2000

Scion Value Fund – A Series of Scion Funds, LLC

Annual Letter

Scion Capital, LLC
Private Investment Management

www.scioncapital.com

To the Members of the Scion Value Fund:

For the fiscal year ended December 31, 2000, encompassing the entire two months of the Fund's existence to that date, the Fund's net asset value increased 6.63% after expenses and contingent fee allocations. The gross performance of the Fund was 8.24%.

It is my opinion that the most stable, cost-effective, and eternal alternative to the Fund is the S&P 500 Index, and hence this index should be used as a benchmark. I propose the S&P 500 as a benchmark not because the character of its securities closely matches the character of the Fund's investments – I have yet to find an index that can do this - but rather because one may invest in the S&P 500 with great ease and tax efficiency. Moreover, the S&P 500 has shown an incredible resiliency by outperforming the great majority of money managers as well as most other indices over a great number of years.

During the two months ended December 31, 2000, the Fund's net performance bested that of the S&P 500 by 14.08%. Let me be the first to tell you that this is no small anomaly – it is a quite large anomaly. Over periods greater than 5 years you should rightfully expect the Fund to beat the S&P 500 handily, but in these first two months the Fund certainly overreached. I trust that you will not hold me to this standard every two months henceforth.

During the period just ended, the Fund acquired neither short positions nor options contracts. As well, the Fund neither wrote calls on its positions nor borrowed exorbitant sums of money to enhance returns. The Fund instead has remained quite simply long stocks and on balance has held a small cash position.

No member need write a check as a result of this year's activities. Scion Capital will fold its bill for these last two months into its bill for the 2001 fiscal year. As you are aware, Scion Capital does not charge a quarterly asset-based fee and instead relies entirely on its performance as your manager. Finally, no member will owe taxes on this year's profits, as a small tax-loss is built into the aforementioned gain. You should expect your K-1 tax forms to arrive separately and in timely fashion.

The Portfolio

In order that this Fund's performance escape the randomness of return that defines much of the investment management industry, it is imperative that I as manager respond only to the value of an individual investment when making capital allocation decisions.

Value is far from the only potential input in the typical portfolio manager's investment process, however. Throughout the universe of public and private funds, managers are measured quarterly against one index or another, defined by statistics, and corralled into this category or that category so that fund of funds, pensions, and other institutions can make comforting – if not necessarily prudent – asset allocation decisions. Such forces restrict and otherwise harm the manager's ability to invest intelligently and are entirely deleterious to performance. Managers who respond to such inputs fight an uphill battle.

The Fund is structured to allow its manager to ignore these secondary inputs. The less definition offered, the less positions revealed, the less statistics applied – all the better for the portfolio that aims for these supra-normal returns. Hence, the Fund's individual portfolio positions may not be revealed except at the discretion of the manager.

Hedge Fund Defined?

Private investment funds such as the Fund are nearly always lumped into the category of "hedge fund." Common hedging techniques include shorting stocks, buying put options, writing call options, and various types of leverage and paired transactions. While I do reserve the right to use these tools if and when appropriate, my firm opinion is that the best hedge is buying an appropriately safe and cheap stock. This is not the prevailing opinion, however. Hence, according to a common interpretation of this Fund's activities, the charter investors in the Fund – myself included – entered November invested in a hedge fund that was, by all convention, completely un-hedged.

What happened? The stock market promptly morphed into a minefield. During the single month of November, the technology-laden Nasdaq Composite Index – the best performing market measure of the last several years – experienced a 22.9% loss of value. The Russell 2000 – a measure of small companies with market values averaging just under $600 million – stumbled 10.40%. The S&P 500 fell 8.01%, and the Dow Jones Industrial Average finished off 5.07%.

While striking, these statistics likely do little justice to the potential risk for those investors holding concentrated portfolios. Indices are not about stock picking. Concentrated portfolios – those holding less than 25 stocks or so – are entirely about stock picking. And there were tremendous devaluations in widely held issues over the course of November as well as December.

During this time, the Fund was comfortably positive. The main accomplishment of the Fund, in my opinion, was not grossing 8.24% in two months but rather avoiding such debilitating devaluations as affected the indices and many widely held stocks during that month. While I cannot proclaim that my stock-picking ability is responsible for the gain – the size and most probably the direction of that gain is almost surely a random short-term fluctuation in our favor – I can with some confidence assert that my strategy is entirely designed to avoid and otherwise minimize the price risk in individual securities. As a result, I would argue that it is the lack of a loss in a month like November that represents the most reproducible and the most potent characteristic of the Fund. It is a tenet of my investment style that, on the subject of common stock investment, maximizing the upside means first and foremost minimizing the downside. The deleterious effect of permanent capital loss on portfolio returns cannot be overstated.

Some basic math elucidates this point. When planning for a double, every dollar in excess cost amounts to two dollars in excess gain required. Every dollar saved amounts to the same two dollars in excess gain already realized. And it goes without saying that a 33.3% loss requires a 50% gain just to attain breakeven. On the flip side, 33.3% saved on the buy price makes a 50% gain back to the price of first consideration. On a percentage basis – and it is on this basis that we must evaluate each and every decision – lost dollars are simply harder to replace than gained dollars are to lose.

This focus on a margin of safety in each and every investment is what should make the Fund special. But for the unwieldy nature of such a term, "fund of well-conceived investments" might make an apt handle. Whether or not the Fund ought to be called a hedge fund is an individual decision grounded only in semantics.

Fund Expenses

The most significant potential weakness of the Fund is its expense ratio. You do not earn a return unless the annual return exceeds expenses. I do not earn an income unless your annual return exceeds 6% net of expenses. Hence, aside from my fiduciary duty to maximize your return, both my very nature as something of a cheapskate and my financial incentive to have an income give me every reason to rationalize expenses in favor of return.

There are two main drivers of the Fund's expense ratio, which is expressed as a percentage of assets under management. One is the absolute level of expenses, which should remain relatively fixed. The other is assets under management (AUM) – as AUM increase, the expense ratio will decrease.

Not surprisingly, the vast majority of potential members of the Fund backed out for one reason or another as the deadline for committing funds approached. This has had the effect of increasing the expense ratio for the rest of us. Many of these individuals and institutions are now "sitting on the fence" waiting to see how the Fund and/or the market do. I fully expect the expense ratio to which you are exposed to decrease quite significantly in response to increased assets under management as these and other potential investors become members of the Fund.

Affiliated Parties

Just prior to the opening of the Fund, I was approached by two interested parties – neither of whom I solicited – who separately expressed an interest in owning a part of Scion Capital, LLC. The first party, Gotham Capital V, LLC, is run by Joel Greenblatt, who has been involved in money management for the better part of two decades. An author, professor and portfolio manager, Mr. Greenblatt is an extraordinary special situations investor with whom any professional value investor should be proud to be associated.

The second party is White Mountains Management Company, a subsidiary of White Mountains Insurance Group, Ltd (symbol WTM on the New York Stock Exchange). Led by Warren Buffett associate and insurance guru Jack Byrne, White Mountains is an extraordinary company managed in a manner to warm a shareholder's heart. Once called the "Babe Ruth of insurance" by Mr. Buffett, Mr. Byrne himself is legendary among value investors as the man who turned around GEICO for Mr. Buffett and subsequently turned around Fireman's Fund. White Mountains is his latest venture, and Mr. Buffett himself recently stepped in to acquire nearly 20% of White Mountains.

After some discussion, separate agreements were made with both parties whereby a family trust and I would option portions of our interests in the management company to these parties. The option agreements, now consummated by premiums paid, give Gotham Capital V, LLC the 5-year option to acquire 22.50% of the management company and give White Mountains the option to acquire up to 15.44% of the management company. The agreement with White Mountains is structured such that 5% of the interest would be acquired upon investment of a substantial amount of capital in the Fund for a little over three years. In this manner, I have given up a portion of my own future profits in an effort to jump-start assets under management and hence reduce the expense ratio experienced by investors in the Fund.

Needless to say, I very much appreciate having these parties on the Scion Capital team. I do expect that the options will be exercised within the next year or so, and that both White Mountains and Gotham Capital V will become full non-managing members of Scion Capital, LLC. I alone will retain the majority economic interest in Scion Capital as well as the entire managing member interest.

Since nearly the entire interest allocated to these parties will come from my personal stake in Scion Capital, it is natural to wonder why I would enter into these agreements at all. To be clear, were it not for the quality and integrity of the individuals associated with both parties, I would never have entered into such agreements. The net of it is that, as a result of these agreements, the financial incentive for me to manage the fund for the benefit of the shareholders is significantly increased. At the same time, Scion Capital has acquired potent partners in terms of raising additional assets under management and thereby driving the expense ratio lower.

As part of these transactions, Scion Capital re-organized from a subchapter S corporation to a limited liability company. The firm's Form ADV was re-filed with the state of California, and you will be receiving an updated Part II of the Form ADV, as required, once the Form ADV becomes effective.

Outlook

I have no view on whether the market, broadly defined, will fall or rise during the coming year. At year-end, the situation certainly appeared dire. But it is well known that Wall Street climbs a wall of worry, making appearances, like past performance, no guarantee as to future results. The prudent view, in my opinion, is no view.

Rather, I prefer to look at specific investments within the inefficient parts of the market. I seek individual investments that will allow me to target total portfolio returns of at least 20% annually after fees and expenses on an annual basis over a period of years, not months. Such opportunities are more prevalent now than they have been in recent years, and I do not feel the current climate is particularly adverse with regard to the attainment of this goal.

The Fund maintains a high degree of concentration – typically 15-25 stocks, or even less. Some or all of these stocks may be relatively illiquid. As a result, apparent short-term returns may be adversely or positively affected by otherwise normal fluctuations in portfolio holdings. While it has not been my observation that the Fund experiences undue volatility on a daily basis, there can be no certainty of this trend continuing. I do not view volatility as being in any manner a measure of risk, and hence the Fund is not managed to minimize volatility.

As I write this, I personally have over $1 million invested in the Fund. You should understand that this amount represents the vast majority of my net worth, and the entire amount of my net worth aside from that required for daily living expenses. I maintain no personal securities account aside from the investment in the Fund, and my entire professional focus is this one Fund. Scion Capital does not manage separate accounts or participate in wrap-free programs. I will most certainly notify you at once if any of these circumstances should change – though you can be quite confident that you will not hear from me on this matter.

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

January 8, 2001

Scion Value Fund, A Series of Scion Funds, LLC

April 3, 2001

Dear Fellow Members:

During the first quarter of 2001, the Scion Value Fund ("Fund") appreciated 7.81% after deducting accrued and actual expenses and fees. The S&P 500 Index experienced a net loss of 12.21% during the period. Since its inception, the Fund has appreciated 14.96% net of fees and expenses, while the S&P 500 Index has recorded a loss of 18.82% during the same time period. As a result, since inception five months ago, the Fund has outperformed the S&P 500 by 3,379 basis points, or 33.79 percentage points.

This performance was not without volatility. However, allow me to be quite stern on this subject: volatility does not determine risk. I guide the Fund to a net long position by investing in a concentrated manner and by frequently taking relatively illiquid positions in undervalued situations. The goal here is long-term capital appreciation, with the emphasis on long-term. Therefore, while the Fund may yield surprising results over short time frames, this phenomenon neither concerns me when the results seem cause for lament nor lifts me when the results seem cause for celebration. I urge the same reactions in you.

Thus, I will advise that whatever numbers you see before you on your capital account statements, they should not be compounded into the future indefinitely. I fully expect and recommend that members of this investment vehicle judge my performance over a period of five years or greater, not five months or less. This will prove to be the most fruitful and enjoyable manner in which to participate in the Fund.

Tax Policy

One facet of my style and my investment manner is extremely well suited to finding and profiting from tax-loss losers during November and December and riding them through January. In the past, this has been a successful activity, and I have occasionally found some longer-term holds within the group. Never have I had the success I had this past January, however, and I did not react well to it in context.

Here's the context. Tax loss selling takes many poorly performing stocks to even more extreme lows nearly every year during the late fall. Mutual funds must realize such losses by October 31st and others have until December 31st. However, in many cases these stocks represent businesses under significant duress. Aside from a moderate January bump as selling pressure is alleviated and as stockholders once again buy into these stocks, one would not expect such despised stocks to truly reflect, in short-run, any realization of longer-term or hidden value. With the clarity of hindsight, I see now that my stocks bought amidst the vicious sell-off of mid-December were no match for the vicious sell-off of mid-March. While nearly all remained above the purchase price, the amount of short-term profits given back to the market this quarter remains wholly unsatisfactory.

Most unsatisfactory results are not without reason, and this one is no exception. I failed to clearly re-establish the tax policy of the Fund after it was subtly suggested that paying taxes was something to avoid. Although this thought was far from startling, I allowed it to persuade me to hold on to a few extremely profitable positions too long. This feeling is not uncommon in the market today, but I did know better, and I did break with a long-standing tax policy that has contributed significantly to my success as a portfolio manager.

In order to ensure we do not have a repeat, allow me to clarify the Fund's position on taxes. I am a tax-paying US citizen, and hence I am in the same boat as many, but not all, of you. I also have more of my net worth in the Fund than any other member, and in dollar terms it is the largest as well. However, I will not let the prospect of taxes on gains prevent the achievement of those gains.

To recap, January saw a rapid run-up in the value of your investment in the Fund. One competitive advantage of mine has been taking advantage of the fast times to raise cash for the next slow time, to rotate into less-appreciated securities, and occasionally to short into speculative excess. This can result in my investment strategy producing higher profit, higher turnover, and, yes, higher taxes. In the past, it has done so. In the future, I expect it to do so. For now, I must simply point to one opportunity sorely missed, to one achievement not yet accomplished on your behalf, and to taxes, unfortunately, drastically reduced.

Market Overview 1Q 2001

When I stand on my special-issue "Intelligent Investor" ladder and peer out over the frenzied crowd, I see very few others doing the same. Many stocks remain overvalued, and speculative excess – both on the upside and on the downside – is embedded in the frenzy around stocks of all stripes. And yes, I am talking about March 2001, not March 2000.

In essence, the stock market represents three separate categories of business. They are, adjusted for inflation, those with shrinking intrinsic value, those with approximately stable intrinsic value, and those with steadily growing intrinsic value. The preference, always, would be to buy a long-term franchise at a substantial discount from growing intrinsic value. However, if one has been playing the buy-and-hold game with quality securities, one has been exposed to a substantial amount of market risk because the valuations placed on these securities have implied overly rosy scenarios prone to popular revision in times of more realistic expectation. This is one of those times, but it is my feeling that the revisions have not been severe enough, the expectations not yet realistic enough. Hence, the world's best companies largely remain overpriced in the marketplace.

The bulk of the opportunities remain in undervalued, smaller, more illiquid situations that often represent average or slightly above-average businesses – these stocks, having largely missed out on the speculative ride up, have nevertheless frequently been pushed down to absurd levels owing to their illiquidity during a general market panic. I will not label this Fund a "small cap" fund, for this may not be where the best opportunities are next month or next year. For now, though, the Fund is biased toward smaller capitalization stocks. As for the future, I can only say the Fund will always be biased to where the value is. If recent trends continue, it would not be surprising to find the stocks of several larger capitalization stocks with significant long-term franchises meet value criteria and hence become eligible for potential addition to the Fund.

Where the Value Isn't

With many large cap technology sector stocks falling out of favor, one might be tempted to jump into the fray and find a bottom. This is all well and good, but there is a flaw at the first assumption here. All stocks, including technology stocks, must find a floor in terms of fundamental value and expected return to the stockholder before they find an era-defining floor in price. In most all cases, the floor will be much lower than popular opinion might indicate – and much lower than "fair" value. Investors ought to take care to be coldly realistic in their appraisals.

Following is an outline of a problem that a lot of technology-related companies face – and that makes their stocks in general overvalued. Unlike nearly every other industry, technology companies, as they are generally grouped these days, compensate their employees in a manner that hides much of the expense of the compensation from the income statement. Of course, the subject here is options compensation.

With the most prevalent type of option - called "nonqualified stock options" – the difference between the price of the stock and the price of the options when exercised accrues to the employee as income that must be taxed because it is considered compensation. Not according to GAAP ("Generally Accepted Accounting Principles"), but according to the Internal Revenue Service (IRS). So the IRS gives companies a break and allows them, for tax purposes, to deduct this options expense that employees receive as income. The net result is an income tax benefit to the company of roughly 35% of the sum total difference between the exercise price of the company's nonqualified options during a given year and the market price of the stock at the time of exercise.

Since GAAP does not recognize this in the income statement, the cash flow statements record this "Tax benefit from exercise of stock options" as a positive adjustment to net income. After all, the company included neither the cost of the options nor the income tax benefit on the profit/loss statement. Hence, the correction to cash flow.

So cash income is understated by net income, right? Wrong. When evaluating US companies, conservative investors ought to assume that if the IRS can tax something, then it is a real profit. And if they allow one to deduct something, then it is a real cost.

In a rising market, the net income tax benefit can be quite large – but it only reflects roughly 35% of the actual cost of paying employees with options. How does it cost the company? Because the company must either issue new stock at a severe discount to prevailing market prices or buy back stock at prevailing market prices in order to provide stock at a discount for employees exercising their options. The cost is borne by shareholders, who suffer from significant dilution. The per share numbers worsen, while the absolute numbers improve. After all, issuing stock at any price is a positive event for cash flow if not for shareholders.

Adobe Systems, for instance, is widely regarded as a good company with a decent franchise. A bit cyclical maybe, but a member of the Nasdaq 100 and the S&P 500. It is widely held by institutions.

Looking at its annual report for 2000, one sees that the income tax benefit for options supplied $125 million, or roughly 28% of operating cash flow. Fair enough. Let's move to the income statement. Divide that $125 million by a corporate tax rate of around 35%, and one gets an amount of $357 million. That's the amount of employee compensation that the IRS recognizes Adobe paid in the form of options, but that does not appear on the income statement.

Plugging it into the income statement as an expense drops the operating income – less investment gains and interest – from $408 million to $51 million. Tax that and you get net income somewhere around $33 million – and an abnormally small tax payment to the IRS. That $33 million is a good proxy for the amount of net income that public shareholders get after the company's senior management and employees feed at the trough. For this $33 million – roughly 1/10 of the reported earnings – shareholders were paying $8.7 billion around the time of this writing. Shareholders of such firms as Seibel Systems, Oracle and Xilinx were paying near infinite multiples on last year's earnings, as a similar exercise shows that these firms paid employees more money in options compensation than their entire net income last year.

Many, and probably most, technology companies are therefore private companies in the public domain – existing for themselves, not for their shareholder owners. Of course, it is a shell game. A prolonged depressed stock price – for whatever reason, including a bear market – would cause a lot of options to become worthless, and would likely require the company to either start paying more in salary or, often worse, to start re-pricing options at lower prices. Even if neither action is taken, operating cash flow takes a hit.

In truth, this type of activity might be expected from companies that were often created with the help of venture capitalists who viewed public shareholders as an exit strategy, not as a group that deserves to benefit from improving company results and prospects. The significant implication here is that shareholders cannot count on these sorts of companies for proper corporate governance. They have demonstrated that they will ask shareholders to bear the burden during good times and that they will re-price options during bad times, thereby taking from shareholders both on the way up and on the way down.

Such an argument has very significant implications for the valuation of many popular stocks. In a coldly calculating market rather than a speculative one, the stocks of companies governed with so little respect for shareholders will suffer. It is not limited to Adobe, Seibel, or Xilinx. Cisco, Intel, Microsoft and many of the greatest technology-related "wealth creators" of the last decade are in the same boat. Now that the bubble is burst, it is not my expectation that we will see any lasting rebound in the stocks of companies in the hands of such reckless management teams. Indeed, it is quite certain that public expectations regarding these companies' stocks will not be met.

Volatility Revisited

Because expenses are relatively fixed, higher amounts of assets dilute the expense ratio. Therefore, in keeping with the goal to lower the expense ratio, efforts must be made on occasion to raise new capital. While attempting to raise new capital recently, your manager has recently had a colorful experience that is fairly illuminating with regards to the hallowed ground on which most investors consider volatility.

I delivered a short talk at the Banc of America Alternative Investment Strategies Symposium in Los Angeles last month. I had a good slot – immediately after the keynote speaker and at about 9 o'clock in the a.m. A room of about 200 wealthy potential clients heard me state unequivocally that risk is not defined by volatility, but rather by ill-conceived investment. The corollaries, as I pointed out, were that portfolio concentration and illiquidity do not define risk. That simple statement, I am told, had not just a few of those in the room shaking their heads.

The very pleasant gentleman who spoke after me then proceeded to delineate how frequently his portfolio moved with a magnitude greater than 1% on a *daily* basis. I think the number was quite impressive for an institution that measures itself by such things – somewhere around 25 days in the past two years or so. And this, he proclaimed, minimized volatility and thus risk. He seemed a decent fellow, and if you wish me to provide his name and number, I would be happy to do so.

Not that he necessarily needs the business. Perhaps it is not so surprising that your portfolio manager sat relatively alone at his lunch table, while the second fellow was quite popular. By and large, the wealthiest of the wealthy and their representatives have accepted that most managers are average, and the better ones are able to achieve average returns while exhibiting below-average volatility.

By this logic, however, a dollar selling for 50 cents one day, 60 cents the next day, and 40 cents the next somehow becomes worth less than a dollar selling for 50 cents all three days. I would argue that the ability to buy at 40 cents presents opportunity, not risk, and that the dollar is still worth a dollar.

The stock market is full of dollars selling for much more than a dollar. A dollar that consistently sells at 1.1X face value may even be respected for the consistency of this quality, earning it the "right" to have that premium.

These are not the investments your portfolio manager chooses for the Fund. A wildly fluctuating dollar selling for 40 or 50 or 60 cents will always remain more attractive – and far less risky. As for my loneliness at the lunch table, it has always been a maxim of mine that while capital raising may be a popularity contest, intelligent investment is quite the opposite. One must therefore take some pride in such a universal lack of appeal.

Policy Matters

While I will continue to attempt to raise new capital, it will not be my policy to compromise the Fund's current policies to do so. You have all accepted the Fund on its own terms, and first and foremost it is my intention to protect your capital and enhance your returns. Be assured that I eat my own cooking. The vast majority of my net worth, aside from money set aside for modest living expenses, is in the Fund. If I compound my own investment in the Fund at a rate of 20% annually, excluding fees, for 30 years, I will have over $250 million. If I can do 25%, I will have nearly $1 billion. This is how I think about your investment. It is also why I do not think in terms of monthly or quarterly snapshots of performance, although I do understand that after five years or so you would expect to see a favorable trend. I intend to provide it.

To this end, I will change the schedule of new investment to a quarterly basis. May 1st will be the last start date on which new investment in the Fund may be initiated on the monthly schedule. From then on, the Fund will accept new investors on the first of July, the first of October, the first of

January, the first of April, and so forth. I will retain the right to allow investments at other times, but only as a rare exception in the face of overwhelming justification. Members may continue to add to their holdings on a monthly basis.

Also, the minimum initial investment in the Fund for future investors will be raised to $250,000 as of the July 1, 2001 investment date. Current members and those with planned investment during April for a May 1 start are exempt from this new minimum.

Please feel free to call me if I have not been clear, or if you need further clarification on a matter discussed above.

Sincerely,

Michael J. Burry
Scion Capital, LLC

Scion Value Fund, A Series of Scion Funds, LLC

July 3, 2001

Dear Fellow Members:

During the first half of 2001, the Fund appreciated 22.00% net of all actual and accrued expenses and performance allocations. Year-to-date, the S&P 500 has experienced a net loss of 6.68%. Since its inception on November 1, 2000, the Fund has appreciated 30.06% net of allocations and expenses, while the S&P 500 Index has recorded a loss of 13.63% during the same time period.

	1H 2001	Since Inception[1]
Scion Gross[2]	+26.98%	+37.44%
Scion Net[3]	+22.00%	+30.06%
S&P 500	-6.68%	-13.63%

[1]Inception November 1, 2000
[2]Return before 20% performance allocation
[3]Return after 20% performance allocation and expenses

It would be disingenuous of me to state that the Fund's performance relative to the S&P 500 Index does not appear startling. On the surface, it certainly is. However, you should realize that the Fund in no manner attempts to mimic an index, much less the S&P 500 Index. Securities attract an investment from the Fund when they stand alone as tremendous values
– there are simply no other criteria.

Therefore, I must reiterate that I present the S&P 500 Index as a long-term benchmark only because it has proven a mighty foe for most portfolio managers over the decades. Many managers of average talent have recorded outperformance as well as underperformance relative to the S&P 500 Index over short time periods. Hence, during these early years of the Fund, I will present the S&P 500 Index only to set proper precedent for the distant future years when it actually means something. In truth, for now, please ignore the S&P 500 Index with respect to the relative performance of the Fund.

It would be similarly disingenuous of me to state that the short-term returns since inception do not appear strong in an absolute sense. They certainly *appear* strong. Yet I must emphasize once again that while the Fund may yield surprising results over short time frames, this phenomenon neither concerns me when the results seem cause for lament nor lifts me when the results seem cause for celebration. I urge the same reactions in you.

Thus, I will continue to advise that whatever numbers you see before you on your capital account statements, they should not be compounded into the future indefinitely. I fully expect and recommend that members of this investment vehicle judge my performance over a period of five years or greater. This will prove to be the most fruitful and enjoyable manner in which to participate in the Fund.

Performance Revisited

For some reason the "quarter" has been set upon as an ideal unit of time in the investment world. Yet in terms of measuring investments prowess, a quarterly compartmentalization of returns is no better than a monthly, weekly, or daily division of returns. Indeed, one of the most harmful aspects of human nature in terms of the investment process is the tendency to extrapolate to any extent into the future a manager's performance in the most recent period. Enclosed is a 1985 U.S. Trust memo that, with striking data, addresses this notion. I urge you to take the time to read it. I trust you will find its conclusions as timeless and as powerful as I find them; they are indeed relevant to your investment in this Fund.

Strategy

I have previously written that I strive to discover the proverbial dollar bill selling for 50 cents, preferably with enough volatility such that I have the opportunity to buy at 40 cents or less. I certainly view volatility as my friend – and hence your friend. This works out well because most in the market treasure the dollar bill that consistently sells for $1.10 or more – as long as it consistently does so. In short, volatility is on sale because 99+% of the institutions out there are doing their best to avoid it – under the mistaken but Nobel Prize-winning impression that volatility and risk have some relation. Those of us that feel affection for volatility therefore hold title to the most disabused yet undervalued quality that the markets have to offer.

As much as the Fund is a value fund, it is an opportunistic fund. And as much as I enthusiastically explore the value of each business behind every stock, I seek the pockets of the market that are the most inefficient, the most temporarily imbalanced in terms of price. Whatever extra return this Fund will earn will be borne of buying absurdly cheap rather than selling dearly smitten. I certainly have proven no ability to pick tops, and I do not anticipate attempting such a feat in the future. Rather, fully aware that wonderful businesses make wonderful investments only at wonderful prices, I will continue to seek out the bargains amid the refuse.

Current economic conditions present a recurring opportunity that occasionally offers dollar bills for at most 55 cents on the dollar. Importantly, this opportunity allows the accumulation of large positions in illiquid securities with relative rapidity, although liquid securities are also occasionally affected. This is yet another opportunity that presents for our benefit because institutional investors are exceptionally good at crowding the exits. In most cases, I expect many of these securities to move back to par within a reasonable time frame. Already, the Fund has benefited significantly as one such opportunity worked out as expected. As June came to a close, another opportunity of this sort presented itself. While I am not certain of the time frame, I am very certain of the value.

While the Fund may hold securities short, this is not generally the case. In fact, since inception the Fund's minimal short-selling activities have yielded a mere one percentage point addition to the year-to-date performance numbers listed above. Similarly, the Fund may take advantage of leverage. However, again, this is not generally the case. My preference is to hold a portfolio of 15-25 securities long while holding a small cash position in order that I may take advantage of particularly valuable opportunities without leveraging the Fund or rashly selling another position. Since inception, the Fund has generally operated in this manner – that is, holding a portfolio of 20 or so securities long together with a decent cash position.

Many would consider such a portfolio to lack any hedging feature. One hedges when one is unsure. I do not seek out investments of which I am unsure. Hence, except to the extent that buying a security very cheaply may be considered a hedge, I do not hedge.

Despite the Fund's unhedged portfolio, I expect bear markets to be most favorable for the Fund in terms of relative performance. Generally speaking, this means that I expect the Fund will fall less than the market in a bear market. Similarly, I expect that in the event of a general bull market in stocks, the Fund will not shine so brightly in terms of relative performance. The math of investing would favor the Fund, however, over several bull and bear market cycles because, on a percentage basis, lost dollars are simply harder to replace than gained dollars are to lose. The emphasis will always be placed first on preventing the permanent loss of capital, and good results should follow.

Risk

Although an outsider might think the goal of prevailing modern investment practice to be one of mediocrity, there in fact remains much more competition to achieve gains in the market than there is competition to record losses. Laissez-faire security analysis paired to an entirely misdirected view of risk management nevertheless dooms most institutional portfolios to mediocre performance. In fact, traditional risk management – centered on minimizing volatility in various forms – relies on theories that assume security analysis is a rather fruitless effort, courtesy of efficient markets. There is a great paradox in this line of thinking that should warn investors away from all portfolio managers that employ it. The correct view remains that risk is minimized not through the alchemy of volatility calculus but rather through respectful business evaluation.

Respectful business evaluation in turn requires respect for the boundaries of one's fund of knowledge, however dynamic the boundaries may be. Venturing cash-first into unfamiliar territory nearly always results in either losses appropriate for the bonehead move or successes borne of dumb luck. Be assured that neither do I employ dumb luck as an input into my investment process nor do I count on its sudden appearance by my side. Risk management need not be more complicated than this.

Options Revisited

I do realize that in addition to your investment here, some of you invest for your own accounts. The Fund does not generally offer portfolio transparency. Hence, for those of you that do manage portfolios of individual securities, being a member of the Fund provides no specific insight into what I believe you ought to be doing. It is with this knowledge that I share with you my thoughts on some of the more baffling aspects of the stock market in these letters. Be aware, however, that how I think of these things may be more instructive than what I think of them.

One area that is particularly perplexing is the accounting for options compensation. In the last letter I outlined one particularly Draconian manner with which to examine options compensation. In that manner, I take the tax benefit that the company receives from the IRS for its employees' exercise of non-qualified stock options and divide by the company's tax rate. This calculation yields the amount of money that the IRS -- but not GAAP – recognizes the company paid its employees in options compensation during that period. After all, if companies get to deduct this options expense from their tax statements, is it not a real expense?

Well, yes, shareholders should think so. But there is much more to options compensation accounting than I outlined previously. Maybe I hear a groan or two from the gallery. Put in the words of not one or two but three investors, "But, Mike, what if you are the only one that thinks of options this way? If everyone else thinks another way, doesn't that make how you think of it irrelevant?" I would argue that if I am the only one that thinks in this manner, and if I am correct, then my understanding becomes a competitive advantage that makes the subject even more relevant. I would also argue that a policy of minimizing risk requires that these complex issues be investigated and understood rather than ignored. Granted, this is my job, not yours. For those of you interested in the subject, a discussion follows. Others feel free to skip to the next section.

As I mentioned, the subject of options compensation is quite complex, and what I previously outlined is only one particularly strict interpretation. The pitfall with the tax rate divisor methodology is that it assumes that this compensation is some sort of precise ongoing expense infinitely into the future. It also ignores the impact of share repurchases and share issuances relative to intrinsic value.

That is, to the extent the company is issuing stock at prices in excess of intrinsic value and in numbers and dollar volume in excess of any buyback, the company is creating incremental intrinsic value per share. To illustrate, when an employee exercises an option to buy stock at $15, the company issues stock at that $15 price and hence receives $15 cash. At the same time, assume intrinsic value is $10 per share. Intrinsic value is thus created at a rate of $5 per share issued.

Note that it does not matter if the market is currently valuing the stock at $20 per share. Intrinsic value is created whenever shares are issued at a price per share in excess of intrinsic value per share. Indeed, one could argue that for companies that issued and had exercised many options with high strike prices, value was created on a per share basis even though the shares were being issued to employees at seemingly low prices at the time and even though the even greater value creation that could be realized by issuing stock at much higher prevailing market prices is ignored. Here, "high" and "low" are defined relative to intrinsic value per share, not relative to prevailing share price.

Of course, if the company simultaneously buys back stock at those high prices, then it is to an extent offsetting any benefit. In many cases, one finds that the issuance of stock far outpaces the repurchase of stock, resulting in the seemingly paradoxical circumstance of shares outstanding rising in the face of an ostensibly strong share buyback. The gut reaction is that this is very wrong – that is, that the share buybacks are helpful while the share issuances are deleterious. The gut reaction is imprecise and possibly in error, however.

When evaluating an options compensation program, one must weigh the net value creation from (a) the issuance of excess options-related stock at prices higher than intrinsic value and (b) the tax benefit associated with the program against the net value destruction from (a) buying stock back at market prices higher than intrinsic value and (b) issuing options-related stock at prices lower than intrinsic value. Such an evaluation is most illustrative when it encompasses several bull and bear cycles in the company's history. Also, note that this methodology does leave open the potential for tremendous value destruction if option-related stock is consistently issued at a discount to intrinsic value while an ongoing buyback consumes stock at a significant premium to intrinsic value.

To be clear, there is no easy rule of thumb, and digging through ten or more years of SEC filings to find the relevant numbers and trends is not generally a task most investors like to pursue. Certainly it is easier to listen to someone else's opinion regarding the company's growth rate or some other easily understood metric. It is likely, however, that the investors in the habit of overturning the most stones will find the most success.

Following are two general conclusions that I found while investigating options compensation over the last decade. One, it takes tremendous growth in the underlying business as well as a significantly inflated share price to justify options compensation. Such characteristics may result in share price issuances at prices above intrinsic value at the same time the value creation of early share buybacks is magnified and the value destruction of recent buybacks is minimized. So, to the extent that companies used options compensation to attract the key workers that helped drive earnings and share prices upward at dizzying rates, the options program may be less dilutive to shareholder value than a skeptic might initially believe. On the other hand, low stock prices relative to intrinsic value may increase shareholders' susceptibility to options re-pricing or re-issuance, both of which tend to destroy value.

Two, many of the leading growth companies benefited tremendously from the substantial share buybacks that took place in the early part of the last decade. These buybacks were performed at prices that subsequently proved to be substantially less than intrinsic value, and were not accompanied by significant options-related share issuances. It is not clear that, given current corporate governance abuses, such a circumstance would repeat in the future. Indeed, in the first half of the 1990s, many of today's leading technology companies saw their shares outstanding shrink significantly. Without these early buybacks, growth would have had much less impact on per share value creation over the decade.

Several corollaries arise from these conclusions. One line of thought holds that the approved 10K-ready method of using Black-Scholes methodology to evaluate the cost of an options program ought to be thrown out a window. Black-Scholes relies on volatility for pricing. In the case of 5-10 year options that are subject to re-issuance and re-pricing in tougher times, volatility means little to the value of an option. To clarify, to reject Black-Scholes and to accept my line of reasoning above, one has to reject both the idea that the stock market is efficient and the idea that risk is derived from volatility. I find it relatively easy to reject these ideas.

Fees & Expenses

Allow me to clarify the difference between this Fund and the typical private fund with respect to expenses. The typical fund charges a 1% asset management fee and does not necessarily include within that fee the costs of accountants, lawyers, and several other additional expenses borne directly by the fund. In addition, in some cases, "soft dollars" allow office space, back office help, software, and other items to be bought with excess commission dollars. Hence, the expense ratio for most funds is generally doomed to be higher than 1%.

The Fund takes a different approach. With no automatic 1% asset management fee, the expense ratio is generally doomed to be no greater than 1%. While the Fund bears all expenses taken on its behalf directly rather than through indirect means such as asset management fees and soft dollars, managing the Fund simply does not require a lot of overhead. Moreover, every dollar of expense subtracts from the performance that is the basis for the whole of Scion Capital's income. In short, these factors conspire to minimize the expense ratio.

Equity in the Fund now exceeds $14.7 million. As has been the experience thus far, the expense ratio will continue to fall as this number grows.

Policy Matters

The minimum initial investment for new members is now $250,000. Current members may contribute a minimum additional investment of $50,000 as frequently as monthly. Word of mouth remains the primary method for marketing the Fund's existence, and introductions are welcome.

You will not often find me highlighting one time or another as a particularly good time to invest. However, with the Fund in a cash-rich position, the current risk of buying into the Fund at a near-term portfolio high is minimized to a degree that is not generally predictable under more normal circumstances.

I continue to maintain the vast majority of my net worth in the Fund. As long as the Fund exists, it will be my only investment.

Please feel free to contact me if you require further clarification on a matter discussed above.

Sincerely,

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

Scion Value Fund, A Series of Scion Funds, LLC

October 2, 2001

Dear Fellow Members:

During the first nine months of 2001, the Fund appreciated 10.98% net of all actual and accrued expenses and performance allocations. Since its inception on November 1, 2000, the Fund has appreciated 18.31% net of allocations and expenses.

	2001 YTD	Since Inception[1]
Scion Gross[2]	+13.49%	+22.84%
Scion Net[3]	+10.98%	+18.31%
S&P 500	-20.39%	-26.33%

[1]Inception November 1, 2000
[2]Return before 20% performance allocation and expenses
[3]Return after 20% performance allocation and expenses

Again, I will continue to advise that whatever numbers you see before you on your capital account statements, they should not be compounded into the future indefinitely. The portfolio is a fairly concentrated one, and significant volatility is to be expected. I fully expect and recommend that members of this investment vehicle judge my performance over a period of five years or greater. This will prove to be the most fruitful and enjoyable manner in which to participate in the Fund.

The Third Quarter

In the second quarter letter, I made light of the investment industry's fascination with the quarter as a unit of time. Indeed, Scion Capital, as a California registered investment advisor, is required to provide you a report on a quarterly basis at minimum. Therefore, the quarter has become the fabric of our lives regardless of my opinion on the matter. Normally, I write these letters with the standard disclaimer, as in the paragraph above, that the timing of report is rather arbitrary – and that very little predictive value can be conveyed in simple quarterly performance numbers.

It is fair to say, however, that September proved a unique month in stock market history – overshadowed only by its unique place in human history. The tragic events of September 11th have caused performance during this third quarter of 2001 to be particularly irrelevant to the task of measuring investment skill.

That is, the ability to take such a quarter's performance and extrapolate it into a general summation of the investment manager's ability is fraught with even greater difficulty than usual. To this end, however, my position has been that the narrative of the quarterly report ought provide some aid to such an evaluation, and my efforts on this front follow.

The Portfolio

All major stock market indices saw significant declines during the third quarter. The Dow Jones Industrial Average, the most venerable of the group, lost 16%, its worst quarterly performance since 1987. The Nasdaq Composite, a recent favorite, lost 31%. The S&P 500 Index, the modern standard, fell 15%. And the Russell 2000, a small cap benchmark, lost 21%.

The Fund fared comparatively well, but I have to say such comparisons are not necessarily valid. The general market decline was not the reason for downward fluctuation in the Fund. Indeed, the results of the third quarter have no more reason for correlation with the market than the results of the first half of 2001. Rather, the Fund fell because I simply chose several key stocks that declined in price during the quarter. Any correlation with the indices in terms of direction and magnitude is largely coincidental. Certainly, in large part, the price declines of portfolio holdings do not reflect any similar deterioration in intrinsic value. And because the Fund has added to several of these decliners, the Fund is more valuable now than one quarter ago.

So, with this preface, I will review several specific reasons for the third quarter performance that you see on you account statement. For this was one quarter in which run-of-the-mill market volatility was not the culprit.

First and most important, 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. In a steep decline throughout July and August, the stock found the week after the markets re-opened particularly brutal as panicked sellers found relatively few buyers. Very few investment funds would want this stock on their books at the end of the quarter. Indeed, as the quarter came to a close, the stock came under renewed selling pressure, presumably as other investment funds worked to "window dress" their portfolios for public viewing. Some element of early tax-loss selling may have played a role. As well, it appears a very large institutional investor, having used the stock as collateral for a loan, has disclosed that it is dumping several weeks' worth of volume -with apparent disregard for price. All of these factors were detrimental to reported third quarter performance, and quite beneficial for the Fund. This position now ranks as among the largest in the Fund.

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.

This one position, while a very significant drag on the third quarter performance numbers, did not account for the entire decline. The events of September 11th affected the portfolio as well. Unlike one fund manager who found himself holding a fortuitous top four -- a defense electronics manufacturer, a videoconferencing company, a medical company involved in the treatment of depression, and a bible publisher – I cannot claim that the Fund was particularly well-positioned, in terms of short-term price performance, for incomprehensible human tragedy involving commercial jumbo jets as weapons of mass destruction.

Specifically, you should understand that the largest holding in the Fund on September 11th was an airline stock. Breaking with tradition, I feel I should explain this position in a bit of detail. For no matter how strenuously I emphasize that this was a rational decision, buying an airline stock rarely looks like a good idea – especially in retrospect, after the seemingly inevitable monstrous loss has been realized. The rationale for buying this airline stock, and for patiently growing it into a very large position, is provided in the Appendix, attached.

The effect of our national tragedy on the market value of the portfolio was not limited to this one airline holding however. The Fund held two hotel stocks on September 11th – one of which was, and is, among its top five holdings. I will not reveal the name of this company here, as I do hope it continues to fall – thereby providing the Fund an opportunity to add to the position. Hotel stocks ranked with other travel-related industries and airlines as among the worst performers in the wake of the September 11th tragedies. In several cases, the short-term reaction was entirely unjustified, as long-term intrinsic value was not significantly impaired. The Fund's largest hotel holding is one such business, and I expect the Fund to receive full value for the shares in the future. Such recognition had simply not arrived by quarter's end.

As well, another hotel stock held in the Fund's portfolio, though not among the top 5 holdings, fell over 30% in the aftermath of September 11th. It now trades at the value of the free cash on its books, meaning an international hotel franchise lacking any recourse debt now goes for free on the stock exchange. Publicly traded real estate has always been neglected, but this is ridiculous. I fully expect it will recover and ultimately head much higher over time. The stock rarely trades, but if I am successful in my efforts to acquire more of this stock at these prices, the Fund will participate to a much greater degree on the way up than it did on the way down.

Finally, the portfolio has generally held relatively illiquid stocks for the balance of the year. The logical reason for this is that the more liquid, larger capitalization stocks had remained stubbornly overvalued since inception of the Fund. The logical consequence, however, is that the portfolio is susceptible to short-term downside volatility in times of rampant market fear. With all seriousness, a 2500 share sell when no one is looking could torpedo the apparent market value of several of the Fund's holdings. Such volatility in no way impacts the intrinsic value of the portfolio, and rather provides opportunity. In one case, this volatility has allowed the Fund to build a smaller stock position into significant size at a free cash flow yield approximating 20% – and at a price that is only half its private market value. Just ask the three separate financial buyers who bid to buy the company outright earlier this year. A tight financing market stymied these efforts. The value remains – and will be realized by the markets in good time.

Towards the very end of September, I allocated capital to several larger capitalization stocks as they fell to levels that implied extraordinarily high long-term returns. Indeed, I have been very happy to pick up several consumer franchises, with ever-widening competitive advantage, at discounts that imply virtually no growth going forward. Given the quality of these companies – and the natural ability of these companies to raise prices at a rate greater than inflation – such discounts imply an unrealistically low valuation.

Terrorism, External Shocks, and Risk

A portfolio manager must understand that safeguarding against loss does not end with finding the perfect security at the perfect price. If it did, then the perfect portfolio would likely consist of one security. Rather, to the extent possible, I have the responsibility to structure the portfolio such that if any of a number of unforeseen events occur, that I do not lose the whole, or even a significant portion, of the clients' money. To do this, I seek to minimize the correlation between the intrinsic values of the various securities held in the portfolio.

Minimizing this correlation involves a bit of diversification among industries. Minimizing this correlation does not involve straying from sound principles of securities analysis. Including speculative or overpriced stocks in the portfolio simply to diversify against the impact of an array of possible external shocks is simply irrational given the relative odds involved. Moreover, minimizing this correlation does not require a portfolio of more than fifteen or so stocks. Therefore, a relatively concentrated portfolio may still offer decent protection against unforeseen adverse future circumstance.

Although it so happened that on September 11th the Fund's largest position was an airline, and that another large position was a hotel stock, the impact of this tragedy should not, in the long-term, prove significant to the Fund's performance. The principles by which I invest served the Fund well during the recent turbulent time, and I expect that these principles, applied consistently, will continue to serve the Fund well – whatever additional shocks the future may hold.

On Portfolio Upgrades

One reason that several of the Fund's illiquid common stocks fell during the quarter is that many value managers, who might hold similar stocks, saw the opportunity to "upgrade" their portfolios during mid-late September. That is, acting on the fact that larger, well-known companies were recently trading at steep discounts to historical prices, portfolio managers dumped their illiquid, ignominious stocks and rushed into these more popular but depressed stocks. The phrase "I am upgrading my portfolio" became one I heard frequently among fellow portfolio managers as September came to a close.

In order to apply this technique to the Fund's portfolio, the existing securities and the securities to which one might upgrade, would have to come to some sort of equilibrium in terms of value offered. This most certainly has not been the case, at least not on any widespread basis. Indeed, the very fact so many investors acted rather eagerly to upgrade has recently pushed the value differential that much further in favor of current portfolio holdings. As a result, the time to exit such positions is certainly not the present.

Another issue I have with this sort of thinking is probably best summarized by the word "Ick." Ick investing means taking a special analytical interest in stocks that inspire a first reaction of "ick." I tend to become interested in stocks that by their very names or circumstances inspire an unwillingness – and an "ick" accompanied by a wrinkle of the nose - on the part of most investors to delve any further. In all probability, such stocks will prove fertile ground for the rare neglected deep value situations that could provide significant returns with minimal risk, and minimal correlation with the broad market. Occasionally, well-known stocks fall into the "ick" category, and it is at those times that I become interested.

Finally, I suspect that many who are actively upgrading their portfolios are doing so because they fear missing either a major market rally or the next bull market. With stocks in general having come down fairly far, the feeling a bottom is near may be fairly pervasive. The optimal way to participate in a market rally, by definition, is to buy the better-known stocks that either are in the major indices or are comparable to those that make up the indices. However, doing so exposes one to the risk that one is wrong on the direction of the market. To my knowledge, such a hazard has proven notoriously difficult to avoid. In any case, the goal, always, of intelligent investing is not to mimic the market but rather to outmaneuver the market.

This is not to say that I am not a fan of larger, well-run businesses with fantastic economic characteristics and durable competitive advantage. I have a list of about eighty or so stocks that represent businesses with very decent and predictable long-term business characteristics. At the right price, I would like to include any one or more of these stocks in the Fund. Of course, what I consider the right price seems ridiculously low given where most of these stocks have been priced in recent years. When these stocks come to my prices, then I will consider adding them to the Fund. But only because they represent absolute value, and not because of any desire to "upgrade the portfolio" into either more palatable or more market-responsive stocks.

Also on this subject, I should note that recently, as many well-known companies saw their stocks fall drastically, a select few made it to my buy prices. Those that did were added to the portfolio on the sole criterion of absolute value. The vast majority of popular stocks continue to be valued as popular stocks rather than as real businesses. Certainly, in the broader market, many stock prices overestimate the permanence of the underlying businesses.

Summary

As I have noted in previous letters, I will always choose the dollar bill carrying a wildly fluctuating discount rather than the dollar bill selling for a quite stable premium. This will often result in surprising quarterly results. To the extent prudent, I will attempt to explain surprising results when they occur. During the third quarter we saw an attempt to buy a cheap security become a process of averaging down into what is now, apparently, the most undervalued security available on any exchange. We saw investors start to dump illiquid small capitalization stocks using an order process that may be summarized as "Just get me out of this stock!" And to top it off, we saw a human tragedy of rare proportion directly and negatively impact the market values of several of the largest portfolio holdings of the Fund – with surprisingly little offset.

Thus, a confluence of happenings seems to have knocked the Fund for a decent price decline in just three months time. However, my entire net worth resides alongside your investment in the Fund, and I neither bemoan these recent short-run declines nor fear long-term impairment of my net worth. On the contrary, I am enthused that the market is offering up values on a scale not seen previously during the Fund's existence. Moreover, the Fund holds significant cash and sources of cash to put to work in such an environment.

Policy Matters

The minimum initial investment for new members is $250,000, and the next investment period starts January 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 call me first.

Attorneys have updated the offering memorandum and operating agreement of the Fund in order to adjust the minimum investment from $100,000 to $250,000. As well, the documents were amended to provide more clarity on expenses. While certain powers and expenses were clarified, no additional expenses or powers were awarded to Scion Capital. Updated versions of these documents are enclosed with this quarterly report. Please file them for future reference.

I continue to maintain the vast majority of my net worth, and the whole of my family's investment account, in the Fund. And I continue to earn a paycheck only if I achieve a return on your capital in excess of the hurdle rate. My interests remain very much aligned with yours.

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

Scion Value Fund, A Series of Scion Funds, LLC

January 6, 2002

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%

[1]Inception November 1, 2000
[2]Return before 20% performance allocation and expenses
[3]Return after 20% performance allocation and expenses
[4]Including 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 <u>any</u> 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

A Primer on Scion Capital's Subprime Mortgage Short
November 7, 2006

Subprime mortgages, typically defined as those issued to borrowers with low credit scores, make up roughly the riskiest one third of all mortgages. The vast majority of these mortgages fall well within the loan size limits set by Fannie Mae and Freddie Mac, but are not deemed eligible for purchase by these two mortgage giants for other reasons. That is, they are non-conforming. For these non-conforming subprime mortgages, the originator can certainly choose to hold onto the mortgage and retain credit risk in exchange for the interest payments. Alternatively, the originator can sell subprime mortgages into the secondary market for mortgages. This secondary market is vast and deep thanks to the invention of mortgage-backed securitizations back in the 1970s.

In a securitization, a finance company buys up mortgages from the original lenders and aggregates these mortgages into large pools, which are then dumped into a trust structure. Each trust is divided into a set of tranches, and each tranche is defined and rated by the degree of subordination protecting the tranche's principal from loss. The tranches are then sold in the cash market to fixed income investors by a placement agent -- typically a well-known securities dealer. The lower-rated tranches may not be offered to investors, but may be retained by the finance company. Too, the dealer placing the securities with investors may choose to purchase some of these securities for its own account, either as an investment decision or to help ensure a full sale of the deal. At the time of the creation of the trust, a servicer, also rated by the agencies, is hired to administer the mortgages within the trust. The trustee will manage the trust and all relations with investors, including monthly reports. The month's end is typically the 25th.

For instance, we can take a look at PPSI 2005-WLL1, an early 2005 mortgage deal.

Tranche	Description	Moodys	S&P	Fitch	Principal
A-1A	Senior Float	Aaa	AAA	AAA	600,936,000.00
A-1B	Senior Float	Aaa	AAA	AAA	66,769,000.00
M1	Mezzanine Float	Aa1	AA+	AA+	29,049,000.00
M2	Mezzanine Float	Aa2	AA	AA	26,524,000.00
M3	Mezzanine Float	Aa3	AA-	AA-	16,419,000.00
M4	Mezzanine Float	A1	A+	A+	14,314,000.00
M5	Mezzanine Float	A2	A	A	13,472,000.00
M6	Mezzanine Float - NO	A3	A-	A-	13,051,000.00
M7	Mezzanine Float - NO	Baa1	BBB+	BBB+	10,946,000.00
M8	Mezzanine Float - NO	Baa2	BBB	BBB	10,525,000.00
M9	Mezzanine Float - NO	Baa3	BBB-	BBB-	5,894,000.00
M10	Mezzanine Float - NO	Ba1	BB+	BB+	6,315,000.00
M11	Junior Float - NO	Ba2	BB	BB	8,420,000.00
CE	Junior OC Reserve - NO				19,365,046.51

Here, it happens that Argent Mortgage Company and Olympus Mortgage Company separately originated a set of subprime mortgages, and each sold these mortgages to Ameriquest Mortgage Company. Ameriquest, which will be the seller in this deal, deposited these mortgages with a wholly owned subsidiary, Park Place Securities

Incorporated – PPSI. Park Place is therefore the depositor. Park Place refashioned this pool of mortgages into a trust, with Wells Fargo Bank being the trustee and Litton Loan Servicing being the servicer as set out in the Pooling and Servicing Agreement, or PSA. The Seller hired Merrill Lynch as the placement agent to sell the deal to investors. Those tranches designated "NO" were not offered to investors but rather retained by Ameriquest for other purposes. An investor buying a tranche will receive LIBOR plus a fixed spread that correlates with the tranche's rating and perceived safety.

Note the senior tranches, designated A-1A and A-1B, make up 79% of this particular subprime pool. That is, these senior tranches can count on credit support amounting to 21% of the pool as well as any additional credit support that builds up during the life of these tranches. If the pool experiences write-downs in excess of the credit support for the senior tranches, then the senior tranches will suffer erosion of their principal. This is deemed extremely unlikely by the ratings agencies, and these senior tranches therefore garner the AAA rating.

The mezzanine tranches in this pool include all those tranches that are rated, but not rated AAA. For the lowest rated tranche – M11 in this particular pool - credit support is just 2.3% at origination. Baa3, or equivalently BBB-, is considered the lowest "investment grade" rating, and the lowest investment grade tranche in this PPSI deal is M9, which had 4.05% in credit support at origination. Note the M9 tranche is just under $6 million in size, less than 1% of the original deal size -- these are tiny slices of a large risk pool. Still, the ratings agencies say each tranche is worthy of a difference in the rating due to the historically very low rate at which residential mortgages actually default and produce losses. Because home prices have been rising so steadily for so long, troubled homeowners have been able to refinance, take cash out, and often reduce the monthly mortgage payment simultaneously. This has had the effect of reducing the rate of foreclosures. Also because of rising home prices, foreclosures have not resulted in enough losses to counteract the credit support underlying mortgage-backed securities. To be perfectly clear, write-downs occur when realized losses on mortgages within the pool overwhelm the credit support for a given tranche.

Credit support is therefore a key feature worthy of more attention. A tranche will not experience losses if any credit support for the tranche still exists. In addition to the structural subordination that contributes the bulk of credit support, finance companies build in overcollateralization – essentially, throwing more loans into the pool than necessary to meet the payment obligations of the pool – and the trust itself can engage in derivatives transactions to insure the pool against loss. An example might be an interest rate swap that produces excess cash for the pool as rates rise. Over the first couple of years, which are typically relatively problem-free for mortgages, one already normally sees an increase in credit support for all tranches. In an era of hysteria over a home price bubble, one would expect that the organizer of a new mortgage pool would include or extend use of these extra protections to help further bolster the credit support for the pool's tranches. As 2005 came to a close, this is exactly what happened, and this is why I find many more recent deals much less attractive from a short's perspective than mid-2005 deals.

As is always the case, timing is therefore important for an investor short-selling tranches of mortgage-backed securities. Catching a peak in home prices before it is generally recognized to be a peak would be critical to maximizing the chances for success.

Now, because the more subordinate tranches are so wafer thin, they are typically placed with either a single investor or very few investors. Securing a borrow on such tightly held subordinate tranches would be difficult, and as a result shorting these tranches directly is not terribly practical. A derivative method was needed - enter credit default swaps on asset-backed securities.

Credit default swap contracts on asset-backed securitizations have several features not common in other forms of swap contracts. One feature is cash settlement. Again, examining PPSI 2005-WLL1 M9 - the BBB- tranche - we see it has a size of $5,894,000. Because credit default swaps on mortgage-backed securities are cash-settle contracts, the size of the tranche does not limit the amount of credit default swaps that can be written on the tranche, nor does it impair ultimate settlement of the contract in the event of default. By cash-settle, I mean that the tranche itself need not be physically delivered to the counterparty in order to collect payment. An investor with a short view may therefore confidently buy more than $5,894,000 in credit default swap protection on this tranche.

As well, these credit default swap protection contracts are pay-as-you-go. This means the owner of protection on a given tranche need not hand over the contract before full payment is received, even across trustee reporting periods. For instance, if only 50% of the PPSI 2005-WLL1 M9 tranche is written down in the first month, the owner of $10,000,000 in protection would collect $5,000,000 and would not need to forfeit the contract to do so. If in the second month the remaining 50% is written down, the owner of protection would collect the remaining $5,000,000.

A mortgage-backed securitization is of course a dynamic entity, and a short investor must monitor many different factors in addition to the aforementioned credit support. For instance, as a mortgage pool matures, mortgages are refinanced and prepaid, and the principal value of mortgages in the pool declines. Prepayments reduce principal in the senior tranches first. Generally, the idea is that investors in subordinate tranches should not get capital returned until the senior tranches are paid off. There are some minor exceptions, but this is generally true. For instance, today, the current face value of the AAA tranches in PPSI 2005-WLL1, which was issued in March of 2005, is roughly $243,691,000 versus the original face value of $667,705,000 due to a high rate of refinancing. Those who can refinance will. Our focus is on those who cannot.

For those who cannot, some mortgages will go bad. Lenders tend to consider loans delinquent for roughly 90 days of missed payments, and then the foreclosure process looms. Typically within 90 days but occasionally up to 180 days after foreclosure, the real estate underlying the bad mortgage is sold. If the proceeds cannot pay off the mortgage, a loss is realized. If the cash being generated by the mortgage pool cannot cover the degree of losses, the mortgage pool takes a loss. This is applied to the most subordinate tranche first.

Most of these subprime mortgage pools will likely see maximum foreclosures a little over two years into the life of the pool. The reason is that most subprime mortgages included in these pools – typically 80% of the mortgages in the pools – are adjustable rate mortgages. As a result, the mortgage pool will experience its most significant stress when the initial teaser rate period ends on its set of adjustable rate mortgages. Generally, this period ends on average 20-24 months from the date of issuance of the mortgage pool.

Since the Funds shorted mortgage pools mostly originated in spring through late summer 2005, I expect the pools shorted will see maximum stress during the latter half of 2007. No one shorting these tranches would expect to see a payoff during the first year of holding the short and likely not even during the second year. In fact, the apparent credit support under each rated tranche will grow during the first year or two. If the thesis plays out as originally contemplated, the reduction in credit support and ultimately the payouts on credit default swaps would come shortly after the mortgage pools face their peak stress, or roughly 2-2.5 years after deal issuance.

In the interim, the value of these credit default swap contracts should fluctuate. In a worsening residential housing pricing environment, and with poor mortgage performance in the pools, one would expect that protection purchased on tranches closer to peak stress would garner higher prices, provided that home prices have not appreciated significantly during the interim. As well, credit protection purchased on tranches more likely to default should garner higher prices. I would note that during the summer of 2005, national residential home prices in the United States peaked along with the easiest credit provided to mortgage borrowers in the history of the nation. Recent year over year price declines have not been seen since the Great Depression.

With that in mind, let us examine how the tranches I selected as shorts are performing relative to the other 2005-vintage deals. The data in this table was compiled by a third party data provider. This provider captures approximately 80% of all 2005 home equity deals in its database, which is up to date through August.

Percentages	Bankrupt	Foreclosed	Real Estate Owned	Total
Loans in Scion 2005 Deals	1.04	3.48	1.32	5.83
Loans in All Subprime 2005 Home Equity Deals	0.56	2.94	0.75	4.25
Loans in All 2005 Home Equity Deals	0.28	1.48	0.38	2.14

I do believe trends such as these validate the proprietary criteria upon which I selected the pools for the mortgage short portfolio. While these numbers seem low, the Funds shorted the more subordinate tranches within these pools specifically so that the short position would not be dependent on the Armageddon scenario for U.S. residential housing.

Fundamental developments, however, do not necessarily play into pricing of these credit default swaps while we await peak defaults because most off-the-run deals simply do not have an active market. So, how exactly are the values of the Funds' positions priced during this time? In a nutshell, our counterparties set the values. The seller of credit default swap protection is the buyer's counterparty, and vice versa. The Funds have six counterparties from which credit protection on subordinated tranches of mortgage-backed securities has been purchased. The creditworthiness of our counterparties is an integral part of the investment thesis. We have chosen counterparties that are among the largest banks and securities houses in the world, and we have negotiated ISDAs with each of these counterparties. ISDA stands for International Swap Dealer Association, and an ISDA is the common term for the contract governing the dealings between counterparties to a swap transaction.

Importantly, we negotiated ISDA contracts that give us the right to collateral should our swap positions move in our favor. To the extent the Funds see the values of our swap positions move the other way, the Funds send collateral to our counterparties covering the decline in value of the positions. This mechanism protects each counterparty in the event of a default by the counterparty on the other side. The dealer counterparties are the marking agents for the Funds' positions, and therefore the values set by these dealer counterparties determines how the collateral flows on a daily basis.

Scion Capital has been using these same counterparty-assigned contract values that we use for collateral purposes to determine the net asset value of the Funds. The value of credit default swaps on subprime mortgage-backed securities is a calculation involving certain assumptions. For any buyer of protection to have confidence in the value assigned to his positions, he must have confidence in the methodologies behind the pricing data provided by his dealer counterparties. The pricing data we receive from our counterparties is often very old or stale-dated. These prices are sometimes tied to movements in the on-the-run index products, which contain neither any of our deals nor any deals remotely similar to our deals- almost all of which are off-the-run. We have found the methodologies to be frankly inconsistent. In the absence of confidence in counterparty marks, a third party may be considered, but today there is no sufficient third party marking agent for credit default swaps on mortgage-backed securities. Some may rather use a mathematical model to price the portfolio, but Scion Capital does not price its portfolio securities to models.

The Funds currently carry credit default swaps on subprime mortgage-backed securities amounting to $1.687 billion in notional value. As I selected these, I was not looking to set up a diversified portfolio of shorts. Our shorts will have common characteristics that I deemed to be predictive of foreclosure, and therefore they should be highly correlated with each other in terms of both the timing and the degree of ultimate performance. Again, ultimate performance matters much more than the valuation marks accorded us by our counterparties in the interim. In the worst case, I expect our mortgage short will fully amortize to nil value over the next three years, corresponding to an average annual cost of carry over that time of roughly six percent of current assets under management. Calibrating the more positive outcomes will become easier as 2007 progresses.

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

RMBS CDS & Side Pockets - Some Good Questions

November 7, 2006

Can't the servicers manipulate these pools? Don't they advance interest? Generally, servicers may advance interest payments to the pool when a mortgage goes delinquent. Once a mortgage is foreclosed upon, the servicer's advance is typically billed to the mortgage pool. Servicers are themselves rated and in my view would have little incentive to refuse to foreclose upon mortgages or delay sales of real estate during a time of declining home prices. Recent data has implied that servicers have been more willing to take bigger losses on mortgages as national home price levels weaken. As far as deciding when a tranche should be written down, this duty is left to the trustee rather than the servicer. It is the trustee, not the servicer, which administers cash flows to investors within the trust.

Can't the manager of the mortgage pool replace bad loans with good ones? For reasons of fraud and similar concerns, it is often the case that a bad loan may be replaced during the first six months to one year of a trust's existence. Nearly all our shorts involve deals for which this period is past. To the extent such replacement of fraudulent loans happened, it was disclosed in servicer reports, and it was not significant.

What is loss severity? Loss severity is the average percentage loss realized on mortgages during the trustee reporting period. Losses on mortgages are realized when the underlying foreclosed real estate is sold, but proceeds cannot fully repay the mortgage.

What is the deal with the step-down at three years? Is this a concern? This is a somewhat complex mechanism built into most mortgage pools that allows for the senior tranches to be repaid relatively quickly if the pool is performing poorly and to be paid down more slowly if the pool is performing very well. The 37^{th} month is a frequent date for this mechanism to kick in. Given the subordinated status of the tranches we are short and the accelerated deterioration of these pools, this mechanism would appear to be not very relevant to our position.

What is interest rate swap protection and is it relevant? In the earlier years of a mortgage pool, income is relatively fixed, while the payout to investors in the pool floats based on LIBOR. Rising rates may cause payouts to exceed income, causing a mismatch. At the time the mortgage pool is structured, the seller may purchase an interest rate swap that itself is profitable in the event of higher interest rates so as to mitigate risk of a mismatch. These swaps typically have a fixed term. This is relevant. Not all pools have this feature, and all else equal pools with this feature tend to be less interesting as shorts.

How is your portfolio of mortgage shorts split by rating? On a notional basis, 41.6% and 49.8% of our shorts are on BBB- and BBB tranches, respectively. The remaining are A-rated tranches.

Is PPSI 2005-WLL1 representative of the rest of the portfolio? No. This is an example, and it is not meant to be representative. For instance, many pools do not have a credit enhancement, certificate of equity, or CE, tranche, like PPSI 2005-WLL1 does. Commonly, there is an overcollateralization layer that is not specifically set out as a tranche.

Do you really believe the dealers are colluding to mark your book low? No. I believe the dealers are acting in their best interests, but I have no evidence of collusion of any kind. I do not believe our counterparties best interests are necessarily aligned with the Funds' best interests, and I feel it is the better part of prudence to maintain that opinion. I generally feel people follow the incentives before them.

Why did you ever allow the counterparties to mark your books? I have not been aware of a better alternative. I have been wary of the conflicts of interest that would arise should we set foot on the slippery slope that is marking our own book.

Do your concerns with day-to-day valuation affect the enforceability of the CDS contract in the event the underlying tranche experiences write-downs? No. These are cash-settle, pay-as-you-go contracts backed by the full credit of our counterparty. When the trustee reports a tranche has had write-downs, we will have the contractual right to payment from our counterparty. There will be no assumptions involved, and valuation will not be a factor.

How will you mitigate losses if it doesn't work out like you think? Should I detect a reason for the Funds to exit some or all of these positions, I will seek out ways in which to liquidate the positions. I am hopeful that our careful monitoring of the Funds' positions will lend us the insights necessary to mitigate losses should the need arise.

What is the longest these credit default swaps on mortgage-backed securities can be in force? The stated life of each swap contract is technically 30 years. Practically however, prepayment speeds have determined the lifespan, or duration, of mortgage pools for nearly the entire history of the market in mortgage-backed securitizations. Most dealers estimate the life of the mortgage pools containing the tranches underlying the swaps in our portfolio at 2-3 years.

Isn't there an active market in CDOs? We do not invest in either cash CDOs or synthetic CDOs. The cash residential mortgage-backed securities, or RMBS, market is also very large, but we do not participate in this market. The securities we have invested in are credit default swaps, also known as CDS.

Do synthetic CDOs do the same thing as Scion? No. Synthetic CDOs are roughly similar in architecture to the PPSI example above, but with credit default swaps on specific corporate names or on specific asset-backed securities substituting for mortgages. Buyers of these swaps then provide the cash flows that will support the synthetic CDO. Generally, buyers of synthetic CDO securities go long a credit while the buyers of the swaps are going short the credit. Most of the supply of credit default swaps in 2006 is tightly linked to the issuance of new synthetic CDOs.

What is the ABX Index? An ABX index is an index of credit default swaps on mortgage-backed securities. There are multiple ABX indices, each defined by a vintage and an average credit rating. The first ABX index was launched in early 2006, and the structure of the index bears very little resemblance to the Funds' portfolio of mortgage shorts. I do not view any such index as a good proxy for the Funds' positions.

What are the other side pockets again? Why do the side pockets fluctuate in value a bit? From the perspective of an investor, the number and level of side pockets will depend on the timing of the investor's capital additions to the Funds. The other side pockets are Livedoor, Blue Ocean Re, and Symetra. All continue to be represented at cost. Any variation in side pocket value today comes from the fact that the Livedoor position is held in Japanese yen, while we report in dollars. This leaves that position exposed to foreign exchange movements. Additionally, side pockets may appear to loom larger when assets under management have fallen.

If you side pocket these and you get a lot of withdrawals, are the remaining investors stuck with very large positions in these side pockets? No. The nature of a side pocket is that exiting investors retain their portion of the side pocket. As a result, the remaining investors see no increase in concentration in the side pocketed position.

Will you allow investors transparency into all the different positions in the mortgage CDS side pocket? I hold no plans to offer transparency into these positions, nor do I expect to compromise the opportunity to trade out of these positions at opportune times.

Why are you not side pocketing the corporate CDS positions? Although we hold off-the-run single name corporate credit default swaps that I do not find to be very liquid, there is a bona fide and adequate market in corporate credit default swaps. A side pocket is not necessary.

How big is the corporate CDS portfolio? As of the end of October, single name corporate CDS amount to 3.27% and 3.55% of assets under management in the Scion Value Fund and the Scion Qualified Value Fund, respectively. The duration of this portfolio is roughly 3.5 years. These credit protection contracts cover $4.27 billion in notional value, largely focused on financial companies. A number of these companies are engaged in the mortgage business.