slow to reopen, business travel remained sluggish, and many stores and restaurants stayed closed. Just as the pandemic seemed to be coming under control in the summer, the Delta variant took hold, and the economic rebound experienced another hiccup. Then, in late November, the Omicron variant emerged and life was, as Yogi Berra might have remarked, "déjà vu all over again."

Overall, 2021 was a year of strong economic recovery in the United States. Indeed, the U.S. in 2021 outperformed the global economy by the biggest margin in this century. In December, first-time unemployment claims hit their lowest level in 52 years and J.P. Morgan Chase predicted that the economy in 2022 would return to normal. Early in the pandemic, there was widespread concern about rising unemployment, but as the economy recovered, labor shortages emerged instead. COVID-19 caused many people to re-examine their lives, re-think their careers, and, in a record number of cases, quit their jobs or even abruptly retire, a phenomenon that came to be known as the "Great Resignation." In November alone, more than 4.5 million workers left their posts. With a tight job market and legions of workers checking out, many positions went unfilled even after employers offered significantly increased pay and/or generous sign-on bonuses.

In the sometimes perverse way of markets, bad news for people turned out to be generally good news for the valuation of businesses. The stock market rebound that began in late March

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2020 continued throughout 2021. The S&P 500 hit 70 new record highs during 2021, the second most for any year, going 227 consecutive sessions without so much as a 5% pullback. This index rose nearly 29% on the year, reaching an astonishing 40 times its cyclically adjusted price-earnings ratio, a level exceeded only during the dot-com bubble. The price-to-sales multiple on the S&P 500 hit 3.1x, a 31-year record. One strategist has calculated that 80% of the rally in the S&P 500 since 2019 is attributable to multiple expansion, not to earnings growth.

Thanks to stimulus payments, continued low interest rates, and most importantly TINA ("There Is No Alternative") thinking, cash poured into the U.S. equity market more or less indiscriminately and in record volumes, driving the surge in share prices. These inflows totaled five times the level of the previous year's. Numerous records were set in 2021 that captured the market's ebullience: in global equity fund inflows, options trading, corporate merger activity, and the number of U.S. IPOs. Investors poured over $900 billion into global equity funds in 2021, a figure exceeding the total net inflows of the previous 19 years. Some of that money flowed into so-called meme stocks, companies like nearly bankrupt GameStop and AMC, which became short-term trading favorites. Indeed, in the U.S., AMC stock was the second most common news search on Google in 2021; only the lottery ranked higher. Household ownership of equities neared an all-time high.

On the credit side, nominal interest rates remained extremely low, with the 10-year Treasury yield ending 2021 at 1.52%. At a time of sharply rising inflation, the 10-year real rate of interest (net of inflation) hit its lowest reading on record while credit spreads remained compressed. With people's savings being gradually confiscated by inflation and suppressed interest rates, it's no wonder they have continued to plunge their savings into the stock market. Yet a record of over $500 billion also flowed into fixed income in 2021. The market met investor demand for fixed income with new issuance of U.S. junk bonds and leveraged loans, which both set records.

As the economy cranked back up, serious snags developed in global supply chains and resulted in bottlenecks at ports, shortages of key components, and strong inflationary pressures. When it comes to inventory, the once vaunted "just in time" approach was revealed to be "not in time."

Commodities prices soared in 2021, as consumer-price inflation in the United States, which had averaged 1.8% in the decade ended in 2019, accelerated sharply over the course of the year. Oil briefly rallied to more than $80 a barrel, and the price of gasoline in some markets briefly reached $5 a gallon. The cost of shipping also soared. Consumer prices rose 6.8% in November compared with those of one year prior, a 39-year high. If anything, that number may understate the inflation experienced by Americans, due to the arcane methodologies used to calculate the figure, especially around the costs of home ownership. Meanwhile, inflation in the European Union reached 4.9%, the highest reported level in 24 years.

Even as inflation moved from a business page news item to a kitchen table reality, the Federal Reserve, which had been far more concerned about deflation than inflation in recent years,

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at first seemed to believe that the current spate of price increases was (to borrow one of its own words) transitory. But the Fed subsequently rejected that language, accelerated the tapering of their bond buying, and signaled three interest rate hikes in 2022. Short-term interest rates moved higher. Clearly, the Fed has shifted from having a single-minded focus on full employment to an inflation-fighting mindset, something most investors in today's market have never witnessed.

As to the future rate of inflation, there are good arguments on both sides of the debate. On the one hand, globalization, a driver of relentless deflation, may be in retreat; wages, always sticky to the downside, are rising sharply; and the Fed may feel forced to keep interest rates low, which will continue to stimulate consumer demand while encouraging speculation. On the other hand, unprecedented economic stimulus is probably over, and high debt levels and aging populations in the world's largest economies are deflationary forces. Many of the best-performing commodities in recent months have lately come off their highs. We are late in this economic cycle, and a downturn would help extinguish inflationary forces. And the steady stream of technological advances is likely to have a deflationary impact. In the words of market strategist David Rosenberg, "to bet on inflation is to bet against human ingenuity."

At its core, inflation is a psychological as well as monetary phenomenon. A prolonged uptick in inflation causes people and businesses to alter their decision-making. They may, for example, stockpile inventories in anticipation of further price increases, which could drive prices up even faster. Indeed, inflation expectations are already moving sharply higher. As Greenmantle Research observed late in the year, the "supply side was scarred on all fronts by the pandemic while fiscal overkill has ensured [that] demand remains robust and growing." We don't know how bad the current bout of inflation will be, but we believe that mounting inflation and the related possibility of materially higher interest rates are posing a real danger to financial markets. To protect against continuing inflation and the prospect of rising rates, we have purchased hedges that stand to gain in such an environment.

Market exuberance increasingly swelled to mania in 2021. When people see others rake in seemingly easy riches (e.g., tales of incredible gains being achieved in startups, hot IPOs, meme stocks, or cryptocurrencies and tokens), it's natural for them to urgently want in, too. FOMO ("Fear of Missing Out") is an incredibly powerful psychological force; leaving money on the table can feel worse than actually losing it. Moreover, when there are so many well-publicized winners, people begin to wonder whether the risks have been overstated and find an excuse to capitulate.

Some of the greatest excesses of recent years were revealed over the course of 2021 and started to be corrected. Perhaps the most dramatic example is China Evergrande Group. Years of profligacy and mismanagement caught up with this real estate developer, and late in 2021 the company defaulted on some of its mind-boggling $300 billion in liabilities. The prices of the bonds of other Chinese developers also plunged. In addition, the Chinese government sent chills through a number of market sectors by cracking down on some wealthy Chinese individuals as well as businesses deemed inconsistent with the Communist Party's goals of "common prosperity." This should serve as a helpful reminder to global investors that autocratic countries aren't always friendly to foreign investors.

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Perhaps triggered by Fed Chairman Jerome Powell's remark about accelerated tapering and his less transitory view of inflation, toward year-end the most speculative market sectors—such as high-flying, profitless technology companies and meme stocks—took a drubbing. As one pundit put it, "Below the surface of the broad indices, there is deep trouble." Market breadth continued to narrow, with only five stocks—Microsoft, Alphabet, Apple, Nvidia, and Tesla—accounting for roughly one-third of S&P gains on the year and 45% of the gains since May 1. At least one prominent biotech fund, experiencing steep losses, closed its doors near year-end. And even with the S&P 500 setting all-time highs, 40% of the stocks on the Nasdaq Composite Index were trading 50% below their highs. With the possibility of higher interest rates coming into focus, investors had become less willing to pay astronomical multiples for uncertain and distant future cash flows.

Covid as an Accelerant of Social Divisions

One of the more pernicious effects of COVID-19 during these past 22 months has been its damage to our social fabric, inflaming the vast political and social divides between red and blue. Mask and vaccine mandates have become the subjects of particularly ugly partisan rancor and civic strife. In a very real sense, public health and democracy have become partisan issues.

The year began with an unprecedented attack on the U.S. Capitol. Fueled by a relentless stream of wild lies and misinformation about the presidential election, on January 6, 2021, an unruly mob of Trump supporters, some 8,000 strong, stormed and occupied the Capitol building to disrupt the certification of the 2020 election. Only two House Republicans, the courageous Liz Cheney and Adam Kinzinger, joined a bipartisan investigation of the insurrection. Over the ensuing months, in response to Trump's nonstop and baseless allegations of election fraud, Republican legislators and elected officials in several states initiated clownish audits of the 2020 result and ultimately uncovered nothing amiss. Many local election officials, who had acted with high integrity in determining the result, were threatened with physical violence. A number of them chose to step down from their posts, only to be replaced, in many cases, by partisan hacks. The "Big Lie" continued to be repeated, not only by Trump but also by a large number of politicians and members of the right-wing media, and it metastasized. The January 6 insurrection became a rallying point for many Republicans and fueled enormous fundraising efforts.

The conservative scholar Robert Kagan later observed that the United States was "heading into its greatest political and constitutional crisis since the Civil War, with a reasonable chance over the next three to four years of incidents of mass violence, a breakdown of federal authority, and the division of the country into warring red and blue enclaves." What was particularly ominous, Kagan noted, was that "Trump and his Republican allies are actively preparing to ensure his [2024] victory by whatever means necessary. ... The stage is thus being set for chaos."

Democracy is a precious gift that we have inherited from our forebearers. Unfortunately, it comes without operating instructions or a warranty. As with anything breakable, democracy must be handled with care. It's time to once again heed Benjamin Franklin's prescient warning about the government that the Founding Fathers were creating: "A Republic if you can keep it."

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Once upon a time, Americans debated policy options and possible solutions to society's greatest challenges. But increasingly today, we are fighting over the facts themselves. We have become a people with two radically different versions of the truth. The financial markets, to date, have shrugged off many things, including the widening social divides and growing anger and violence spreading throughout American society, but we worry that these ills could creep into the business world. Even everyday tasks of managing relationships with customers and employees could become very difficult. An ever-more polarized America, incapable of peacefully bridging our divides, may someday cease to be a reliable destination for investment capital.

Finding Value in an Expensive Investment Environment

Amidst a roaring bull market with swollen valuations, one might think that Baupost would experience a drought of investments that meet our criteria for return and risk. We are pleased to report instead that the shelves of opportunity today are fairly well-stocked. On a recent webcast, we were asked our impression of why we were finding so much to do in a market that has been going straight up. Aware that cognitive biases and the psychological pressures of the investment business can lead even the most astute investors astray, we ask ourselves this question regularly, as part of our own perennial skepticism.

Warren Buffett famously noted that investing resembles poker in an important respect. In a poker game, when you look around the table and can't identify the patsy—the rube invited by the more skilled and experienced players—then it's probably you. And so, for each investment we evaluate, we consider whether we could be at an information disadvantage; we never want to be the patsy. We also regularly ask ourselves, Why does this apparent opportunity exist? What is the market inefficiency? Have we inadvertently lowered the bar, causing investments to appear more attractive than they really are? If a particular opportunity is truly compelling, why haven't our competitors jumped in to correct the apparent mispricing? All these questions must be answered to our satisfaction before proceeding with an investment.

At Baupost, we have always taken an idiosyncratic approach to investing, and finding opportunity well off the beaten path was a primary driver of capital deployment in 2021. We seek to benefit from our size and scope, sourcing and sifting through a great many prospective opportunities to find the ones with the best risk-adjusted returns. We are decidedly not trying to buy the hottest high-flyers hoping they will continue to soar. Rather, we are always anchored to valuation and focused on business fundamentals, attempting to make investments that will earn good returns across a wide spectrum of future market and economic scenarios. We strive to safely grow client capital over the next three to five years, not next week or next quarter. Our experience is that opportunity regularly migrates across markets, industries, and geographies, as capital flows inflate the prices of some investments while leaving others orphaned. To navigate the natural evolution of markets, we employ an investment approach that is fixed in its general principles yet flexible in its implementation. Our portfolio is painted with a wide palette. Sometimes, this means originating an urgently needed, well-covered financing at a compelling yield. Other times, we come across a mispriced stock (sometimes catalyzed, sometimes not), an attractive private equity

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investment, or an opportunity to buy or develop a property at a price that holds the promise of a very attractive risk-adjusted return. Because of our wide-ranging approach, we don't need the entire market to become undervalued—just a limited number of investments from time to time.

Many investors, in their apparent quest for quick profits, lately seem to have abandoned certain parts of the financial markets; their lack of attention attracts ours. We often have success searching through the "abandoned property" bins of the market. While, broadly speaking, capital is remarkably plentiful at this time, it is far from equally available to all. Today's market is one of considerable skew; the higher-valuation deciles of the major indices trade at roughly twice their historic multiples, while the lower-multiple cohorts are trading only modestly higher.

One area where we found opportunity in 2021 was in commercial real estate, a sector that experienced capital shortfalls due to the pandemic (and the ensuing lower occupancy levels, limited leasing activity, and construction delays). These funding gaps have allowed us to inject fresh capital into real estate projects that are temporarily struggling but still economically attractive over the long run. For example, we made a $380 million loan we believe to be very well-covered in January 2021 against high-end condominiums in the Central Park Tower development in New York City. Our real estate group closed on three additional lending opportunities in 2021, including a mezzanine loan to an Austin, Texas, condominium project. We have also identified and either closed on or are likely to fund opportunities to build lab space, cold storage, and data centers[redacted] Our real estate investments at year-end comprised approximately 11% of the portfolio.

Our decision several years ago to significantly expand our private corporate group and to ramp up our sourcing efforts made a real difference in the volume of attractive private equity, credit, and credit-like opportunities making it into our portfolio in 2021. Most of these investments fall in the range of $50 million to $200 million, below the threshold of the largest players in these sectors, though occasionally a larger opportunity comes along. Over the course of the year, we deployed $1.6 billion of fresh capital into private equity investments[redacted]– [redacted] (There's another $1.2 billion of deal flow in the current pipeline that we anticipate will fund in 2022.) Portfolio additions include Compo, Europe's largest gardening-products business, being unloaded by a distressed Chinese seller; a chain of veterinary surgical hospitals; and a group of orthodontia and pediatric dental practices. Private equities accounted for roughly 13% of portfolio assets at year-end.

We have also been finding a myriad of inefficiencies in the bespoke private credit and preferred stock markets. Examples include companies seeking to secure growth capital without immediately diluting their equity or giving up control, as well as other proprietary sourced financing opportunities. We put more than $1.2 billion of gross capital to work in this space in 2021, [redacted]–with $1 billion of future transactions in the pipeline. Private credit–like investments accounted for 3.5% of the portfolio at year-end.

Our recognition a number of years ago that the technological disruption of this era was unlike any other force we have encountered in our investment lifetimes also positively impacted

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our performance in 2021. In investing, it's crucial to differentiate between what is secular and what is cyclical—or, to put it another way, whether there will be a "reversion to the mean" and when "this time, it's different." Usually, "this time" is not different, and typically, there will be a reversion to the mean. But currently, and with the pandemic as an accelerant, the forces of technological disruption are even more rapidly eroding some business models while propelling others forward at unprecedented speed. This revolution has altered the risk-return calculus, resulting in greater upside for the biggest winners and abrupt and potentially catastrophic declines for the losers. Implementing these insights has helped us in two ways: to identify a subset of reasonably priced investments that we believe will reliably compound our capital; and to avoid firms likely to be adversely impacted.

In investing today, change is the real constant. What might have seemed a safe investment to Benjamin Graham, such as owning the shares of an asset-rich underperformer, is not necessarily safe anymore because the company's business model may be imploding. In the world of investing, the idea of dramatic change is nothing new as one era ends and another begins. Consider that the word "technology" doesn't even appear in the index of Graham and Dodd's classic investment tome, *Security Analysis*.

This discussion would not be complete without noting that while we remain value investors to the core at Baupost, our definition of value is not the one often taught in business schools. The academic view of investing divides the equity universe into "value stocks" and "growth stocks." Value stocks are then defined as the low-multiple part of the market: low price-earnings multiples, low price-to-cash-flow multiples, and low price-to-book value multiples. But, as mentioned, even very-low-multiple stocks may fail to represent value if the underlying business is quickly eroding, turnaround seems unlikely, and management is squandering corporate cash. Our definition of value is more expansive and includes any investment, whether growing or not, whose current price is materially below its underlying value.

Our approach to value investing is to search for mispricings. Mispricings can exist for many reasons, including situational complexity, institutional constraints, investor error or irrationality, short-term disappointments, disparate time horizons, the urgent unwinding of leverage, turmoil driven by financial distress, and investor indifference or neglect. Over Baupost's history, the locus of opportunity has varied significantly. Both the public and private markets have generally become more competitive over the years. And yet, both hold the prospect of significant mispricings that investors can uncover if they are patient, disciplined, relentlessly curious, and agile. Many investors, by charter or regulation, can invest only within narrow silos and thus are unable to view opportunity from a sufficiently wide lens. Value may be found, for example, in the stock of a reliably growing company trading at a fairly high multiple based on current results and a materially lower multiple a few years out if (and this is a big "if") the expected growth actually materializes and is sustained. While the shares of companies enjoying strong growth can become mispriced for many reasons, as noted, a particular risk with high-multiple stocks is that if growth falters, the shares may suffer the double whammy of a lower multiple applied to lower projected earnings. This, in turn, may create opportunity, as disappointed growth investors exit and value investors spot a bargain.

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Finding value in 2021, as is often the case, involved a combination of factors: knowing where to look, moving quickly, operating with a flexible investment mandate, having the ability to take the long view, and possessing the legal and negotiating skills to structure investments to meet the particular requirements of a counterparty. Creative structuring may provide us with significant one-way optionality, enabling us to maintain exposure to most or all of the upside of an investment with far less exposure to the downside. Our nimble investment process lets us act rapidly; we can swiftly close transactions of virtually any type or size. We can provide debt or equity capital, or both. We can take control of a business or hold a minority stake. We can make an investment in which the seller retains an interest in the upside above a specific performance threshold. Companies sometimes have priorities beyond simply financing their activities at the lowest cost of capital. They may seek a value-added partner with sound judgment, high integrity, and a long-term outlook. Or they may particularly value confidentiality, for instance, or certainty or speed of execution. And in such cases, Baupost's capital may be the best fit.

[redacted]

[redacted]

Many of our equities also involve soft or hard catalysts for the realization of underlying value. While ultimately correlated with business performance, the returns from most investments depend on the market forces of supply and demand. A catalyst involves a transaction, process, or plan that shifts the outcome of the investment away from the vicissitudes of the market to the successful execution of a value-realizing transaction, such as a takeover, plan of reorganization, or spinoff. [redacted]

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[redacted]

We also initiated an investment in the less well-known share class of a top-quality large-cap growth stock at a very sizable discount to the regular shares. We expect that the events of the next several years will reduce or eliminate this discount to the benefit of shareholders. Overall, public equities comprised 43% of portfolio assets at year-end.

[redacted]

In summation, today's investment markets are characterized by pandemic-related dislocations as well as by mega-trends, including political uncertainty, government intervention in the economy and markets, climate change, and technological disruption. These factors, in the context of the usual market inefficiencies and institutional constraints, drive opportunity creation that is often fast-moving and requires flexible capital and agility. Our approach is particularly well-suited to investing through disruption and high levels of uncertainty and unpredictability. Key success factors include our long-term flexible investment mandate, experience investing amidst great uncertainty, intellectual honesty in a rapidly evolving world, appreciation of optionality, and a record of assessing and mitigating downside risk.

Upside Potential with Downside Protection: Our Risk-Averse Approach

In 1982, four families came together to form Baupost. Each had significant concerns that the high and rising interest rates of the period could crush the economy, financial institutions could fail, and financial markets—which had been subdued for most of the prior decade—could continue to falter. They were seeking the reliable compounding of capital over the long run while avoiding the wrenching downside volatility that can accompany a strategy of simply being long equities. While none of us believed we could accurately forecast the markets, we were confident we could successfully assess individual businesses, which would enable us to generate attractive absolute returns by searching for mispricings on a bottom-up basis, one investment at a time. We built a team to identify individual securities, businesses, and assets that were fundamentally undervalued. Many of these were event-driven investments, with partial or full catalysts for the realization of underlying value; we believed these investments would have limited correlation with the overall market and shorter duration than uncatalyzed investments while delivering strong risk-adjusted returns. One area of particular focus was the senior securities of companies in financial distress; our analytical capabilities are particularly valuable in evaluating such complex instruments undergoing an uncertain process, while the seniority of the claims would provide a degree of downside protection. Portfolio hedges would further serve to mitigate our exposure to market risk.

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We would also implement guardrails to protect against extreme downside scenarios, including our decision to refrain from leveraging the overall portfolio as well as our willingness to hold cash in the absence of immediate and compelling opportunities. As we enter our 40th anniversary year, we can say that our approach has worked well, resulting in the strong compounding of capital and only four money-losing years over our four decades in business.

The history of wealth is that it has always been hard to build and easy to lose. Great fortunes have been amassed, usually over long periods, but often subsequently depleted for any number of reasons, including profligate spending, ill-advised investments, wayward heirs, wars, revolutions, and taxes (and sometimes philanthropy). But today, the opposite seems to be occurring. Fortunes are being amassed rapidly, sometimes instantly. A wisp of an enterprise can be capitalized at hundreds of millions or billions of dollars seemingly overnight, and a clever business plan may be far more generously funded by venture investors than at any time in the past. The story of the past dozen years is that, in financial terms, the haves have ever more, while the have-nots continue to barely scrape by. The possibility of a dramatic reversal does not seem to be prominent on the radar screens of people who have come into their fortunes only recently.

Historically, financial markets have exhibited significant volatility, but over the past 12 years that volatility has mostly been absent. As interest rates were held at rock bottom by the Fed, stocks have almost relentlessly gained ground; investors have seen their net worth consistently marked up but rarely down. "The idea of persistent low rates," we noted in last year's letter, "has wormed its way into everything: investor thinking, market forecasts, inflation expectations, valuation models, leverage ratios, debt ratings, affordability metrics, housing prices, and corporate behavior. … Moreover, by truncating downside volatility, forestalling business failures, and postponing the day of reckoning, such policies have persuaded investors that risk has gone into hibernation or simply vanished." Because nothing really bad has happened over this lengthy period, investors increasingly behave as though nothing really bad could ever happen.

Because financial markets discount expectations for the future (and today, at historically low interest rates, they do so very generously), the reward for entrepreneurs often materializes well before the cash flows of the underlying businesses do. We have two things to say about this: First, connectivity driven by the internet, advances in big data, and developments in artificial intelligence have enabled the formation of exceptional businesses that can grow unusually quickly, often while requiring little or no incremental capital. Blockchain-enabled businesses using tokenomics to incentivize network behavior appear to be the newest disruptive force that enables the formation of fast-growing enterprises (and the potential disruption of more mature business models).

But second, achieving business success is not as simple as it seems right now. It's easy to mistake an ephemeral stock market appraisal for an enduring accomplishment, and relentless capital inflows provide an additional layer of cloud cover. Remember, it's easier to envision the rapid growth of an enterprise than to actually achieve it. A clever business plan does not automatically translate into corporate cash flow. A spreadsheet cannot meet a payroll, pay a dividend, or manage a team of people. Poor execution by management can negate any structural corporate advantage, erode employee and investor confidence, and destroy customer trust. Also,

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today's disruptor may become tomorrow's disrupted. Competitors are perennially hard at work finding ways to eat your lunch.

Today, aggressive risk-taking seems to many like the only sane thing to do; risk aversion may actually appear to some to be the more dangerous path, especially in terms of career risk for the money manager. We have read an increasing number of stories about institutional investors actively seeking to add risk to their portfolios, apparently from the perspective that higher risk must inexorably lead to higher returns, one more unfortunate remnant of the efficient-market hypothesis. This risk is derived from using leverage and/or increasing exposures to riskier asset classes like venture capital, leveraged buyouts, and frontier markets. Our considered view is that incurring greater risk leads to only one thing for sure: more risk. Any enhanced return, by contrast, may or may not be achieved. Fewer investors these days seem interested in the minutia of valuation metrics when adherence to reasonable valuation criteria has been such a drag on performance. David Knutson, head of credit research for the Americas at Schroders, demonstrated a sophisticated view when he recently noted that "this is the kind of market you almost want your manager to underperform."

Of course, consistent market gains are intoxicating; if a bull market could have a brain scan, we'd see all quadrants brightly lit up. With animal spirits perpetually aroused, both investors and insiders are also loath to sell, because they fear missing out on further upside. One paradox is that with very low interest rates and an historically elevated market multiple, the return expectations of investors seem to be going up, ignoring the mathematical tether that the higher the multiple you pay for stocks and the lower the bond yields you lock in, the lower your future returns are certain to be.

It is said that bull markets always climb a "wall of worry" as the cautious are left behind while the intrepid get ahead and the reckless lead the pack. But the opposite may also be true—bear markets must inevitably descend a mountain of overconfidence and hubris. With the risks to investors increasingly masked by this 12-year bull market, we are resolute in maintaining our balanced approach by finding ways to achieve good returns while limiting and protecting against downside risk.

It is especially important for investors to maintain their bearings in periods when others do not. To do so in even the most challenging moments, investors must have been prepared for adversity all along. By the time you realize you were overexposed to risk, the market price of what you own may have already plummeted, and by then it's too late to affordably arrange hedges or find mitigants. To prepare ourselves for the possibility of a market reversal and lower business valuations, we follow our usual playbook: Avoid the incurrence of recourse leverage, limit portfolio duration by holding investments with catalysts, focus intently on the downside in the evaluation of each individual investment, and actively manage a book of hedges. This combination of fundamental analysis conducted in fertile hunting grounds, within guardrails designed to avoid the financial distress of substantial drawdowns and the resulting psychological trauma, is intended to enhance the net worth of our clients over time. Having like-minded clients is a key element in the equation.

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Given the emphasis we place on mitigating risk in our investing approach, we should elaborate on what we mean by "risk." To us, it's the probability of losing money and the potential magnitude of any such loss. Many would define risk as volatility, the expected price sensitivity of what you own compared to the market's volatility. We don't see this as a risk (unless you're poorly positioned or leveraged and can't hang on amidst downdrafts). Instead, we see unwarranted downside fluctuations as a buying opportunity (and excessive upside spikes as a selling opportunity). Because it is a driver of opportunity creation, volatility should more properly be considered a value investor's best friend.

Our assessment of an investment's risk seeks to incorporate all the likely events and circumstances that could jeopardize our invested capital. Note that hedging investments against *every* eventuality, even those with a very low probability, is impossible and that attempting to do so would in most cases drain the investment of excess return. This is why we focus on building our hedge book when risks are underappreciated by others and the cost of hedges is not elevated. After all, it generally makes sense to insure your home against fire even though it probably won't burn down. No one reasonably laments having paid a modest insurance premium for a casualty that didn't occur. You don't hedge or insure to achieve gains, but rather to hang on to what you have.

We worry about risk for each individual holding but also, especially, for the portfolio as a whole. Primary risks we consider are those common to the business world, driven by the behavior of competitors and suppliers, the forces of technological disruption, and the abilities of corporate managements. Some risks are firm-specific, while others involve systematic risk—events that would impact the shares of most companies in the same direction at the same time. Such risks can emanate from actions by the Fed, tax rates, regulation, and government behavior, as well as from investors' overconfidence in the ability of policymakers to safely navigate through unexpected turbulence. We also try to incorporate risk assessments related to the physical world, such as those stemming from pandemics or climate change. At the portfolio level, we carefully assess our concentrations as well as the possible correlations between disparate holdings.

Risk is heightened when investors believe things that aren't demonstrably true—the idea that some banks are too big to fail, for example, or that housing prices may decline regionally but never nationally. Risk involves uncertainty and unpredictability, events that could happen but aren't certain to happen. Some of these can be imagined in advance and assessed in terms of probability. But others are bolts from the blue, things that have never happened before, the unknown unknowns; their likelihood is impossible to foresee, much less to assess. It is nonetheless prudent to position ourselves in a way that maintains a degree of downside protection no matter how the future surprises us.

Risk is also driven by investor psychology, both of others as it impacts markets, but also of one's own reactions to gains, losses, successes, and mistakes. Psychological forces such as greed and fear, overconfidence and loss of confidence, lie behind most of the extremes that happen in the market: bubbles, crashes, and financial panics.

With equity markets moving relentlessly higher in recent years, it's natural to wonder

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whether this may reflect that risk has somehow been lessened through events, circumstances, wiser macroeconomic policies, more skilled corporate executives, more advanced risk-management tools, or greater investor sophistication. While it may look like risk has faded, we believe this is a dangerous illusion. We maintain that risk is ever-present. Some risks can be hedged or effectively transferred from one investor to another, but they are generally not hedgeable for the entire community of investors. In our view, the greatest peril in the markets today lies in psychological risk. At the end of the day, you can't change human nature. Against a backdrop of relentless money printing, a very active Federal Reserve, and fiscal largesse, many investors have been lulled to sleep, unaware of and unfocused on risk. They are like the cat that didn't jump on the hot stove. Market participants with less than 12 years of experience have never been burned and have no idea how hot the stove can get. No investor under the age of 60 has lost money on a bond due to a general rise in interest rates; indeed, an entire generation has no direct familiarity with interest rate risk. With interest rates relentlessly suppressed by policymakers since 2009, it is genuinely difficult to think of an asset class at this time whose valuation is not elevated and whose recent market performance has not been sensational. Policies designed to aid individuals hurt by the pandemic have had the effect of insulating investors from economic loss by propping up business results at many firms. This has exacerbated moral hazard by masking the connection between real-world events and the value of their portfolios. And without relevant recent experience, standards become lax and investors drop their guard. Greater risk is willingly incurred and regularly misperceived, often without adequate compensation or any effort at mitigation.

As a result of today's euphoric market conditions, and in the absence of downside volatility, investors have become focused almost exclusively on the return they make *on* their capital rather than on the likelihood of a full return *of* their capital. Their eyes are turned upward, toward the probability of further market gains, not lowered, toward what could go wrong; optimistic scenarios, for both business results and valuation multiples, therefore get baked into the pricing of securities. Investors dabble in companies with very long-term business plans in the hope of generating short-term trading profits. The buying frenzy of the past 12 years has lured many market participants into speculative holdings that someday will seem like roach motels, easier to get into than get out of. If the past decade has taught investors one thing, it is that the government is predisposed to take action to support asset prices when the world surprises to the downside, and so they believe they effectively have a "put" to the government that makes speculation almost a sure thing. The threat of deflation has emboldened governments to be as stimulative as they want—including monetizing their own debt—with little apparent risk or cause for concern.

To date, these policies seem to have been a free lunch. But at some point, the bill will come due: There will be constraints on maintaining stimulative policies, such as those imposed by rising inflation, unstable foreign exchange markets, an elevated ratio of government debt to GDP, or fiscally hawkish politicians. At some future tipping point, governments may no longer be the masters of their own fate; the markets themselves will have taken charge. The "bond market vigilantes" of years past will regroup, gain new members, and once again be a powerful force. As we saw in the case of Greece in 2010, market complacency regarding extreme sovereign debt levels can turn to panic in an instant.

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At such a future moment, the market will certainly have trouble coming to terms with an environment in which the Fed is no longer bolstering asset prices but instead pursuing policies that could dampen them. A volatility drought, as economist Hyman Minsky is famous for noting, can serve as dangerous tinder for the next period of much higher volatility.

Amidst extreme selloffs, following this approach has helped us to stay on course and put capital to work at especially attractive valuations, often precisely when others are frozen or panicked. This is not easy. The father of value investing, Benjamin Graham himself, apparently got into financial trouble twice through the employment of leverage, and the brilliant, Nobel Prize–winning principals at Long-Term Capital Management failed to accurately assess the risks inherent in the highly leveraged strategy they employed. It only takes one moment of overconfidence, distraction, or sloppiness to undo a lifetime of painstaking compounding.

During the past 39 years, have we sometimes left potential profits on the table? Absolutely. Could we have earned higher returns in the past 12 years if we had incurred portfolio leverage, never held a nickel of cash, and avoided hedging costs? After the fact, the answer is obvious: yes. But history tells us that the low-market volatility and historically phenomenal investment returns of that period should be taken not as an all-clear signal, but as a red-flag warning. We can say with certainty that the high interest rate and depressed stock market conditions of the early 1980s fueled a 40-year-long period of exceptional stock and bond market returns. It seems highly improbable that today's super low interest rates and lofty market valuations would somehow also lead to a multi-decade period of equally strong investment performance.

We see today's market as characterized by stretched valuations, deep complacency, and a host of looming risks. But we also know how hard it is to make macro forecasts. While we have significant concerns, we can also make a case that the U.S. economy will remain strong for some time, since corporate, consumer, and financial institution balance sheets are healthy. Bonds at today's yields provide scant returns, so equities remain the only game in town. Corporate stock buybacks continue to be a major driver of demand for equities. And pockets of the equity and private markets remain attractively priced. Top-down, we are seriously concerned. But bottom-up, looking at our holdings investment by investment, we see an attractive upside as well as a reasonably protected downside.

Driving Toward Truth: A Perspective on Investment Process and Decision-Making

To make the best possible decisions in their jobs, investors must seek facts and truth in an intellectually honest and unbiased way. The entire enterprise of securities analysis is dedicated to this end. We continually ask, What are the prospects for a business? How capable is its management, and what are their priorities? What are the greatest risks to the success of the investment? Finding answers to these questions is essential. In pursuit of facts to assist in the formulation of an investment thesis, we gather enormous amounts of information. The value of a single new insight can be immense. We embark on this search knowing we will never have the full truth, a complete set of facts. But in investing, full and complete information is never attainable—businesses and markets are not only complicated but also endlessly evolving—so investors must be

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comfortable making decisions with only partial information amid varying degrees of uncertainty.

Baupost's investment process involves the never-ending gleaning of facts and their integration into our rigorous decision-making framework. When considering any investment, we gather all available information—including, increasingly, data streams made possible by new technologies. As the facts are collected, we analyze them and formulate opinions. In the fast-moving world of business, information quickly becomes stale, and then obsolete or even potentially misleading. As a result, we continually update our findings. There will be no final truth, only a consistent, energetic, and ever-evolving process of seeking it.

A sound investment process benefits from the scar tissue of past mistakes, a front-of-mind awareness of the very many things that can go wrong in any investment. It is also well-served by clear, unbiased thinking and intellectual consistency. Nobel Prize–winning economist Daniel Kahneman's latest book, *Noise: A Flaw in Human Judgment* (written with Olivier Sibony and Cass Sunstein), identifies two primary flaws in human judgment, two kinds of errors that people are prone to making. One involves bias, the other noise. While many of us like to think of ourselves as completely rational actors, Kahneman and others have shown that we are susceptible to a wide variety of biases in our decision-making. It's how people are wired. A good investor must be aware of this and actively struggle to overcome these innate tendencies.

In an investment context, bias refers to systematic errors, such as over-optimism. If one's analysis consistently projects returns higher than what is actually achieved, then there is optimistic bias. Theoretically, such bias could be corrected by regularly substituting more conservative assumptions. Conversely, if a member of an investment team were perennially more cautious than warranted, some of their tepid recommendations could be sized up.

In Kahneman's view, "noise" refers to the variability of decision-making. Ideally, with the same facts, you should follow a process that will reach the same conclusions every time. Many things can create noise in decision-making, Kahneman observes, from the inevitable swings in human emotion, such as greed and fear, to basic physical concerns, such as hunger and tiredness. The wiring we all have as humans can trip us up. Exuberance after a positive result, for example, can lead to over-confidence in making other decisions, and dismay after a mistake can lead to an unfortunate re-calibration or hunkering down, causing one to miss out on subsequent opportunity.

Throughout our history, Baupost has been focused on the necessity of avoiding noise in our own decision-making. Our investment process must be consistently and fairly applied. With the same facts, it is important to draw the same conclusion on Thursday as on Tuesday, in the late afternoon as well as in the early morning, in July as in January, whether we have been posting gains or losses, and whether the stock market is up or down. We aspire to build a firm where we would make more or less the same decision, no matter who is heading up a particular investment.

We reduce noise by creating favorable conditions for good investment processes to thrive in. First off, we aim to have a culture where every voice and every opinion is heard and respected, where people feel comfortable saying what they really think, where emotions are under control,

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and where the acknowledgment of mistakes is encouraged and valued. Ours is a culture not of brash risk-taking and swagger but of humility, caution, reflection, and calm. Another important element is the aforementioned imposition of guardrails and norms that help ensure that our investment decisions will be based on fundamental factors and not emotional responses.

To fight the bias and noise that could corrupt our decision-making, we attempt to find points of resemblance between investments under consideration and past successes or mistakes. Pattern recognition is short-hand, an oversimplification that must be stress-tested. And yes, past performance is no guarantee of future results. But carefully assessing case studies of prior investments may help to confirm or disprove impressions. Investors must retain the mental flexibility to react to new information and, as warranted, reject a current thesis for another, possibly very different, one.

Perhaps we can learn something about investing by examining what is happening in the larger societal context. In his extraordinary new book, *The Constitution of Knowledge*, Brookings scholar Jonathan Rauch explores the growing threats to truth plaguing our society. Misinformation, disinformation, conspiracy theories, and what has become a firehose of falsehoods on social media and elsewhere are making the truth harder and harder to ascertain. Amidst a proliferation of "alternative facts," as well as a widespread disbelief in science and disdain for expertise, the very fabric of society itself—a view of who we are, a consensus on our common knowledge, and a shared history of what came before—is being ripped apart.

Rauch offers a solution to these challenges. We must, he insists, develop a constitution of knowledge, a common view not just of the facts themselves but also of how knowledge is to be created or determined, as well as agreed-upon ways to update and revise that constitution. Like scientists and scholars, he stresses that method is what matters. And, of course, an interest in and acceptance of new ideas—the best ideas, regardless of authorship—is essential to finding the truth and making discoveries that advance society.

According to Rauch, we must strive to live under two crucial if somewhat counterintuitive rules. The first is that every fact and belief must be subject to ongoing scrutiny. Make a list of what you know about something, and by the time you finish, items on it may already have been replaced by updated ideas and more-current information. Personal agendas must be off the table; getting the facts straight in an effort to discern what is true must be the only consideration. Nothing is ever finally settled—the job is never done—because there is always more to learn, unknowns to know, fresh facts to uncover.

Asset management firms like Baupost are in the fact business, engaged in a perpetual search for the truth about their investments. This quest goes on even though full knowledge will always be unattainable. With public companies, for instance, while much disclosure is required, much about their operations and performance remains privileged information. Even the best-intentioned accounting principles can provide only a crude sketch of a company's actual business performance. We do everything we can to get closer to the truth, by building financial models, talking to experts, parsing Wall Street research, and endlessly debating our own assessments. Even

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so, we can never know as much as corporate insiders, who themselves do not have the full truth.

One implication of these principles is to avoid becoming emotionally attached to investments. Since people tend to see what they want to see or already believe, we may think we have stumbled upon a truth when, in reality, we are merely observing what we *want* to be true. It's crucial to remain open to changing your mind. The paradox is that investors must develop strong convictions, but hold them lightly.

At Baupost, we endeavor to keep our minds open by engaging in frequent and open debates about every investment by having a team that is diverse on the basis of background, lived experiences, and ideas; by identifying and following best practices for uncovering new facts and updating our conclusions; by generously sharing knowledge throughout the organization; by undertaking thorough postmortems to learn from both our mistakes and successes; and by trying to separate, as best as we can, the effects of skill from those of luck, so that investment success can be replicable.

In order for such debate to be productive, of course, there must be an environment and culture that enables it to thrive. It is crucial to maintain trust among team members, so that everyone feels comfortable modifying their conclusions and changing their recommendations as needed. By setting a good example and creating proper incentives and alignment, personal agendas can be eliminated and the firm's agenda promoted. To produce the collaboration that leads to better decision-making, teamwork must be encouraged and rewarded while selfish behavior is made culturally unacceptable. Recruiting and management efforts must be conducted with the goal of creating such a culture.

Rauch's second rule is that there can be no highest authority who determines facts or truth, no dictator or president who gets to decide what we all must accept as true. So, who gets to decide? We all do. It is up to all of us—the learning community—to posit ideas and then challenge and debate them. While there probably won't be complete agreement, we may well agree on many things, including what we do know, what remains unknown, and what we might do to fill in the gaps.

But in an investment firm, doesn't someone, in the end, need to decide? Yes, but decision-making authority should be accompanied by humility and the ability to listen closely to others in order to choose wisely. As depicted in Daniel James Brown's exceptional book *The Boys in the Boat*, an organization must strive to be better than the individuals who make up the group would be on their own. This is done by pursuing a worthwhile goal through a clear, consistently applied, and ever-improving process. If the portfolio manager of an investment firm just does what she or he wants, then she or he will be building, over time, a cohort of sycophants, which leads to a process that is ineffective and a firm that is far from optimizing the wisdom and perspective of its members. A better approach is a highly inclusive—and uncomfortably unsettled—one in which everyone's thoughts are welcome and necessary and yesterday's conclusions can be debated safely and potentially revised. That's why at Baupost, every idea, including mine, goes through the same meat grinder of process.

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Rauch is saying, in effect, that the crucial mistake many members of society are making today stems from a lack of intellectual curiosity, a self-destructive eagerness to mock facts and expertise, an unwillingness to question and update their beliefs based on evidence, and a fundamental disinterest in learning from the broader community of thinkers.

Imagine for a moment an investment approach based on Rauch's worst nightmare: belief systems built on misinformation and tribalism. It may seem ridiculous to invest while ignoring or even denying facts, but this is what many market participants do. Consider meme stocks, which rise and fall as a result of speculative impulses and magical thinking that takes place in spite of rather than after full consideration of investment fundamentals.

Finally, it's crucial to recognize that the stock market is neither reality nor truth. It is a reflection of the collective herd's best assessment at any given moment, with a healthy dose of irrationality and emotion mixed in, that is buffeted, in the short term, by the forces of supply and demand. For example, Tesla's share price suggests that it is currently the sixth most valuable company in the world despite a nearly profitless history, but that judgment is necessarily ephemeral. Investors must keep in mind that the market's verdict is never final, but merely a perception at a single moment in time.

The truth about a business can be masked almost indefinitely by stock prices that depart from reality. Our friend and former colleague David Abrams, head of Abrams Capital, refers to this as the "Great Illusion" of the stock market. For a time, any stock can trade at any price. In the short term, as Benjamin Graham famously pointed out, the market is a "voting machine," setting a price at the immediate intersection of supply and demand curves for a company's shares. This creates opportunity for discerning and patient investors. Only in the long run does the market become a "weighing machine," providing an assessment that inexorably comes to more accurately measure the true underlying value. Although stock prices may seem as if they can remain irrational indefinitely, real-life corporate developments often serve as a forcing mechanism. Consider what happens when a company offers to sell more shares to the public, buys back its own shares, is (or isn't) able to achieve a rescue financing to save it from a cash shortfall, sells an asset at a favorable price, or receives a takeover offer. At such junctures, the opinion of the stock market is no longer relevant; what matters then is the ultimate reality of business valuation and cash flows that are being more directly delivered to shareholders.

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As always, please let us know if you have any questions or comments. We wish each of you a prosperous, and healthy, 2022!

Very truly yours,

Seth A. Klarman
CEO and Portfolio Manager

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