

Civilization is hideously fragile . . . there's not much between us and the horrors underneath, just about a coat of varnish."

- Charles Percy Snow, British Novelist and Chemist

"All models are wrong, but some are useful."

- George E.P. Box, British Statistician

"To be absolutely certain about something, one must know everything or nothing about it."

-Henry Kissinger, Former U.S. Secretary of State

"But who shall dare to measure loss and gain in this wise? Defeat may be victory in disguise; The lowest ebb is the turn of the tide."

- "Loss and Gain," Henry Wadsworth Longfellow, American Poet

Dear Limited Partner,

The Baupost partnerships returned between roughly breakeven and a decline of less than one percent for the year ended December 31. A detailed report on our investment returns will be available on our website in early February together with a number of charts and tables displaying the largest individual position gains and losses, as well as year-end allocations to various asset classes and our 10 largest positions at December 31.

As we do every January, we offer this report to share our perspectives on the year just ended, including our observations on markets and on a range of economic, political, and societal developments that may impact investors and their capital. We also offer some thoughts about investor behavior and provide an update on the Baupost team.

This year's letter has been particularly challenging to write, because so much kept changing near the end of the year as we were putting our thoughts together. In 2016, we told you that year had been a tale of two markets, declines followed suddenly by gains. This year has likewise been such a tale, though in this case it was gains followed by an abrupt reversal. 2018 is a stark reminder that on Wall Street anything can happen, as investment profits were negated in a punishing final month.

While it is painful to have a reasonably successful year reversed in its last weeks, there are three bright spots that auger well for 2019 and beyond. First, we successfully protected capital in a very treacherous environment. Our event-driven holdings performed well, while our uncatalyzed public equities fluctuated more in line with the market. Our private investments posted a positive return, as did our hedging portfolio.

Second, our team generally performed excellent fundamental analysis all year. During the worst moments of the fourth-quarter market carnage, we were entering buy orders and our bids were getting hit. We were adding to positions which had become cheaper, and moving into attractively priced new investments. We are particularly energized to be making new investments when other investors have pulled back, competition is subdued, and prices are in near free-fall. As this was unfolding, we also reduced several positions that seemed less attractive than other opportunities that were emerging, and we redeployed those funds. And we were preparing the groundwork to be ready for situations that seemed like they could become dislocated in the future.

Third, we believe the year-end valuation of our portfolio is extremely attractive. At the end of December, many of our public equity holdings were trading at high single-digit or very low double-digit forward earnings multiples, an attractive level for companies generally expected to significantly increase their earnings and cash flows well into the future. Other holdings offer attractive returns to catalyzing events if they transpire as expected; these include announced mergers and restructurings that are progressing well and could result

in relatively near-term monetizations. A number of our larger private (mostly real estate) holdings are also nearing fruition, where they may be partially or fully monetized through sales or refinancings.

Needless to say, we also made mistakes in 2018. For example, our original thesis on Colony Capital, a three-way merger of real estate and investment firms, was just plain wrong, though that stock, which we continue to hold, at year-end traded at more than a 9% dividend yield and at a considerable discount to NAV. We purchased a few stocks, including Pacific Gas and Electric and Univar, right before those shares slumped badly, in the first case on tragic developments that led to financial distress and in the second on cyclical fears that we believe ignore business fundamentals. We remain holders of both.

Last year once again demonstrated that markets can be confoundingly fickle. Well-known conditions and widely anticipated events, such as Federal Reserve rate hikes, ongoing trade disputes, and the unsettling behavior of an erratic president, were shrugged off by the financial markets one day and driving markets down the next. Is there a cumulative impact, where no one thing matters until the collective weight of them starts to? Is the market simply myopic, whereby it ignores signs of trouble until they become more immediate and it can ignore them no longer? It's always hard to know why the market does what it does. That's part of the ever-interesting challenge we face in traversing the twists and turns of fluctuating prices and evolving fundamentals. On any given day, the sheer number of players, behaviors, economic factors, and business developments defy anyone's ability to fully grasp what is going on and why. That's why we develop and follow a game plan that does not purport to tell us what to do moment by moment, but rather is intended to help us successfully navigate the most challenging tumult. This is the essence of value investing.

At periods of maximum turbulence, stock and bond markets come to resemble commodities markets. Capital whips into stocks and out of bonds, or vice versa, as pension funds, mutual funds, hedge funds, algorithmic traders, and asset allocators rebalance their holdings. Our perpetual challenge in such markets is to rely on our acumen and analytical capabilities, while keeping our emotions under control and maintaining a long-term perspective.

2018 in Review

The major U.S. stock market indices steadily gained ground for the first three quarters of 2018, before plunging in a highly volatile fourth quarter. Early in the year, those who had bet that the market would remain on a steady uptrend were briefly caught flat-footed when volatility surged higher. The most jarring example was the near complete wipeout and sudden liquidation in February of the exchange-traded note XIV, a retail product used by many traders to short volatility. (The name XIV is the reverse of VIX, the common measure of market volatility.) Since its inception in late 2010, this instrument had appreciated 14-fold into early 2018, and then it was shockingly wound down within a month after it had lost 95% of its value. By mid-April, however, volatility abated and the stock market resumed its seemingly habitual march higher.

Generally rising share prices over the ensuing months more or less moved in tandem with higher corporate earnings, the result of massive fiscal stimulus, large corporate tax cuts, and historically low – albeit generally rising – interest rates. Cash continued to move into indexing strategies and out of the hands of active managers, with U.S. index fund holdings, after doubling from 2002 to 2009, nearly doubling again by 2018 (with important ramifications for market liquidity and corporate governance). Market pundits calculated that valuation multiples, with earnings assessed on a cyclically-adjusted basis, had reached the second-highest level ever (though reported earnings were more in line with historical averages). The economic expansion, clocking in at nine-and-a-half years, neared the longest on record. As usual in a bull market, the warm feelings generated by rising prices had the effect of overcoming any sense of looming danger in the hearts and minds of most investors. And as in all bull markets, skeptics lost both credibility and assets to manage. Many investors had evidently adopted the usual dubious emergency plan: Get out when the market starts to fall. In August, the bull market became the longest on record – at nearly 3,500 days and counting. It felt like forever.

But in October, it was as though a trapdoor had opened under global equity markets. Widespread optimism instantly yielded to abject pessimism. Concerns arose that the Fed was increasing interest rates faster than conditions warranted, leading to growing fears of a U.S. economic slowdown or even downturn. Worries mounted as trade tensions with China escalated. As a result, stocks plunged indiscriminately – on some days, resembling a post-Thanksgiving sale with storewide markdowns. We did what we usually do amidst market turmoil, which is to re-check our analysis, prioritize our opportunities, and buy.

In the fourth quarter, the market increasingly looked like what our retired Partner Brian Spector once referred to as a “tide market.” When the tide goes out, it takes everything with it, and an investor must adjust in real time to the rapidly changing prices while considering the possibility of a deterioration in fundamentals. Sometimes, prices decline unrelated to those fundamentals. But at other times, they are anticipatory of fundamental erosion and can even be reflexively linked: lower share prices can adversely impact the economy in a sort of “reverse wealth effect;” investors feel poorer when the value of their portfolio falls, so they consume less. In addition, corporate management may view the share price decline as a potential increase in their cost of equity capital, causing them to delay capital expenditures or expansion plans, again reflexively weakening the broader economy. Yet as the market sold off this fall, there were mixed indicators as to whether the U.S. economy was actually cooling. “Hard data,” such as holiday retail sales (November 1 – December 24), posted a very healthy 5% increase over the year before, even as “soft” survey and sentiment data such as consumer confidence fell from the October highs.

Waves of selling swamped equity markets in the fourth quarter, as volatility surged. While in 2017 the U.S. equity market did not experience a single daily fluctuation up or down of as much as 3%, in 2018 there were 15 such days, 10 in the fourth quarter alone. The Wall Street Journal reported that by mid-November a record share of all investible assets – 90% – had posted losses on a year-to-date basis, as stock, bonds, and commodities all retreated. As news emerged of Iran sanction waivers, U.S. oil prices abruptly plunged 27% in six weeks (from \$76 per barrel to less than \$56 per barrel), with that commodity at one point declining a record 12 consecutive sessions in a row. The equity market plunge accelerated in December, resulting in the worst final month for the major indices since 1931. (At one point the S&P 500 had fallen 15% for the month alone.) Overall, the S&P 500 declined 4% on the year (inclusive of reinvested dividends). The NASDAQ officially entered bear market territory, down over 20% from the highs, while the S&P 500 and Dow came ever so close to bear market status before rallying. The small cap Russell 2000 index ended the year down 11%, after falling more than 20% from its August 31 record high. As equities plunged, U.S. government bonds rallied significantly, with the yield on the U.S. 10-year note declining from 3.24% on November 8 to 2.68% on December 31.

Equity market weakness extended well beyond the U.S. in 2018. The major European indices posted declines ranging from 8% to 18%. Equities in Korea, Mexico, China, and Turkey all posted 2018 losses of 15% or more in local currency terms. Cryptocurrencies quietly but definitively completed their year-long collapse, with Bitcoin ending 2018 down more than 70%. Low-yielding cash was one of the few asset classes that gained ground in 2018. The challenging conditions and sudden carnage took a toll on Wall Street. No one was immune: mutual funds, hedge funds, and quant funds all suffered, and several prominent investment firms made the decision to shut their doors in the fourth quarter after decades in business.

For the first time in years, technology behemoths – the so-called FAANG stocks – came under a cloud and their share prices experienced significant declines. Apple’s smartphone sales fell short of the level expected by investors, and its shares fell 38% from their highs. Large segments of the mobile phone supply chain dropped sharply on fears of slumping demand and trade tensions. Meanwhile, Facebook stock slumped as the company disclosed that it would have to spend substantial amounts to address mounting privacy concerns, costing the company significant credibility with investors as well as legislators. Amazon and Netflix shares ended the year down 26% and 36%, respectively, from their highs set earlier in 2018.

The most over-extended asset class in 2018 may well have been private equity. With public equity markets expensive and yield still scarce, many investors have lately concluded that private equity is the one place where double-digit returns may be achievable. Private equity fundraising has set records, with estimates of more than a trillion dollars in capital available to be put to work. The multiples of leverage extended in private equity transactions is approaching previous peaks, as are valuations of such transactions, while the laxity of financing terms is unprecedented. Private equity investors have had the wind at their backs for a decade, the result of a steadily growing economy and sustained low interest rates, conditions that will almost certainly not prevail forever.

In 2018, the Federal Reserve raised interest rates four times as it sought to get to the “neutral rate,” but late in the year it signaled it would slow the pace of rate hikes in 2019. The Fed continued the process of reducing its bloated \$4.5 trillion balance sheet. In Europe, interest rates remain at historically low levels, with over \$4.7 trillion of sovereigns still offering negative rates as of year-end, but the European Central Bank announced the completion of its almost four-year long program of net asset purchases in December. Even though everyone knew it was coming, the end of low rate policies and planned reduction of central bank balance sheets is far from a riskless endeavor, since these policies are unprecedented in scale, and

such an unwind has never before been attempted. There should be concern about symmetry: If lowering interest rates coupled with central bank asset purchases stimulated economic expansion and a bull market in stocks and bonds, will raising rates drive a reversal? If the market's reaction to the Fed's December rate hike is any indication, the path to normalization of interest rates and of central bank balance sheets is going to be rocky indeed.

There are also concerns that the lengthy 36-year bond bull market is nearing its end. At one point last year, rates on U.S. Treasury 10-year bonds had more than doubled from their 2016 lows. Given the length of the bond buying spree, many of today's market participants have never experienced a bear market in bonds. The riskiness of their exposures may surprise them. And because marketplace conditions have evolved greatly over the last three decades, when we do eventually enter a fixed income bear market, neither historical correlations nor prior experience are likely to provide much guidance for how to successfully navigate this treacherous terrain.

Driven by such a protracted period of near-zero interest rates, investors have stampeded into anything – bonds, loans, REITs – offering a current return, leading to a degradation in the quality of outstanding credit. The proportion of U.S. non-financial corporate investment grade bonds rated BBB – the lowest investment grade rating – has increased to 58% today compared to 48% in 2011, even as the total investment grade market has increased from roughly \$2.2 trillion in 2007 to \$3.8 trillion today. The proportion of total non-investment grade issuance rated B- or below is nearly 25% of the overall high yield market. And high yield plus BBB-rated bonds comprise 68% of the total U.S. corporate bond universe.

The leveraged loan market, a critical funding source for lower quality issuers, has been on fire, with a record \$788 billion of leveraged loans issued globally in 2017, and just below that pace of issuance in 2018. Almost 80% of the 2018 vintage was issued as “covenant-lite” – compared to about 30% in 2007. Record annual volumes of low grade bond issuance – including a 130% increase in the U.S. CLO market since 2008 – has surely created a vast future supply of distressed debt, but any calamity has seemed off in the distance. By year-end, however, it appeared to draw closer. Bank trading desks have pulled back from risk-taking, resulting in lower liquidity for bondholders and the possibility of greater price volatility. Late in the year, corporate credit spreads started to widen. The credit markets were hard hit in November, with yields on U.S. corporate debt reaching an 8 1/2-year high of 4.38%. Yields on the debt of fallen icon GE at one point hit 6.4%, from under 3% earlier in the year.

By the end of the year, cracks had also started to appear in the leveraged loan market, and investors pulled a record \$3.3 billion out of U.S. loan funds in one week in mid-December. Junk bond fund outflows also set a record in 2018. Higher interest rates will significantly burden today's highly leveraged issuers, and the challenges will be made more severe when the next economic downturn hits.

Because it is always easier for politicians to borrow rather than pursue a responsible fiscal course, there is a propensity for sovereign debts to grow over time, not only in absolute terms, but also as a percentage of GDP. Since the 2008 financial crisis, aggregate global sovereign debt has nearly doubled, and most major sovereign debtors have experienced a significant increase in their debt-to-GDP ratios. In the U.S., this ratio actually had declined for many years after wartime spending started to wind down in 1945, but then it began ramping up significantly between 1980 and today. The ratio of U.S. government debt to GDP, for example, has grown from over 74% of GDP in 2008 to 105% in 2017. For the U.K., the ratio has surged from 50% to 88%. For France, 69% to 98%. For Italy, from 102% to 132%. For Spain, from 39% to 98%. Canada has gone from 68% to 90%. China from 27% to 47%. The seeds of the next major financial crisis (or the one after that) may well be found in today's sovereign debt levels.

In 2018, the U.S. budget deficit soared to nearly \$900 billion and could top one trillion dollars in 2019, a sorry consequence of the 2017 tax cuts that were funded with borrowed money. Growing deficits have ballooned the national debt, which by year-end hit a record \$21.9 trillion (with potentially multiples of that in off-the-books entitlement promises), this while debt costs are suppressed by low interest rate policies. Approving massive tax cuts and generating the resultant huge deficits so late in the economic cycle while unemployment is so low seems particularly irresponsible, as there is little room for new fiscal stimulus if and when the economy softens. While the U.S. dollar maintains its de facto reserve currency status, this is a privilege (“America's exorbitant privilege,” it was once called) never to be taken for granted. The nation's fiscal irresponsibility jeopardizes this status, which has allowed Americans to live beyond our means for a

long time without paying any price. There is no way to know how much debt is too much, but America will inevitably reach an inflection point whereupon a suddenly more skeptical debt market will refuse to continue to lend to us at rates we can afford. By the time such a crisis hits, it will likely be too late to get our house in order.

Moreover, we have been increasingly worried that the U.S. financial markets are very highly leveraged not only with copious direct borrowings but also in less obvious ways – psychologically, algorithmically, and structurally – with investors vulnerable to exactly the same sort of urgent pressures that actual portfolio leverage can give rise to. As with a margin call, those pressures can include an intensely short-term orientation, extreme loss resistance, and an inability to stand apart from a panicky crowd.

One factor propelling psychological leverage higher in recent years has been the relentless diminution of market volatility. Economist Hyman Minsky famously put forward the idea that stability itself could be destabilizing. Individuals, professional investors, and financiers are prone to project their own recent experiences into the future. So when adversity is absent, investors become complacent. They assume good times will continue and they grow careless about risk, perceiving it through rose colored lenses. When incurring greater risk starts to seem not only riskless but beneficial, they stretch even further. (We saw glimpses in February and December of how quickly and violently this can reverse.)

As for algorithmic leverage, a growing amount of capital is today managed using model-based technologies to pick investments, many of which attempt to improve over time using artificial intelligence capabilities. (The Wall Street Journal recently estimated that 85% of all stock trading is now controlled by machines, models, or passive investing formulas.) The amount of capital invested in this way has grown massively since the last bear market, and no one can know how the various trading algorithms might respond to (or potentially even trigger) the next major selloff, especially after virtually an entire decade with low volatility. We simply cannot know how those algorithms might respond to new and unexpected conditions.

Meanwhile, many stocks have become less liquid and ownership has become more concentrated; we have previously noted that index funds hold a growing fraction of their shares. Because of limited liquidity and the potential absence of index buyers or even advent of index sellers, a bear market could have a surprisingly severe impact on small cap companies, something we started to see more frequently in the fourth quarter. As for shares not incorporated in major indices or held by ETFs, some days they seem lucky to catch any bid at all.

Today's markets feel strange and enigmatic. We will not complain about this; indeed, we see it as an opportunity. While the indices remain historically expensive, many stocks – of growing, not cyclical or declining firms – recently hit 52-week lows and trade at single-digit P/Es. These are levels that traditionally occur closer to market bottoms than tops. The recent selloff likely presented a buying opportunity – you can go years without seeing such valuations – but not across the board and not one for the faint of heart.

Rising Global Uncertainty

As 2018 progressed, storm clouds started to gather over the global economy. While the year began with IMF proclamations of “synchronized global growth,” by the end of the year that institution was downgrading its 2018 and 2019 GDP forecasts and warning of challenges

ahead. In retrospect, 2018 may be more appropriately categorized as a year of synchronized global disappointment. While some of the weaker emerging markets were the first to stumble (e.g., Argentina and Turkey), others soon followed. Japan's economy, after eight consecutive quarters of growth (their lengthiest expansion in 28 years), contracted in the first quarter and again in the third. Europe experienced its slowest growth in over four years, with even Germany cooling. China continues to be a cause of concern, with investors focusing on the numerous deteriorating data points while trying to decipher the meaning of Communist Party pronouncements. Time will tell if the U.S. economy, which has managed to stay strong thus far despite the turmoil abroad, can remain decoupled. One thing does seem certain – the world is entering 2019 with more economic question marks than were present a year earlier.

For the first three quarters of 2018, the markets more or less shrugged off a steady barrage of troubling

economic and political developments, including escalating White House- driven trade feuds with, first Mexico and Canada, and then China, leading to the mutual imposition of higher tariffs. Turkey was forced to substantially devalue their currency as a result of twin deficits (trade and government) that led to an overheated economy. Argentina also devalued, the result of a widespread drought that impacted agricultural production, which triggered stagflation and a decline in dollar reserves. The U.K. continued to stumble toward some form of Brexit. Prime Minister Theresa May's attempt to negotiate Britain's withdrawal from the Eurozone has proved to be extremely challenging, and perhaps even fatal for her politically, while many investors are holding back from commitments to the U.K. until the details are sorted out. In Italy, a coalition government of the Northern League and Five Star took power and promised tax cuts and an exit from the Eurozone, as well as a hardline anti-immigrant policy. While they have since moderated their language, the risk is heightened that Italy could soon face even deeper political and fiscal challenges.

As the post-World War II international order continued to erode, the markets ignored the longer-term implications of a more isolated America, a world increasingly adrift, and global leadership up for grabs. The post-war order relied on philosophical alignment among democratic societies, investment in international institutions, and effective diplomacy to manage competing interests across nations. American hegemony played a key role in supporting this order and the unprecedented peace and prosperity that had generally prevailed since 1945. Recently, foreign affairs pundit Walter Russell Mead wryly observed that the old system was neither liberal nor international nor an order, yet he added that its absence will surely be felt if it disintegrates.

With the U.S. seemingly preoccupied by a desire to withdraw from its long-prized role as a champion of liberty and democracy across the globe, 2018 proved to be a banner year for strongmen. Vladimir Putin maintained his firm grip on power in Russia while suffering no real consequences for interfering in elections in the U.S. and elsewhere, nor for his alleged involvement in the attempted murder of expatriate Russians on British soil, or for his ongoing military encroachments in Crimea and Ukraine. Recep Tayyip Erdoğan, Viktor Orbán, and Rodrigo Duterte maintained their respective tight holds over Turkey, Hungary, and the Philippines, while constricting the freedoms allowed to their citizens. The far-right candidate, Jair Bolsonaro, won Brazil's presidential election in October. Venezuela closed in on failed- state status.

Tensions with North Korea moderated over the course of 2018 as President Trump expressed his affection for North Korean leader Kim Jong-un, although actual progress toward de-nuclearization of the Korean peninsula seems stalled, and potentially illusory. In March, China's Central Committee eliminated term limits on China's 65 year-old leader Xi Jinping, who could now head the country with the world's largest population and second largest economy through the end of his life.

In October, Saudi Crown Prince Mohammed bin Salman allegedly ordered the killing and dismemberment of American resident and Washington Post Columnist Jamal Khashoggi at the Saudi consulate in Istanbul, leading to the imposition of sanctions on those directly involved but not on the Crown Prince. Meanwhile, in mid-December, after a phone call with Turkey's Erdoğan, President Trump tweeted the news that U.S. troops would be leaving Syria, a development that appeared to shock the Pentagon as well as Congressional leaders on both sides of the aisle. Among world leaders, only Erdoğan and Putin (and presumably Bashar al-Assad) applauded. Days later, highly respected Secretary of Defense Jim Mattis, one of the last remaining "adults in the room" in the President's cabinet, announced his retirement in a letter that cited sharp differences of policy and principle with the President.

Social frictions remain a challenge for democracies around the world, and we wonder when investors might take more notice of this. The recent "yellow vest" marches in France, which subsequently spread to Belgium, Holland, and Canada, began as a petition against fuel tax hikes, and grew through social media into a mass protest movement led by suburban commuters, small business owners, and truck drivers. The demonstrations, which appear to have broken out spontaneously throughout the country, became widespread and even violent. While the French government is clearly concerned – in December, it reversed the planned tax increases while announcing a higher minimum wage – the financial markets have taken the unrest largely in stride, as the French 10-year note at year-end yielded a meager 70 basis points.

In the U.S., meanwhile, investors truly have no idea how to react to the steady dose of presidential tweets seasoned with presidential pique. America's body politic remained inflamed in 2018. The President regularly stirred up his base with campaign-style rallies in which he endlessly warned, without evidence, of rampant

voter fraud while stoking fears over the looming arrival of a caravan of Central American refugees. Claiming, also without evidence, that criminals and possible terrorists made up a significant component of this caravan, Trump sent troops to reinforce the border. Yet in the days and weeks following the midterm elections, the caravan disappeared entirely from his rhetoric, its purpose apparently served. Immigration remains a hot button issue, and whether or not to “build the wall” was the proximate issue in the prolonged partial government shutdown that started in late December.

The November midterm elections became, in many ways, a referendum on the President. The result, with record turnout, was that blue states got bluer and red states even redder, as Republicans tightened their grip on the Senate while Democrats rolled to a net gain of 40 House seats and control of that body, winning by the largest midterm popular vote margin in history. Democrats did particularly well among women, minority groups, and suburbanites, groups which have largely found Trump’s policies and tone distasteful. In December, a bipartisan group of 44 former Senators signed an editorial begging today’s Senate to put country ahead of party. Yet the vast majority of Senate Republicans continued to stand resolutely by the President, despite mounting indications that special counsel Robert Mueller and other investigators are delivering not only a growing number of indictments and guilty pleas but are also uncovering damaging information regarding Donald Trump’s Presidential campaign and business interests. The chaos and consequent uncertainty emanating from Washington D.C. will likely only intensify as we approach the 2020 election.

The bottom line is that leadership matters. The growing turmoil in Washington and other world capitals is taking a toll on the country. As The New York Times columnist Bret Stephens recently observed, “the problem with Trump isn’t that he’s an empty vessel. It’s that he’s a malignant one.” Amid all this turmoil, should investors simply hunker down and keep their focus on markets? That might be a challenge. By way of illustration, on December 18, on the FedEx earnings call, CEO Frederick Smith noted that “most of the issues that we’re dealing with today are induced by bad political choices, I mean, making a bad decision about a new tax, creating a tremendously difficult situation with Brexit, the immigration crisis in Germany, the mercantilism and state-owned enterprise initiatives in China, the tariffs that the United States put in unilaterally. So you just go down the list, and they’re all things that have created macroeconomic slowdowns.”

America Entering 2019: Why We Are So Divided, and Why It Should Matter to Investors

These days, Americans do not seem to agree on much of anything. Some of it is today’s politics: “Deep state” or dedicated civil servants? “Witch hunt” or legitimate investigation into crimes? “Fake news” or free press? “Alternative facts” or facts? Accomplished adversary or “lock her up?” And some of it goes beyond politics into the realms of scientific inquiry and American values. Climate change or “climate hoax?” Refugees seeking sanctuary or “caravan of foreign invaders?”

Does this matter? We think it does. It’s hard for our leaders to guide us when we don’t agree on our values or even on how we decide what is true. Worse, our enemies, including but not limited to Russia’s autocratic government, are using social media and internet postings to confuse us and divide us further. They know which hot buttons to push. Moreover, our willful disbelief of facts, truth, and science increases the chance that we will fail to recognize or take seriously growing threats. In 1993, Senator Daniel Patrick Moynihan, who famously said that “everyone is entitled to his own opinion, but not to his own facts,” observed that America was “defining deviancy down.” His point was that behavior that had once been seen as deviant was now considered acceptable. To paraphrase Moynihan, today we may instead be defining reality down.

This post-truth moment is quite dangerous. Imagine an incident that threatens national security. Will Americans see eye-to-eye on the seriousness of the threat? If our leaders are truth-challenged, will Americans believe the official explanation of the threat and the wisdom of the proposed response? Should they?

Jonathan Rauch, an American journalist and author, has written about a Constitution of Knowledge, an objective reality of facts and truth that he believes is now under attack from President Donald Trump. The Washington Post reports a troubling escalation in the rate of Presidential lies, from an average of around six per day in 2017 to 15 per day in 2018. Former C.I.A. Director Michael Hayden recently observed that “We

have in the past argued over the values to be applied to objective reality ... but never the existence or relevance of objective reality itself.” Nebraska Senator Ben Sasse notes, “we have a risk of getting to a place where we don’t have shared public facts. A republic will not work if we don’t have shared facts.”

Alarming, technology does not necessarily contribute to the expansion of shared facts; it can actually assist in undermining them. For example, the technology now exists to create fake audio of our public figures, whereby you hear them saying in their own voices things that they never actually said. Imagine the havoc this could create in the wrong hands with a credulous public. Worse still, the technology to alter video is now upon us. You may soon watch a video of something that didn’t actually happen – such as a foreign threat or even an attack on our country – but your eyes and brain will tell you it is true. And, of course, these days you don’t need a sophisticated team of scientists to Photoshop a picture. The ramifications could be nothing short of a stolen election – or a war.

We are divided in so many ways. The American dream is well-known: that hard work leads to success, that our children shall do better economically than we have, and our children’s children better still. This dream has been a reality for many (but by no means all), over the first two centuries of the republic. Unfortunately, it is a dream that a diminishing number of Americans believe will come true for their families, and for good reason.

Americans have long seen our country as the land of opportunity. Wondrous things have been accomplished here: The U.S. is a democratic republic that has endured for more than two centuries, a country that reversed a legacy of slavery and healed after a Civil War, an upstart country that defeated global powers to secure democracy for Europe, an economic engine that has relentlessly driven growth, innovation, entrepreneurship, and advanced technology to improve the quality of life for its citizens and others around the world. Uniquely, people from everywhere in the world can relocate here and become Americans. And the energy and striving of immigrants has helped America grow and remain vibrant. I’m forever thankful that my father got on a boat and came here from Poland when he was 12. Like so many immigrants, he quickly adjusted to his new circumstances, making the most of them while never looking back. But lately, immigration has become one of the most divisive issues we face.

Social and economic advancement in America today seems increasingly dependent on demography and geography. The economic advantages enjoyed by college graduates continues to grow. Unsurprisingly, income growth in most major metropolitan areas surpasses gains in rural areas of the country. Economic inequality continued to worsen in 2018, and for many, real wages have not increased in decades. It seems clear that economic anxiety contributed to the election of Donald Trump in 2016.

The divide between Americans has been exacerbated by the echo chambers of modern-day media and the internet. Many have written of how, in only about four decades, an America of three broadcast networks has become an America of hundreds of cable channels. A few decades ago, we had less connectivity but more connection. David Brooks and others write regularly about the challenges of increased loneliness and isolation. A person today can have a thousand Facebook friends – and few, if any, actual friends.

I grew up with three television channels, the Baltimore Sun newspaper (which I delivered six days a week), and the World Book Encyclopedia. The facts I digested were everyone’s facts. My news was everyone’s news. The editors of these media outlets were well-informed and pretty much down-the-middle curators who believed their job was to bring balanced perspective to what their readers or viewers should know. They knew that, even if perfect objectivity was unattainable, the constant pursuit of it, armed with humility and intellectual honesty, was the best antidote to ignorance and demagoguery. The Fairness Doctrine, until it was overturned in 1987, actually required television and radio broadcasters to present contrasting viewpoints on controversial issues of public importance. The network news anchors were among America’s most trusted figures – Walter Cronkite, Chet Huntley, and David Brinkley. But today, this commonality is lost. My news and your news may have nothing in common, and each of us must work hard if we are to experience a diversity of viewpoints and perspectives. As social psychologist Jonathan Haidt and his co-author, Greg Lukianoff, president of the Foundation for Individual Rights in Education, observed in “The Coddling of the American Mind,” “both the physical and the electronic isolation from people we disagree with allow the forces of confirmation bias, groupthink, and tribalism to push us still further apart.”

This is very unfortunate, because, as Haidt argued in his earlier book, “The Happiness Hypothesis,” “A good

place to look for wisdom...is where you least expect to find it: in the minds of your opponents. You already know the ideas common on your own side. If you can take off the blinders...you might see some good ideas for the first time." To perfect our own thoughts and ideas, we need to chew on and debate the ideas of others, even and especially of those with whom we disagree. Yet, it seems more and more people are choosing to only seek out information from those who share their views, and technology and social media have made it increasingly easy to do so.

Virtually all of the human knowledge accumulated since the beginning of time is available instantly on our iPhones. As a society, we have never known more. But some of us choose to know less. We avoid facts and instead consume partisan media content that is largely focused on demonizing supposed adversaries. We have become increasingly tribal, choosing sides and selectively processing only the information that fits with our team's narrative. Deliberate ignorance and denial of facts and truth are disturbing phenomena, not likely to lead to good decision-making or thoughtful voting choices.

Even science is losing ground in this era. In his commencement address at Caltech in 2016, surgeon, writer, and public health scholar Atul Gawande observed that science was being left behind by increasingly popular anti-scientific beliefs. "From 1974 to 2010, despite increasing education levels, the public's trust in the scientific community has been decreasing." This is tragic, he argues, because "having a scientific understanding of the world is fundamentally about how you judge which information to trust."

By 2018, a growing number of Americans had become concerned about potential erosion in American democracy, a concern for which there is ample evidence. Whereas 71% of those born in the 1930s believed it was important to live in a democracy, only 29% of those born in the 1980s share the same belief. About 40% of eligible voters in the U.S. failed to cast a ballot in the 2016 elections, and tens of millions of Americans are not even registered. Because of increased gerrymandering and the influence of big money in politics, many Americans have come to feel that their votes do not matter. Moreover, as a result of the tendency of primary elections to pull parties to the political extremes, many feel that the candidates in the general elections do not reflect their own views. Yet because of the perceived threat of being "primaried," incumbents are today less willing to reach across the aisle. It's almost as though we are living in two countries - there are the battleground states, where the presidential candidates show up and the ads run non-stop. And there are the gerrymandered districts, where elections are effectively over before they begin.

American democracy operates not just from a system of rules but also norms. Norms have provided historically valuable guardrails for proper behavior that protect the integrity of the system from possible misdeeds by the people in it. The critical importance of norms is easily dismissed, especially by those willing to pursue power and self-interest ahead of all other considerations. But norms reflect a core cultural aspiration of fairness, civility, and community that is more socially powerful, and broader in reach, than any statute or regulation. There can be a certain reckless power in violating norms, since the sanctions for doing so are neither immediate nor obvious. But the consequence is a dangerous erosion of our greatest bonds of community.

Rachel Kleinfeld, senior fellow in the Democracy, Conflict, and Governance Program at the Carnegie Endowment for International Peace, sees the breakdown of democratic norms in post-election developments. She notes, "Democracy requires citizens' votes to be counted fairly, and those votes must determine who wields power ... in Wisconsin, the Republican legislature has stripped the incoming Democratic governor of capabilities that voters assumed their leader would have when they voted." For the great majority of American history, Supreme Court nominees needed 60 votes in the Senate for confirmation; otherwise, a filibuster could hold up a nomination indefinitely. But in 2017, the Republicans exercised the "nuclear option," changing the required vote to a simple majority. This eliminated the need for the President to identify mutually agreeable centrist nominees and instead increased the politicization of the Court.

We would argue vehemently that democracy, and the liberties and protections it provides, is not just of importance to individual citizens, but also to businesses and markets. In a democracy, businesses have the benefit of equal treatment under the law, including unbiased regulation. Yet these days, the President often singles out for criticism enterprises he finds personally objectionable or executives who disagree with him politically. These anti-democratic tendencies are extremely dangerous, particularly as the Congressional Republicans show no interest in reprimanding him, even though his behavior violates a core principle of the conservatism they claim to espouse.

We would also argue that social cohesion is essential for those who have capital to invest. Businesses need a long-term horizon to plan, and social unrest makes planning more difficult. It can't be business as usual amidst constant protests, riots, shutdowns, and escalating social tensions. It is not hard to imagine worsening social unrest among a generation that is falling behind economically and feels betrayed by a massive national debt that was incurred without any obvious benefit to them. If things get bad enough, we could see taxes once again raised to confiscatory levels. We should all be rooting for (and acting to support) social cohesion and a renewal of the American dream.

David Moss, a Harvard Business School professor, teaches a course on democracy and has found that over much of American history, partisanship was cutthroat and political divides were wide and bitter. Yes, people said horrible things about each other. But when critically important issues were being decided, even while participants in the debate were intensely focused on winning, they were also focused on how their actions might affect democracy over the long run. More recently, it seems as though politics has been transformed into an intense focus on immediate victory, the system be damned. We have seen behavior in national and local politics where those in power changed the rules to the disadvantage of those out of power (or about to come into power) simply because they could. As stewards of your capital, we see these ominous and widening social divides as risks to the economy and even to the system. Politicians have been putting self-interest and party ahead of country. Absent facts, truth, and science, we expect poor governmental decisions to become the rule and not the exception. There is no hedge to such risks, other than to work together to reverse course, heal the divides, and strengthen American democracy.

The Art of Portfolio Management: Balancing Risk Aversion with Risk-Taking

In this world of political divisiveness, economic uncertainty, and technological disruption, what's an investor to do? Like sailors navigating the turbulent waters between Scylla and Charybdis, investors must regularly set a course between excessive caution and excessive risk-taking. Erring in the overly cautious direction leads to potentially meager returns, missed opportunities, and a failure to compound capital. On the other hand, the pressure of never-ending performance comparisons may drive normally cautious investors to embrace greater risk. Sitting on the sidelines is not typically seen as a viable option for many investors. They share the view of a former bank CEO who, a decade ago, quipped "as long as the music is playing, you've got to get up and dance."

But an **excessively risky course** may well lead to capital destruction. No one can embrace risk with impunity; it almost always catches up with you. The obvious path to safe navigation is to balance an energetic offense with a strong defense. But in investing, there are no offensive and defensive units. There is no effective way in investing for the offense to scramble off the field and have the defense replace them; you need to excel at both, and at the same time.

In investing, moreover, the nature of one's mandate matters. Some investors expect their managers to beat the market at every measured interval. Others are willing and able to stand apart from the crowd in the short-term; their goal is to enhance net worth over longer-term (at least several year) intervals. Prudent long-term navigation has always been our focus at Baupost. We are glad to forgo some upside in order to truncate the downside. We are content to hold cash in the absence of compelling opportunity. When you try too hard to earn returns, you become tempted to ride every wave, and you are vulnerable to being seduced by the usual market sirens: soaring growth projections, trend-following zeal, an embrace of leverage, or even resorting to financial engineering.

But there is another side of the coin - you can also fail to try hard enough. When you emphasize risk avoidance too strenuously, you may miss out on legitimate opportunity. You might get out of the habit of searching for new ideas, or you might imagine every potential risk to be more severe or more probable than it really is.

Because investors never know when a storm may arise, or whether the higher wind gusts and ominous clouds are foretelling a brief market squall or a major financial hurricane, you have no choice but to prepare for the worst. But since the worst does not frequently happen, you cannot let the fear of a monster storm

completely paralyze you. The way to build a portfolio that will prosper over the long-term, while avoiding irresponsible exposure to the fiercest storms, involves a constant commitment to fact-based decision-making, diversification, an avoidance of recourse leverage, and the analytical imperative of making conservative assumptions.

In an office building project, for example, it is best to be cautious on cost estimates, time to lease-up, rents, exit cap rates, and exit timing. But not too conservative. Someone who compounds multiple extremely bearish assumptions is unlikely to be the best buyer of much of anything. It is crucial not to become greedy when positions are working well (i.e., you must constantly think about when to sell). You must consistently avoid behavioral biases in decision-making. Avoiding these biases at a firm like ours involves building a culture of humility, intellectual honesty, and open debate as well as maintaining a rigorous and robust investment process, consistently applied. Hedging the greatest risks at reasonable prices is also imperative.

We believe another key element in portfolio management is curtailing the duration (the weighted average life) of one's portfolio through exposure to investments with catalysts for the realization of underlying value. Catalytic events shift the outcome of investments from a reliance on future market multiples and macroeconomic developments (which are not at all under your control) to a dependence on your assessment of the outcomes, probabilities, and implications of announced or anticipated corporate events, including mergers and acquisitions, bond maturities, debt restructurings, bankruptcies, major corporate asset sales, spinoffs, and tender offers. No strategy can avoid all risk of loss. But we believe our approach should increase the likelihood of achieving sustainable gains with limited downside risk over the long-run. To put it differently, a portfolio of near infinite duration (such as an all equity portfolio without catalysts) can trade just about anywhere. With such exposures, if stock prices plummet, the odds go up that an investor will feel pressure to do the wrong thing and sell into market weakness. A limited duration portfolio, both because of the hopefully truncated downside in a bad market as well as the beneficial cash inflows (buying power) that catalysts usually generate, is hugely advantageous in navigating through turmoil.

At Baupost, we try to play to our firm's strengths, capabilities, approach, and long-term oriented client base. That means in a world increasingly dominated by short attention spans, specialized investors and rigid investment silos, our flexible investment mandate and long-term orientation confer a huge advantage. The ability to evaluate and buy anything can be daunting, but the opportunity to look at everything confers a great advantage because it increases the takeovers to see if the merger arbitrage arena remains fertile with opportunity. But do not be surprised to see our exposures drop and even end, if and when the area becomes less attractive.

The late year selloff in stocks, bonds, and commodities has increased the volume of opportunity on our radar, and, as noted earlier, we have initiated a number of new public equity positions, while both adding to and reducing others. For the first time in a number of years, the debt markets have come under stress, credit spreads are widening, and bonds are selling off. Our real estate pipeline of opportunity is strong, as a growing number of projects appear stalled or in need of rescue. Our private equity pipeline has also increased, the result of expanding that team to take advantage of the firm's capabilities, while preparing for an increased opportunity set down the road, at a time when market conditions become more challenging.

The Proper Wiring for a Long-Term Investor

Consider the plight of a relief pitcher. Historically undervalued, unappreciated, often used interchangeably with other relievers, and, until recently, low on the major league pay scale. Required to be ready throughout most games at only a moment's notice. And the role comes with the possibility of major psychological trauma. Few remember the slugger who grounds into a double play in the fourth inning, squandering a one-out, bases loaded opportunity. But everyone knows who gave up the gopher ball with the game tied in the bottom of the ninth to lose in a walk-off.

And that's only the prelude. The really hard part is psychological, and comes in that pitcher's next outing. The only logical, yet psychologically challenging, thing for the reliever to do is let it go and forget it happened, even if his teammates, manager, and fans seem possessed by an indelible and bitter memory that flashes before their eyes as he heads in to the mound from the bullpen.

In this way, a reliever has much in common with an investor. When you make an investment and the price drops, the key is to see the fall in price as not necessarily indicative of a past error or failure (no one, after all, can predict the daily meanderings of the markets), but as an opportunity. It's not a do-over – what's done is done – but it is a fresh chance to make another good investment, potentially an even better one now that those shares are lower in price. As we've said before, the key in investing is to see the market's fluctuations not as a source of feedback, a report card if you will, but as a potential driver of opportunity.

Is there information content in price fluctuations? Might the market have foresight into the future? It could, but it's very hard to tell; we believe it's best to think of the market as a place where hordes of buyers and sellers come together to transact and set a price. The information content largely involves what people are willing to do – volume and price – on that day. And such data rarely foretell that a downturn is coming, or a recovery, or any other macro insight.

We have known many people who find the daily report card the market hands them a source of consternation and even anxiety. If the stock they recently purchased falls in price, they feel like they failed. Had they waited after all, they could buy more shares for the same capital invested. But in investing, it's necessary to experience those price drops and see them as a source of further and greater opportunity and not as a problem. Similarly, price gains should not be experienced as a pat on the back from the market. They represent a diminution of opportunity to buy at the right price, though they do offer the potential to sell at a much fuller valuation.

We wish we had perfect market timing (as well as the ability to fly). The reality is that no one does or ever will. The key is to find a way to care about one's investment results over time, but to not feel burdened by the daily fluctuations of Mr. Market. The only way to invest, after what you purchased has fallen in price, is to be that successful relief pitcher. Put yesterday's outcome out of your mind, get back on the mound, and make the best decision you can today with all the information at hand.

Our Partnership with You

We recently amended several terms in a number of our partnership agreements to create better alignment of terms across our entities and for the benefit of our clients. We also made the decision at year-end 2017 to return a portion of capital under management, remaining true to one of our founding objectives – staying focused on the generation of attractive risk adjusted investment returns for our clients, not the generation of fees for the firm.

We are constantly guided by two fundamental beliefs: 1) you will know and remember forever how we treat you; and 2) we are in this for the long run, and we will only get to the long run by doing everything we can on a consistent basis to serve you, prioritize your collective interests, and position ourselves for long-term success.

How do we prioritize client interests? We will not gouge on fees, go public, or sell the firm. We will reinvest in the business to build investment and operational strength that will enhance the firm's capabilities and increase its resilience. We will be highly opportunistic in our investing, we will avoid fads, and we will remain consistently risk averse. We will be agile and alert in responding to opportunity, stoic in the face of adversity, deeply intellectually honest in our reflections and self-assessments, and unwavering in our character and values. We will be relentless in our pursuit of strong risk-adjusted investment returns for our limited partners.

If there's a golden goose in the investment business, it's not near-term results, which will surely ebb and flow, but having the trust of clients. We will act assiduously to protect that most valuable yet fragile of assets; we know that we must constantly earn and re-earn your trust and confidence.

The Baupost Team

Our firm's achievements are a direct result of the close collaboration achieved by our team of 260 exceptional contributors. Led by our partners, our investment teams worked diligently throughout 2018 to chart a course amid challenging markets, tirelessly uncovering and analyzing new investment opportunities while exiting fully-priced holdings.

In a world that sometimes seems to have tilted off its axis, we continue to pride ourselves on our rationality, teamwork, and discipline. We prize collaboration and the inclusion of diverse points of view. As investors, it's our job to gather facts, make judgments about which information to trust, develop hypotheses, and consider them objectively. It's hard enough to make good decisions armed with data and facts. It would be absurd to attempt to do so with alternative facts and a distorted reality.

Jim Mooney, Baupost's president, oversees the management of our investment team. He continues to drive the ongoing refinement and improvement of our investment process, and his efforts regularly enhance the firm and develop our employees.

In his role as head of Public Investments, Jim is ably assisted by partners Greg Ciongoli, Josh Greenhill, and Rob Bralower, and managing directors Rich Carona, James David, Jianshu Dong, and Ryan Dow, who also play key roles in our public investment effort. This group oversees and directs our analysts in their scrutiny of potentially interesting investment ideas. I'm pleased to report that Michael Sperling was promoted to partner effective January 1, 2019. Michael has been an exceptional contributor and valued teammate since he joined the firm in 2010. In addition, Jesse Downing has been promoted to principal.

Partner Tom Blumenthal leads our Private Corporate team of six principals and analysts who diligently source and manage the firm's private equity investments.

George Rizk oversees U.S. Real Estate and Asset Management and Mark Tsocanos manages International Real Estate; both are partners in the firm. The real estate teams source and manage our real estate investments around the world, while building relationships to grow our network of operating partners.

George and Mark are ably supported by the managing directors on the real estate teams: Nick Azrack, Hunt Doering, David Freibaum, JJ Lenhart, Bill Musto, and Brian Zilla. Sam Plimpton, partner emeritus, continues to source opportunity and provide mentorship. Managing Directors Gianpaolo Burigo and David Drubner continue to focus on development and sourcing efforts for the Real Estate and Private Corporate teams. Also effective January 1, Scott Dunn was promoted to managing director and Luca Lelli was promoted to principal.

Our Trading group, led by Managing Director Scott Haig, consists of four team members who do a sterling job of executing buy and sell decisions across time zones in transactions that have become increasingly complex.

During 2018, three new members joined Public Investments, five joined Real Estate and three joined Private Corporate, enhancing our already deep, talented, and hardworking investment team. In addition, four new analysts have agreed to join Baupost in 2019. During 2018, three analysts and one asset manager left the firm. We believe our ability to recruit exceptional people remains a significant competitive advantage for the firm.

As previously communicated, Barbara O'Connor, partner emeritus and former CFO, transitioned in late 2018 to a senior advisory role, reporting to Jim Mooney and working closely on projects that intersect investments and operations.

The implementation of our investment ideas relies heavily on the skills of our legal, operations, and administrative teams. Fred Fogel, Baupost's general counsel and partner, leads our legal and compliance functions. Along with Fred, Chief Compliance Officer and Senior Regulatory Counsel Jack Cohen, Assistant General Counsel Rosemary McCormack, Senior Investment Counsel Collin Beecroft, and Senior Tax Counsel John Harvey provide leadership to a team of 11 people who work within our legal functions. Baupost remains deeply committed to establishing and meeting the highest standards of compliance. And Fred continues to bolster our activities in this realm in an era of increasingly complex regulatory requirements.

Our exceptional operations team is led by Chief Operating Officer Elaine Mann. Our diverse and complex investment portfolio imposes a host of complicated demands on the firms' operations departments, and our very talented and hard working group of leaders under Elaine consistently provide operational excellence. Under Elaine, our department heads are: James Conz, Information Technology; Diana DeSocio, Corporate Communications; Beth Mills, Investor Services; Lucy Tshuka, Human Resources & Administrative Services; and finally, CFO Jason Price, who oversees the firm's complex financial operations. Jason's team heads include: Frank Seyboth, Tax Reporting; Tim Cook, Portfolio Valuation, Accounting & Reporting; Amos Pike, Management Company Accounting & Reporting; Jen Lin, Custody & Treasury Operations; and Jason Gorner, Private & Trading Operations. These leaders work with a top notch team of strong contributors who perform a variety of complex operational tasks that help Baupost run efficiently and effectively.

With Our Appreciation

We remain fortunate to have access to the collective wisdom of Baupost's astute 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. Seth Alexander, CIO of The MIT Investment Company, which oversees that university's endowment, and Ben Gomez, managing director of Pilot House Associates, a family investment office, have agreed to join our Advisory Board in the new year. They both know the firm well, and will undoubtedly make significant contributions to our thinking in 2019 and beyond. The board represents a substantial trove of valuable experience and expertise, and its members provide us with important insights regarding both investing and the business of running an investment firm.

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

It is a privilege for us at Baupost to oversee the assets of a limited number of families and institutional investors. Our limited partners are truly long-term oriented, and that makes it possible for the firm to maintain the kind of long term investment horizon that is essential to harvest attractive risk-adjusted investment returns in a challenging financial environment. The trust and support bestowed on us by our clients constantly reinforces our resolve to make sound investment decisions.'

We are pleased to express our sincere gratitude to our clients for your confidence and support. Please let us know if you have any questions or comments.

We hope you have a healthy and prosperous New Year!

Very truly yours,

Seth A. Klarman

CEO and Portfolio Manager