

Scion Value Fund, A Series of Scion Funds, LLC
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Dear Fellow Investors:

During 2001, the Scion Value Fund appreciated 44.60% net of all actual and accrued expenses and of performance allocations to the managing member. Since its inception on November 1, 2000, the Fund has appreciated 54.16% net of allocations and expenses. The 2001 audit is pending.

	2001	Since Inception ¹
Scion Gross ²	+55.44%	+68.24%
Scion Net ³	+44.60%	+54.16%
S&P 500 ⁴	-11.88%	-18.45%

¹Inception November 1, 2000

²Return before 20% performance allocation and expenses

³Return after 20% performance allocation and expenses

⁴Including dividends

Your individual results to date will vary depending on the timing of your investment. Neither leverage nor short selling was a significant factor in the returns displayed above.

As I do not gear the Fund's buying and selling of securities to general market views but rather to available values in individual securities, it is likely that I will allocate capital to simple cash when I have difficulty finding reasonable investment opportunities. This tendency, along with the intent that the individual investments held in the Fund's portfolio ought ultimately perform regardless of general market movements, should result in longer-term returns that do not correlate very well with any of the standard benchmarks. Even so, recent history mandates further discussion.

During 2001, the Fund – before allocation of the performance incentive to the manager – outperformed the S&P 500 Index, adjusted for dividends, by 6,732 basis points. Since inception, covering a 14-month span, the outperformance amounted to 8,669 basis points. This degree of outperformance over short time periods will be an extremely poor guide as to future relative performance. In fact, should common stocks again bask in the speculative fervor that defined much of the last decade, I will welcome any degree of outperformance during such a period.

Over the longer term, however –I continue to recommend evaluation periods in excess of five years, and in no circumstance less than three years – I expect the Fund will show decent outperformance relative to most widely used benchmarks. Such relative performance will occur largely as a byproduct of my focus on achieving respectable absolute returns, and will occur most significantly from the position of being long common stocks that offer supranormal appreciation potential over reasonable time frames.

An Illustrative Situation

The repercussions of the late 1990's asset bubble continued to resonate through the markets during 2001, creating tremendous volatility as well as tremendous opportunity. Those with a clear idea as to valuation likely did not find their portfolios terribly troubled this past year. Those stock market players who respond to other inputs likely had some difficulty finding their bearings. As for the Fund portfolio, one situation in particular provides insight into the character of your investment here.

Within the 3rd quarter letter, I explained that the "Fund has been averaging down in a stock, purchased during the quarter, which has fallen tremendously out of favor over the past couple of months." I further explained:

The future performance of this position will have absolutely no correlation with either the performance of the general market or further terrorist attacks. At quarter end, however, the position sat at a low point, trading at a valuation of just 3/4 the free cash flow of the trailing twelve months. And unlike many businesses that have faded rapidly during 2001, this business achieved record free cash flow yet again during the first half of 2001...I will note that the prospects for a recovery in this position during the fourth quarter are wholly in question. However, over the next year or two, and especially over the next five years, there is a very high probability of substantial gains as a result of this investment. Such gains would be largely irrespective of the status of any economic recovery, or lack thereof.

The Fund continued to purchase this security during the first days of October, while the security remained downtrodden. As it turns out, we did not have to wait five years, or even a year or two. The stock tripled off its quarter-end lows by late October. Moreover, during early December, a competitor agreed to buy all of the stock of the company at a price that amounts to nearly seven times its price as of September 30th, 2001.

Indeed, while this stock traded down and around its lows, allowing the Fund to take advantage of a truly tremendous sale on free cash flow, a secret bidding process was in the works. Two strategic buyers and one financial buyer submitted three separate bids for the company at valuations six to seven times the then-current market price. This extraordinary example of market inefficiency surely increased the reported volatility of your investment in the Fund – but without added risk, and ultimately much to your benefit. There are many in the investment world that believe the sentence you just read describes an impossibility.

Not so coincidentally, both the CEO of the winning bidder and your portfolio manager independently responded to the same July event when finalizing our rather bullish investment theses - even as the market proceeded to punish the stock on news of the very same event. Owing to our different professions, we went about our investments in different ways. I committed the Fund to a substantial investment in the common stock. He called the target and began to bid for the entire company. You should recognize, however, that this is not such a coincidence precisely because I buy common stocks for the portfolio as if I were buying pieces of businesses.

In fact, at all times I strive to buy stock at prices per share that no acquirer could ever pay for the whole company – not because the prices are too high, but because the prices are so low that a potential acquirer proposing them would be laughed out of the boardroom. Such is the opportunity afforded by the very human market for common stocks.

The Current Market

Several investors have asked me to specifically outline my view on the market. I have generally responded that it is neither my policy nor my interest to attempt to predict broad stock market levels to any degree of precision over any useful time frame. Rather, I will respond to the opportunities that the stock market provides, no matter the prospects for or level of the general market. That said, certain current market characteristics are worthy of comment in light of the history of our financial markets.

It is my belief that one constant in the stock market is human nature. For this reason, while I do not believe history provides a precise blueprint for the future, I also do not believe that those who blithely ignore history will have much success understanding the present. Below is text from an article that Benjamin Graham wrote for Forbes in 1932, a few years after the bursting of a speculative asset bubble most like our late-1990's bubble.

A study made at Columbia University School of Business under the writer's direction, covering some 600 industrial companies listed on the New York Stock Exchange, disclosed that over 200 of them - or nearly one out of three - have been selling at less than their net quick assets. Over fifty of them have sold for less than their cash and marketable securities alone...Businesses have come to be valued in Wall Street on an entirely different basis from that applied to private enterprise. In good times the prices paid on the Stock Exchange were fantastically high, judged by ordinary business standards; and now, by the law of compensation, the assets of these same companies are suffering an equally fantastic undervaluation.

While I do not necessarily expect the after-effects of our more recent bubble to approach in any general manner the absolute valuation levels that Graham describes, I do believe that his extrapolation remains quite valid today. That is, by some law of compensation that would derive its permanence from the constancy of human nature, fantastic undervaluation ought to be expected as a reaction to fantastic overvaluation. It is my opinion that we have yet to find fantastic undervaluation on any scale of depth or breadth comparable to the overvaluation previously, and quite recently, wrought.

In fact, common stocks of nearly every persuasion and category have found themselves today at price levels that can only be described as optimistic. To some extent, the events of September 11th may have created the feeling among investors that nothing short of another large scale terrorist attack or other national disaster could force stocks back down below the September lows. This is clearly not the case. Emotion may produce short-term market bottoms just as it may produce short-term market tops, yet logic that attempts to peg valuation levels of any gravity without first and foremost considering valuation is flawed logic at best.

During a brief period of time this past September, I concluded - based on my evaluation of many individual issues rather than on aggregate statistics - that a number of stocks did find valuation levels that were too low. However, by and large most remained at somewhat high valuations despite significant price declines. Therefore, in the absence of a new asset bubble, the current level of common stock valuations – and the eagerness with which the public grew to accept such valuations – appears to promise future returns well below those still expected by the investing public.

To return to the original point, I provide this opinion on general valuations only as a response to the natural question that I have been asked so frequently of late. However, I am not at all convinced that the opinions above bear significantly on the investment process that I employ on behalf of the Fund. That is, I will respond to the value of individual securities, regardless of current or expected market levels.

I should add that those investors who must own a diversified basket of stocks fated to more or less match the market are precisely those who should be most concerned with the state of the economy and, more importantly, interest rate trends. As the Fund owns a more concentrated portfolio of deeply undervalued stocks affected by a variety of special situations, macro trends should naturally be much less of a concern.

The Current Portfolio

Friday, September 21st marked the most recent market low, as measured by the various indices. The prices of that Friday spurred the Fund to invest in a limited manner in a handful of large capitalization common stocks, as I indicated in the last letter. All of these stocks have been now sold as a result of the ensuing broad market rally, which no doubt helped carry these investments to higher valuations. Quite literally, 2-3-year performance goals for these positions were met within two months. The net effect on the portfolio was only moderately significant, however, as these positions were never taken to appropriate size. In retrospect, one might argue I ought to have rushed to take larger positions at the time.

As the broad market rally gained steam over the ensuing months, I continued to hold a sizable cash position while patiently buying a few securities that remained undervalued. I remained wary of the fear so prevalent during the last quarter – that is, the fear of missing either a tremendous rally or the beginning of the next great bull market. Such fear carries the dangerous potential to obscure and even to obliterate any efforts at rigorous and rational valuation of individual common stocks. As I have noted before, whatever excess return the Fund earns will be the result of my natural inclination to buy cheaper rather than any inclination to sell dearer.

As a result, the Fund's cash position – hovering around 40% or so for most of the fourth quarter – prevented the Fund from participating to the fullest extent possible in the recent general price appreciation across most categories of stocks. If this market rally were to continue from this point at this rate, surely the Fund would have little luck in keeping up over the short-term. On the other hand, those placing new or additional investment into the Fund on January 1 – a group that includes me – should know that the Fund is appropriately positioned given current opportunities in the market.

Short Selling

Short selling is of course the investment technique most readily identified with hedge funds. As you know, I do not and will not simply seek to hedge the long portion of the Fund's portfolio with a basket of short positions, or for that matter with index put options. It will never be my purpose to sell stocks short as part of a risk management program, contemporaneously defined. Rather, I approach the shorting of common stocks in an opportunistic manner that is in many ways the mirror image of my approach to going long stocks. I short a stock for the Fund when there is some temporary, manipulated, or misunderstood phenomenon that has caused the stock to rise to an egregious valuation.

Vanguard Group founder John C. Bogle specifically ridiculed my strategy in a Forbes magazine article during the year.

His technique to manage risk is to buy on the cheap and, if he takes a short position--I hope you're all sitting down for this--it is because he believes the stock will decline.

In all respects, he describes my strategy exactly right – even inserting an “if” to reflect that I only occasionally take short positions. I contacted Mr. Bogle after reading this characterization, and not surprisingly we are of a different mind on this matter. He is, after all, a strong efficient markets proponent. What I propose just does not seem terribly plausible in his view. Nevertheless, this is what I do. I occasionally short a common stock in the Fund because I believe the stock will decline, resulting in a profit. I trust, forewarned, you were sitting down.

I will note that short selling has become extremely competitive. Much as the opportunity to find merger arbitrage opportunities at decent prices shriveled as capital flooded investment funds devoted to this activity, the short selling field has become awfully crowded as a result of recent broad market declines. In my opinion, it is possible that managers in aggregate have done poor research on many of the companies that they are short. This would be a different situation from the past, when short sellers in aggregate were generally correct in their assessment, if not always in their timing. Whether relying on a checklist or on a service that supplies potential short-selling ideas, managers new to the practice have potentially allowed the process to become too mechanical. As with most investment activities, the crowding and automating of the short selling field affects the practice and the profitability of more thoughtful short selling, in good part due to the mechanics of creating and maintaining a short position.

I consider all these issues in deciding whether to commit the Fund to short positions, and to what degree. As a result, my version of short selling at the portfolio level might be considered special-situation short selling. It will happen on occasion in stocks that are not generally heavily shorted, and only in cases where I have developed or can independently confirm an original investment thesis that recommends such action. During the vast majority of 2001, the Fund held no short positions at all, and the primary driver of the Fund's performance will continue to be its long positions.

Reiteration

I intend for this Fund to be populated primarily by investors with a longer view, rather than by speculators attempting to catch a brief period of performance. In fact, the policies of the Fund are structured specifically to attract an investor base of special and somewhat uniform caliber. It may not be clear, on first consideration, why I place so much importance on the composition of the investor base. I do so to help maximize the returns earned by the Fund.

An important reason that well-chosen investors actually help good investment managers to maximize returns is that dissonance within the investment vehicle is minimized. For instance, it has been widely reported that substantial cash is now sitting on the sidelines in the form of large cash positions at investment managers, especially hedge funds. To the extent this is true, it reveals that investment managers have become wary even as their investors have remained confident regarding the potential for substantial future returns. The real opportunities in any market of common stocks will occur when it is the investors who carry the pessimism. Of course, when this occurs, average investors – those doomed to mediocre investment returns over their lifetimes - will tend to withdraw their capital from the hands of the investment managers, and the buying power of investment managers will be minimized. As a result, when opportunity is most extreme, it is probable that cash balances at the various investment managers will not be of sufficient size to take advantage of the opportunity. When such a situation arises, the investment manager with the stable, more sophisticated investor base will retain buying power amid turmoil and opportunity. As a result, the entire investment operation will benefit.

My fundamental, personal investment goal is to earn reasonable returns on my invested capital, such that these returns, compounded over a decade or more, will yield significant absolute sums of capital. For aesthetic purposes, it may be ideal that the string of returns over such a span will never once see a losing year, but I am much more concerned with maximizing long-term compounded returns than maximizing the return in any given period, whether the period be a month, a quarter, or a year.

With your investment here, you have not invested in a stock or even necessarily in the stock market broadly defined. Rather, you own a portion of a private investment vehicle, a limited liability company, that gives you the annual right to require repurchase of your investment at then-current book value. My job, as manager and fellow owner, is to allocate the vehicle's capital to produce the highest absolute return on invested capital possible while minimizing the risk of permanent loss of capital. The available options for capital allocation are generally publicly traded securities, which by their frequent outlandish pricing serve as fertile ground for opportunistic capital allocation and re-allocation.

The goal here should be neither to take profits when the Fund is up significantly nor to cut losses when the Fund is down significantly. Your belief in this statement ought stem from a belief that I actively manage the Fund for intelligent capital allocation as well as re-allocation, and that I expect to do this for a sufficient amount of time. Certainly this is my belief, as I have invested the majority of my 2001 income back into the Fund for a January 1 start. The vast majority of my family's net worth continues to reside in the Fund. Our expectations and motivations should be very similar. To the extent they are, we will all benefit.

Policy Matters

The Fund now has about \$27 million in capital, and the minimum initial investment for new investors has been raised to \$500,000. The next investment period starts April 1, 2002. Current members may contribute a minimum additional investment of \$50,000 as frequently as monthly. For regular accounts, no additional paperwork is necessary to make an additional investment. Simply let me know your plans, and I will ensure you have the correct wiring instructions, or the correct address if mailing a check. For IRA accounts, additional investments entail similar paperwork as for the initial investment. To start the process, please contact me first.

Since shortly after the Fund's inception, I have outsourced administration and bookkeeping tasks to Hedgeworks, LLC. Hedgeworks provides expert administrative abilities for much less cost than hiring a full-time, on-site assistant. I have increasingly made use of the services offered by Hedgeworks, and going forward you should expect most paper correspondence to arrive in the mail from Hedgeworks. Please be sure to open any package or envelope from Hedgeworks, as such mail will be certain to contain important information.

Frank, Rimerman & Co, LLP of Menlo Park, California is the certified public accountant and auditor for the Fund. United States investors should receive tax documents sometime during February, shortly after the audit is completed. We have arranged for preliminary audit work to be completed prior to year-end, and therefore it is my hope and expectation that these matters will proceed in timely fashion.

All other aspects of the Fund remain unchanged. Please feel free to contact me if I have not been clear on a matter discussed above.

Sincerely,

Michael J. Burry, M.D.
Scion Capital, LLC