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Margin of Safety Fund Limited

Chairman's report and financial statements

Year ended **31 December 1998**

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Margin of Safety Fund Limited

Financial statements

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Margin of Safety Fund Limited

Management and administration

Directors	Franklin Craig John Mills Philip Boylan
Auditor	KPMG Chartered Accountants 5 George's Dock IFSC Dublin 1 Ireland
Secretary and registered office	Midocean Management and Trust Services (BVI) Limited 9 Columbus Centre Pelican Town Road Drive Tortola British Virgin Islands
Custodian and bankers	Fortis Bank Luxembourg S. A. 12-16 Avenue Monterey L-2163 Luxembourg
Investment manager	MS Investment Management Limited 9 Columbus Centre Pelican Drive Road Town Tortola British Virgin Islands
Investment Advisor	Pastel et Associes S.A. 116 Champs Elysees 75008 Paris France
Accounting administrator	Business Management Services Limited ("BMS") 35 Wicklow Street Dublin 2 Ireland

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Chairman's report to the shareholders of Margin of Safety Fund Limited

This report will be comprised of three parts:

- a review with comments of the investment actions made in 1998
- an overview of the portfolio and of its financial performance at year end
- our outlook for 1999.

Our investment philosophy is based on the premise that in order to achieve superior long term returns, investors should focus on the intrinsic value of the businesses they invest in, in relation to their underlying economic characteristics and pay no attention to, nor make decisions based on fluctuations in the financial markets. As a result our report does not include any comment or forecast with respect to the general market or the economy.

I. Review of the investment actions made in 1998

The fund started its operations in early February. Its purpose has been, since inception, to place investors' monies in listed securities, primarily equities according to a **proprietary value based methodology**.

To honor this commitment in the heated financial markets of the first half of 1998 was not an easy matter. The difficulty we faced in discharging our obligations to the Fund was compounded by the specific nature of our methodology. Not only do we demand "good value" from our investments but we also require "quality". In other words, we, generally, only buy securities when the underlying business is sound and profitable, managed by able and honest people, and available at a price that we consider to be a bargain. As very few stocks met these criteria in 1998, the combined task of identifying these companies, researching and then buying into them kept us busy for most of the year.

As the year went by, we managed to gradually invest close to 89% of the monies available to the Fund. While the securities we selected belonged to a number of industries, they however all shared some common features (see part II).

All the securities purchased were acquired at average prices reflecting significant discounts to their intrinsic value. For some of them (McDonald's, and Gucci), the gap between the market price and the intrinsic value narrowed as the year went by. For others, like Premier Farnell, Carpetright, DFS, and Manpower, the discount widened quite significantly after we made our first purchase, leading us to increase our holdings in such stocks in order to take advantage of what we considered to be irrationally low levels of valuation. We would like to stress that, in keeping with the long term investment approach that we promote, **no sale of securities was made in 1998** as we are not in the business of chasing short term/small scale trading profits.

The table below describes the Fund's dealings during the year. For each position present in the portfolio, we indicated the quarter during which we started purchasing the stock.

	Securities	Cash ratio (%)
First quarter	Gucci, McDonald's, Nike, Premier Farnell	56%
Second quarter	DFS Furniture, Manpower, Thermador	35%
Third quarter	Arrow Electronics, Seb	13%
Fourth quarter	No new addition	11%

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Chairman's report to the shareholders of Margin of Safety Fund Limited

(continued)

II. Overview of the portfolio and of its financial performance at year end

A) Overview of the portfolio

At year end the portfolio had the following structure:

Arrow Electronics :	7.9%
DFS Furniture :	8.7%
Gucci :	11.3%
Manpower :	10.5%
McDonald's :	17.9%
Nike :	16.0%
Premier Farnell :	7.2%
Securities representing less than 5% of the NAV:	9.5%
Cash & cash equivalents :	11.0%

The cash ratio shown excludes the effect of new subscriptions.

Hereunder some of the reasons supporting the decision to purchase significant amounts of the stocks comprising the major positions in the portfolio are discussed briefly:

- **Arrow Electronics:**
  1. a world leader in volume distribution of electronic components to industrial users.
  2. a key position in a fast growing industry. The increasing emphasis placed on supply chain management makes players like Arrow extremely valuable to both suppliers and buyers of parts.
  3. one of the lowest cost structures in the industry.

- **DFS Furniture:**
  1. a leadership (12% of the market) in sofa retailing in the UK, providing it with a commanding position vis-à-vis its suppliers.
  2. a very balanced and gradual expansion strategy characterized by the opening, every year, of a small number of stores and a clear distaste for external growth.

- **Gucci:**
  1. a well recognized brand supported by production, marketing and controlled distribution systems that helped reinforce its value.
  2. an expansion strategy that kept being implemented despite the hard times facing the company's markets.

Chairman's report to the shareholders of Margin of Safety Fund Limited

(continued)

- **McDonald's:**
  1. a world leadership, giving the group an edge in purchasing terms and franchisee recruitment.
  2. a very powerful brand, supported by a controlled distribution system keeping competitors at bay, as long as its well known standards of quality and value were maintained.
  3. a multinational business where the US component seemed to be on the mend after a few years of turmoil because of the loosening of the Company's standards of quality and value.

- **Manpower:**
  1. a leading provider of temporary staffing allowing it to take advantage of the trend for increased workforce flexibility as the traditional bonds between corporations and their employees have been steadily weakening.
  2. a global and growing network of profitable branches providing the group with a proven resilience to depressed markets.

- **Nike:**
  1. a well recognized brand supported by a marketing system based on an entrenched and powerful position in the world of US sports (relationships with schools, coaches, etc.).
  2. a share of the athletic footwear market greater than 40% in the US, that tilted in its favor the relationship with the retailers.
  3. an international expansion in the making: more than two thirds of its sales still coming from the US.

- **Premier Farnell:**
  1. a world leading position in electronic components distribution through catalogues.
  2. a business to business franchise that we considered to have been only slightly damaged by a CEO that the board had to let go.
  3. a growing world market that the new management team is committed to take advantage of through, preferably, internal growth.

In addition to the features briefly described here, all of these companies have two more things in common. They all throw out tremendous amounts of free cash flow year after year, with a rate of return on capital employed greater than 20% on average. Moreover, they all benefit from either a board or a management whose interests are aligned with those of minority shareholders.

B) Performance

From inception on February 2, 1998 to December, 31, 1998, the Fund's NAV has risen by +2.52 %, net of all provisions for fees and expenses. Over the same time period, the absolute annualized benchmark of 15% we attempt to outperform on a three to five year horizon would have returned 13.67%.

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Chairman's report to the shareholders of Margin of Safety Fund Limited

(continued)

III. Outlook for 1999

Again, we won't indulge, here, in making market or economic forecasts, as we do not consider these to be either reliable or useful with regard to our investment process. However, what we feel confident enough to say is that for nearly a year, **large, well managed and consistently profitable companies have been selling in the stock market, at prices that we consider to be outrageously high**. This phenomenon is currently at work in all the major markets we have been following, that is the North American, British, and continental European markets.

Nonetheless, at the same time, and for reasons we won't dwell on herein, **stocks of small to medium companies have been trading at very low valuation levels, irrespective of the quality of the underlying companies concerned.**

We therefore believe that a significant repricing is likely to occur, either through a decline in the stock prices of large multinational corporations, through an appreciation in small to medium stocks', or through both. This is as far as we can go in order to provide our readers with some sort of market guidance. However, we have no insight as to when this so-called repricing might take place.

Barring any major economic disturbances, we expect that in 1999 our companies will continue to improve their profitability as well as their market dominance. Achieving these goals, year after year, should, ultimately, result in significant capital gains for the Fund and its investors.

Franklin Craig
Chairman

3 March, 1999

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Chartered Accountants

5 George's Dock
IFSC
Dublin 1
Ireland

Auditors' report to the shareholders of Margin of Safety Fund Limited

We have audited the accompanying statement of net assets of Margin of Safety Fund Limited as of December 31, 1998 and the related income statement, statements of changes in shareholders' equity and cashflows for the period ended December 31, 1998. These financial statements are the responsibility of the Fund's directors. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the directors, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, these financial statements present fairly, in all material respects, the financial position of Margin of Safety Fund Limited as of December 31, 1998 and the results of its operations and changes in its shareholders' equity for the period then ended in accordance with International Accounting Standards.

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Registered auditors
Chartered Accountants

6 April 1999

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Margin of Safety Fund Limited

Statement of net assets

as at December 31, 1998

	Note	December 31, 1998 US$
Assets		
Investments	*4*	**12,757,238**
Cash at bank		**2,491,563**
Accrued dividends		**4,473**
Deferred formation expenses		**30,243**
Total assets		**15,283,517**
Liabilities		
Subscriptions received		**1,000,000**
Unsettled trades		**637,534**
Management fees due	*3*	**40,768**
Accruals		**13,383**
Incentive fees due		**1,009**
Total liabilities		**1,692,694**
Net assets		**13,590,823**
Shareholders' equity		
Class 'A' preference shares 13,256.79 of US$0.01 each issued and fully paid up		**133**
Share premium		**13,281,852**
Retained earnings		**308,838**
Total shareholders' equity		**13,590,823**

The notes on pages 13 to 15 are an integral part of the financial statements.

On behalf of the board

John Mills
Director

Philip Boylan
Director

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Margin of Safety Fund Limited

Income statement

for the period ended December 31, 1998

	Note	December 31, 1998 US$
Income		
Deposit interest		**208,252**
Dividend income		**189,912**
Unrealised gain on investments		**90,729**
Realised gain on investments		**1,526**
		490,419
Operating expenses		
Management fee	*3*	**148,532**
Incentive fee	*3*	**1,009**
Custody fees		**8,990**
Accounting and administration fees		**17,552**
Operating expenses		**2,061**
Formation expenses amortised		**6,787**
Audit fees		**6,000**
Foreign exchange gain		**(9,350)**
		181,581
Net income for the period being retained earnings at end of period		**308,838**

The notes on pages 13 to 15 are an integral part of the financial statements.

Margin of Safety Fund Limited

Statement of changes in shareholders' equity
for the period ended December 31, 1998

	December 31, 1998 US$
Shareholders' equity - beginning of year	**-**
Shares issued during the year	**13,281,985**
Shares redeemed during the year	**-**
Capital	**13,281,985**
Net income for the year	**308,838**
Shareholders' equity - end of year	**13,590,823**
Outstanding class 'A' preference shares	**13,256.79**
Net asset value per share at end of year	**1,025.20**

The notes on pages 11 to 14 are an integral part of the financial statements.

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Margin of Safety Fund Limited

Statement of cashflows

for the period ended December 31, 1998

	December 31, 1998 US$
Cash flow from operating activities	
Net income for the period	308,838
Adjustment for:	
Unrealised gain on investments	(90,729)
Realised gain on investments	(1,526)
Formation expenses amortised	6,787
Add/(deduct)	
Purchase of investments	(12,051,570)
Proceeds from sale of investments	24,121
Increase in accrued dividends	(4,473)
Formation expenses incurred	(37,030)
Increase in management fees due	40,768
Increase in accruals	13,383
Increase in incentive fees due	1,009
Net cash from operating activities	(11,790,422)
Cash flow from financing activities	
Proceeds from the issue of share capital	14,281,985
Increase in cash and cash equivalents being cash and cash equivalents at the end of the year	2,491,563

Margin of Safety Fund Limited

Schedule of Investments
as at December 31, 1998

Quantity or principal	Description	Market value (US$)	% of total assets
Equities (all listed)			
33,920	Gucci (US$)	1,649,360	10.79%
34,170	McDonalds (US$)	2,624,683	17.17%
57,720	Nike Inc - B Shares (US$)	2,341,268	15.32%
370,700	Premier Farnell (GBP)	977,582	6.40%
379,533	DFS Furniture Company (GBP)	1,190,315	7.78%
60,700	Manpower Inc (US$)	1,528,881	10%
43,350	Arrow Electronics (US$)	1,156,903	7.57%
170,485	Other (FRF and GBP)	1,288,246	8.42%
		12,757,238	83.45%
	Other assets	2,526,279	16.55%
		15,283,517	100%

Margin of Safety Fund Limited

Notes
forming part of the financial statements

1 Organisation and nature of business

Margin of Safety Fund Limited ("the Company"), a limited liability company, was incorporated as an international business company on 19 January 1998 under the laws of the British Virgin Islands.

The company was established to achieve capital appreciation through investments primarily in equity securities.

2 Summary of significant accounting policies

These financial statements are prepared in accordance with International Accounting Standards and are expressed in United States dollars, "US$".

Use of estimates
The preparation of the financial statements in conformity with International Accounting Standards requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from these estimates.

Investments
Investments are valued at last sale price on the date of valuation.

Unrealised gains or losses on investments represents the annual appreciation or depreciation in the holdings of those investments. Any movements in unrealised gains and losses are recorded in the income statement. Losses realised on original cost are recorded in the income statement in the period of sale.

Income taxes
Under current British Virgin Islands legislation, the fund is not subject to income tax.

Margin of Safety Fund Limited

Notes *(continued)*

2 Summary of significant accounting policies *(continued)*

Income
Dividends, net of foreign withholding taxes, where applicable, are included as income when the security is declared to be ex-dividend. Interest is recorded on the accruals basis.

Foreign currency
Assets and liabilities denominated in foreign currencies are translated into United States dollars at exchange rates prevailing at the period and date. Transactions in foreign currencies are translated at the rate ruling on the date of the transaction. Gains and losses on foreign currency translation are included in the income statement as part of the net realised and unrealised gain/(loss) on investment.

Formation expenses
Formation expenses are amortised over 5 years.

3 Incentive and management fees, administrative and custodian fees

The Fund's investment manager is MS Investment Management Limited (the "Manager"), a company licensed in the British Virgin Islands. The manager receives a monthly fixed fee of 1.25% per annum of the net assets of the Class 'A' preference shares. The manager also receives a performance fee of 20% of the annual increase in the aggregate net asset value of class 'A' preference shares over a 15% annual benchmark as defined in the prospectus. The management fee for the year amounted to US$148,532 and the incentive fee to US$1,009. Management fees payable at year end were US$40,768 and incentive fees payable were US$1,009.

The accounting administrator is paid a fixed fee of 0.15% p.a. on the aggregate net asset value of the fund per Class 'A' preference shares subject to a minimum of US$16,000. The custodian is paid a fixed fee of 0.1% pa on the average aggregate assets of the Class 'A' preference shares held over the dealing period by the custodian.

4 Investments

Investments held at year end are valued at US$12,757,238 compared with a cost of US$12,666,509. Investments are comprised of equities. (See schedule of investments)

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Margin of Safety Fund Limited

Notes *(continued)*

5 Shareholders' equity

Investments in the Fund are made monthly by subscription agreement subject to acceptance by the Fund, at the net asset value per share at the end of the month. A shareholder may request and receive redemption of Class "A" preference shares on any dealing day upon 15 days notice.

	1998
Authorised	**US$**
1,000,000 ordinary shares of US$0.01 each	**10,000**
1,000,000 preference 'A' shares of US$0.01 each	**10,000**
1,000,000 preference 'B' shares of US$0.01 each	**10,000**
1,000,000 preference 'C' shares of US$0.01 each	**10,000**
	40,000
Issued and fully paid up	
2 ordinary shares	**-**
13,256.79 Class 'A' preference shares	**133**
	133
Share premium	
Class A preference shares	**13,281,852**

Ordinary shares carry the right to vote and will participate upon a winding up of the company only in the surplus remaining after the payment to the preference shareholders and only to the extent of the par value of the ordinary shares.

Preference shareholders shall in the event of a winding up of the company, have a preferred claim in respect of the assets of the company and shall have divided between them the surplus remaining after the payment to the ordinary shareholders. Preference shareholders have restricted voting rights.

Margin of Safety Fund Limited

Notes *(continued)*

6 Fair values and financial instruments

Substantially all of the Company's financial instruments are carried at market value or at amounts which, because of their short-term nature, approximate current fair value.

Fair value estimates are made at a specific point in time, based on market conditions and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgement and therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Credit risk is the risk that one party to a financial instrument will fail to discharge on obligation and cause the other party to incur financial loss. The company invests mainly in blue chip equities. Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The company invests in denominations of US dollars, Sterling pounds and French francs. However, whilst using its best endeavours to attain the investment objective as stated in note 1, the Board of directors cannot guarantee the extent to which this objective can be achieved. The investments of the fund are subject to normal market fluctuations and other inherent risks and there can be no assurance than any appreciation in value will occur.

7 Related party transactions

One of the directors of the company is a partner in an international law firm who were retained in the formation of the company. Legal fees of US$25,000 incurred in the formation of the company were paid to the law firm.

The accounting administrator has a director in common with the Company. Details of fees paid are disclosed in note 3.

The investment adviser, Pastel et Associes S. A., holds 113 shares in the Company.

No further material contracts or contracts for provisions of services existed during the period under review to which the Company is a party and in which any director was materially interested.

8 Year 2000

The directors have begun the process of assessing the potential impact of the Year 2000 issue on the operations of the company. The objective of the process is to ensure that the Company's operations will not be adversely affected by Year 2000 issues. The directors do not believe that the costs the Company will incur to remedy Year 2000 issues will be significant.

9 Approval of financial statements

The board of directors approved these financial statements on 3 March, 1999.