Outstanding Investor Digest

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

Volume VII Numbers 3 & 4 April 16, 1992

Investors featured in this Issue:

Other Investors in this Issue:

Companies & Investments in this Issue

OID POTPOURRI: JULIAN ROBERTSON ON CHINA, WARREN BUFFETT, ET AL. ON SALOMON & MORE.... (YET ANOTHER) DOUBLE ISSUE

We're pleased to bring you the following assortment of relatively unrelated materials for your reading enjoyment. We highly recommend you read — and, in a couple of cases, re-read — each of these pieces.

First, we're pleased to bring you a perspective on China and Hong Kong by Tiger Management's John Griffin. Second, the thoughts of Buffett, Maughan et al. on Salomon from a special meeting held earlier this year. Last but not least,

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BRANDES INVESTMENT MANAGEMENT'S CHARLES BRANDES & GLENN CARLSON "WE'RE STILL FINDING A FEW BARGAINS IN THE U.S, BUT THERE ARE LOTS OF EXCITING INTERNATIONAL IDEAS."

Clients of Brandes Investment Management and founder Charles Brandes have earned a compound annual return of 19.1% after all fees and expenses for the 14 calendar years ended 12/31/91 — well above the 16.1% of the S&P 500 — despite being loaded with international and small cap stocks.

Interestingly, however, Brandes' international stocks substantially outperformed his overall portfolio — earning an estimated compound annual return of 24.2% vs. 14.9% for

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FPA PARAMOUNT'S BILL SAMS "THINGS LOOK VERY BAD IN ENERGY. THERE'S NO HOPE. THAT'S WHY I'M IN IT SO HEAVILY...."

Bill Sams' name isn't a household word among investors — partially because he divided his career between two funds and partially because he enjoys his low profile.

However, Sams' compound annual return of 18.3% after fees for the 21 years ended December 31, 1991 vs. 12.0% per year for the S&P 500 — first at Pace Fund from 1971 to 1981 and subsequently at FPA Paramount Fund — places him among the top two or three of all fund managers

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GARDNER INVESTMENT'S TOM RUSSO YOU ASKED FOR IT, YOU GOT IT. "GUINNESS REVISITED."

Following Warren Buffett's recent acknowledgement of his purchase of Guinness shares, more than a few of you recalled our interview with Gardner Investment's Tom Russo last July in which he laid out the case for Guinness — which he was buying at the time. You asked us to revisit Russo and Guinness. Your wish is our command...

Russo's limited partnership — Semper Vic Partners — has earned a compound return of 24.4% per year for the 8 calendar years ended December 31, 1991 vs. 16.5% per

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TIGER MANAGEMENT'S
MEMO TO: LIMITED PARTNERS
(cont'd from page 1)

some required reading about business and investing consisting of selected excerpts from Buffett's latest letter to Berkshire shareholders.

The memos which follow — by Tiger Management's Julian Robertson and John Griffin — update clients on their investment strategies and provide an eyewitness account of the remarkable progress to date and the awesome potential of the Chinese experiment with capitalism.

We hope you find them as fascinating as we did.

JAPANESE BANK SHORTS WORKED, INTEREST BETS WILL & ENORMOUS POTENTIAL IN EMERGING MARKETS.

Eclectic tastes: Japanese banks & European interest rates.

Robertson: Our short of the Japanese banks paid off handsomely. As a group, they were down 29.8% in the quarter. On the other hand, our big bets on interest rate declines in Japan and Europe were losers. This in no way changes our strong belief that short-term interest rates in Europe will decline over the next year. In Japan, the interest rate decline is in full swing and should eventually flow through to our investments.

Enormous potential in emerging markets. For example....

Robertson: Enclosed is John Griffin's excellent memorandum on China. As must be obvious by now, we think the potential for investment in emerging markets is tremendous.

JOHN GRIFFIN ON CHINA: LONG-TERM POTENTIAL IS AWESOME....

Small economic players for now, but not for long.

Griffin: Over the last month, I've visited two countries with a combined population of two billion people, constituting almost half of the world's population. Although these two countries, China and India, produce only a small percentage of the world's gross output, that's changing fast.

To supplement Julian's letter on India, I offer the following loosely-organized account of my impressions of China and an assessment of its long-term economic potential, which I'd describe as nothing short of *awesome*.

"To be rich is glorious" & other assorted communist dogma.

Griffin: "MAKE MORE MONEY!" That's the loose translation of the Chinese lettering down the side of a five-cent lighter I found at a roadside stand near the Special Economic Zone of Shenzhen, China. In a communist country? You bet! "To be rich is glorious," says Deng Xiaopeng, the party patriarch and sponsor of the reforms.

Following his lead, the communist newspaper, *The People's Daily*, runs an article on how to become wealthy entitled "Opening up to the World and Using Capitalism."

China's experiment with capitalism is paying off in spades.

Griffin: But despite all the recent press, economic reform is not a new concept in China. Over the last thirteen years, China has been experimenting with capitalism and has achieved results nothing short of incredible. In the Special Economic Zones (SEZ), output has risen over 30% a year, exports are up over 300%, per capita income has soared 400%, and profits have risen ten-fold. Almost 50% of China's industrial output comes from non state-owned enterprises and is increasing daily as foreign investment capital pours into privately controlled joint ventures.

So far, Beijing seems quite pleased with the "experiment" and has hinted at further economic reforms, stating that "developing the capitalistic economy is a beneficial supplement to socialism..."

Populace is absolutely driven to raise its living standard.

Griffin: My one week trip to China began in Shanghai.... And the largest city in the world (population over 14 million) does work. Like most of China, while the populace is undeniably cramped, everyone is housed and fed. The literacy rate is surprisingly high, medical care is adequate and infant mortality is low. Perhaps more importantly, I found a populace that is absolutely driven to raise its standard of living....

High savings and no place to invest it....

Griffin: But consumption is not high on everyone's list, as China's savings rate exceeds 35%. Lack of real capital markets means there is no place to invest these savings where the return is higher than inflation.

In an extraordinary act of entrepreneurialism, some Chinese villagers came up with the creative idea of pooling the savings of their town to build roads and bridges and then charge a toll. Enterprise at its best.

One of the scarcest resources in China — shares....

Griffin: One capital market that *does* exist is the floating crap game known as the Shanghai Stock Exchange. Speculation is rampant. Nine state-owned companies trade at ridiculous valuations because of scarcity of stock supply.

I asked one investor why he was buying stocks. "Because they go up," was his matter-of-fact reply. And he is, of course, right. So he and others continue to buy stocks, and all this buying fulfills their prophecy: stocks do, in fact, keep going up — at least for a while.

I was told that at one company, some of the workers had left their jobs because they were making more in a week of stock trading than in a year of labor. Clearly a bubble in the making, but if China continues to roll, all investors will probably do well in the long run.

Interestingly, when the first share available to foreigners was listed, it was priced at a 50% discount to the local share because the company's current valuation was so out of whack!

From sleepy agrarian town to a metropolis in only 12 years.

Griffin: I left Shanghai for Guangzhou, known in the West as Canton, the capital city in the southernmost province of Guangdong. Guangzhou is booming due to its proximity to the Special Economic Zone (SEZ) of Shenzhen and the spreading north of entrepreneurial fervor.

My two most vivid memories of Guangzhou were how "western" everyone dressed and how poorly they drove — both cars and bicycles.... On the four hour road trip from Guangzhou to Shenzhen we saw nothing but constant

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TIGER MANAGEMENT'S
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(cont'd from preceding page)

building. Apartment complexes were springing up to replace shacks, factories were being completed, roads built. It was an extraordinary sight. Under a hot sun, hundreds of thousands of laborers erecting cities — and on a Sunday!

Shenzhen, which borders Hong Kong, has transformed itself from a sleepy, agrarian town into a modern metropolis in twelve short years.

The formula....

Griffin: How did they do it?...

(1) By establishing Shenzhen as a Special Economic Zone, Beijing basically went hands off — no product quotas, no fixed prices, no restrictions on labor (allowing hiring and firing as the market dictated), no oppressive taxes, and no restrictions on the retention of foreign exchange.

(2) Labor — there's no shortage of people willing to work for $100 a month, including benefits. If these people don't perform, there are ten more workers vying for their job. And they *do* perform — working twelve hour days, six days a week.

(3) But who is providing the management expertise? The Hong Kong Chinese, legendary for their business sense, ambition and shrewdness, have practically taken over south China. In the time it takes to read this memo, they have probably set up another joint venture capitalizing on Shenzhen's cost advantage and work ethic.

An added benefit ... is no currency risk since the medium of exchange in Guangdong is the Hong Kong dollar.

DOLLAR DEMOCRACY FIRST
MAY ACTUALLY BE BEST....

Fears about 1997 are probably overblown....

Griffin: Speaking of Hong Kong, what happens in 1997? Probably not much. From a Chinese governing standpoint, Hong Kong will be considered a Special Administrative Region (SAR) for the next fifty years, retaining its local government, regulations, and basic economic policies.

After this transitional period, China may very well fold Hong Kong into the Guangdong province as a super SEZ. Who knows? By then the whole country might be a Special Economic Zone, leaving a small town in the north known for posterity as the SCZ — Special Communist Zone.

The bad news (for now): democracy's not around the corner.

Griffin: But in reality, the Communist party is not going away and political freedom is not around the corner. Tiananmen Square showed the country and the world that any challenges to government or attempts at western-style freedom will be crushed brutally. Granted, this is clearly a blow to democracy.

But what does it mean economically? A good argument can be made that democracy is not necessarily the best political system to propel an emerging market. Japan, Singapore, Thailand, Korea, Chile, Mexico and many others had (have) strict authoritarian control with little or no political freedom as they rode the capitalistic train to economic success.

Strange as it may seem, timing can be everything....

Griffin: In contrast, the Soviet Union loosened the reigns of *political* freedom before establishing any type of *economic* reforms. The result? Glasnost before Perestroika has been chaos. And without stability, there is no foreign investment, no new business creation, no tourism, and absolutely no way to generate the foreign exchange necessary to take advantage of economic reforms through re-industrialization.

The former USSR will need enormous amounts of capital to finally make products that are competitive in the world marketplace, but political, social, and economic uncertainty will preclude such investment for a long, long time. Why would any global company invest significant capital in the former USSR over China, India or a country such as Indonesia?

Starkly contrasting microcosms: Aeroflot & Cathay Pacific.

Griffin: And there are *huge* infrastructure differences. Just compare the major airlines of China and the Soviet Union: Hong Kong-based Cathay Pacific is regarded as one of the great airlines of the world, while Aeroflot is not just one of the worst, but actually is *the* worst.

My short Aeroflot flight from Soul to Shanghai seemed like an eternity. My seat was broken, filthy and about as comfortable as a bed of nails — and this was First Class. I was accompanied in this cesspool by six extra Soviet pilots guzzling vodka and poring over what appeared to be Russian pornography. I can't even begin to describe the terrible food that was "served", but it made Continental Airlines seem like a four star restaurant.

Avoid Soviet-style disaster & maintain stability at all costs.

Griffin: The Soviet disaster is important to China because it certainly has not gone unnoticed. Remember that two weeks before the Tiananmen Square massacre, Gorbachev was greeted as a hero by 150,000 freedom demonstrators in that same square. To avoid a USSR-style disaster, the party line appears to be: keep iron-tight control over politics, but follow economic reforms to the extent they bring prosperity to the people.

And don't do *anything* too quickly. Like the serene Buddhist temples throughout the country, China always seeks stability at all costs. Although their modus operandi is an authoritarian dictatorship, it is nonetheless a stable one, and one that is following the path of capitalism.

THE INVESTMENT STORY OF THE DECADE
BOUGHT ON THE CHEAP VIA HONG KONG.

Hong Kong offers high China exposure at attractive prices.

Griffin: How do we plan to invest in China? Probably not through the two Chinese stock exchanges which are small and fraught with speculation due to the lack of available alternatives to Chinese investors. In Hong Kong, however, we have found large capitalization companies with high China exposure trading at around 12 times earnings with reasonably sure growth prospects of over 20% a year for the next three to five [years].

China could be *the* major investment story for the next decade or more. You can be sure that future letters will describe specific investments from this part of the world.

—OID

SALOMON'S WARREN BUFFETT,
DERYCK MAUGHAN ET AL.
(cont'd from preceding page)

At Salomon Inc.'s special meeting earlier this year, interim chairman Warren Buffett, COO Deryck Maughan and general counsel Robert Denham and others fielded questions from an all-star lineup of attendees — more than a few of them contributors to *OID*.

We found their answers quite revealing and instructive and hope that you will, too:

GIVEN THE CHANGES WE'RE MAKING,
A RECURRENCE OF PAST PROBLEMS IS UNLIKELY....

Our cooperation has been complete and exemplary....

Bob Denham: We expect to move to a resolution of at least most of the governmental issues in the next few months. It's hard to be any more precise than that.

Of course, we're not in control of the schedule. However, we're trying very hard to resolve things as quickly as possible and keep on the fast-as-possible schedule.

We cannot predict what the resolution will ultimately be or what penalties will be imposed. And we can't rule out the possibility of criminal charges.

We believe though that the firm has conducted itself in an exemplary way. We believe we provided unprecedented cooperation to the government.

We're making extensive changes in culture & procedure....

Denham: We've also taken very aggressive steps to assure a climate at Salomon that emphasizes compliance and business morality. This has included messages from the chairman who speaks in very clear visual images such as "playing in the center of the court" and "reading about your conduct on the front page of the paper." Those images, I think, have been well understood by people working across the globe for Salomon.

We've also had a great deal of activity by the compliance committee of the board which was formed to supervise and review the compliance function worldwide. That committee requires that compliance issues be reported to them. And they're reviewing at their meetings — which are occurring virtually once a month — the changes in compliance-related procedures that are being introduced.

Finally, we've engaged in a thorough desk-by-desk review of all U.S. trading desks with the help of Coopers & Lybrand. As a result of that, we've made and are in the process of making extensive changes and improvements in compliance and control procedures.

I believe the actions of the past will be put in perspective.

Denham: First, I think the actions of the past will be put in perspective as actions of a few people not having been condoned or supported by senior management, not having been a source of significant profits to the firm and not having been central to the way Salomon makes money.

Second, we believe people will ultimately focus more on the future and understand that this isn't the last time that a few employees will engage in wrongdoing in a large financial firm.

Most important — making sure these problems don't recur.

Denham: The questions looking at the future are two: First, what kind of example is going to be set for how to respond to this kind of problem when it occurs in the future in other firms and second, where is this kind of problem most and least likely to occur in the future?

We believe that given the kinds of changes we've made, and what we've learned somewhat painfully from our experiences, that if you were asked to place a bet on which firm would be most likely to experience a significant issue of compliance in the future of the kind we've experienced, we believe it is unlikely you would place that bet on us....

That ultimately is most important for us to accomplish — to provide all reasonable assurance, all assurance that can be obtained, that these kinds of problems will not recur at this firm.

WHEN THESE MATTERS ARE RESOLVED,
OUR CREDIT WILL BE BETTER THAN BEFORE....

We won't escape credit watch until authorities have spoken.

Warren Buffett: We're on credit watch. We've had a downgrading. And my own guess is that until the matters with the government authorities are dealt with, that we'll stay in this status intermediate-term and stay on watch. Why should they change it? It isn't that far away, presumably. And they'll know more once the authorities have spoken.

So I would not personally expect a change until that happens. However, I don't expect to have to change our reserve by more than moderate amounts in either direction. Changes shouldn't be terribly significant and our capital level isn't in question.

We are paying a price in funding. It isn't a huge price, but it's not an insignificant price, either — both because of the credit downgrade and the general uncertainty. Of course, the market credit rating of our securities in September or thereabouts was dramatically negative — although it has come back to a very significant degree.

You've had a de facto market rating that may have taken us off credit watch, in effect, to quite a degree....

But upon resolution, our credit will be better than it was....

Buffett: I think that when matters are resolved, that our credit should be viewed perhaps as better than it was going into this. And if so, you can expect me to be around arguing for an upgrade.

Deryck Maughan: When we were downgraded, if you look at the announcement, it specifically referred to the government investigations — the question of the primary dealer license and so on. The same announcement said that the firm was financially strong and paid a compliment to those who are responsible for managing our funding. We meet with the rating agencies all the time. So I don't think that it's a question of our financial strength. It's more a question of the government investigations....

The other comment I'd make in terms of operating our business day-to-day is that it's a clear objective for us to get an upgrade. We'll do what it takes in terms of business design, profitability and earnings to get our rating up. We don't want to sit on the edge. We're in credit-sensitive businesses. We want to get away from the edge.

So whatever the rating agencies tell us to do, we have a

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SALOMON'S WARREN BUFFETT,
DERYCK MAUGHAN ET AL
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very strong internal motivation to upgrade the credit....

HOW MUCH CHANGE IS ENOUGH?
HOW MUCH IS TOO MUCH?

We can't freeze like a rabbit in the headlights....

Maughan: There are two interacting series of thoughts or actions going on in the firm. One is how you respond to external crises and what it means for our clients, the regulators, the balance sheet, and so on.

The other thought is, do we preserve the franchise, the firm as it was as of August of last year, or are there some constructive changes that we would make in any event, absent the scandal, so that we improve our long-term financial performance.

It's a little hard on the inside, let alone on the outside, to disentangle these two parallel processes. But they're very much present in the minds of management. We could not and should not freeze the firm while we await resolution of the government's investigations.

This is a dynamic, human organization. We can't freeze like a rabbit in the headlights and say, "We'll deal with our problems later."

We will emerge a more focused, more profitable firm....

Maughan: Against that, you might argue that you can have too much change. And there is risk of dislocation.

I accept that as the lesser of the evils. My vision is that we will emerge from the government investigations a more focused, more profitable, more cohesive firm, and one where there is better alignment between the people who work here and shareholders.

SIGNIFICANT SHORT-TERM COSTS,
BUT THE LONG TERM LOOKS JUST FINE....

Our balance sheet — liquid, sound & quite functional.

Maughan: The funding situation is under excellent control. We're seeking a balance between what I would call prudent financial management and a performance or earnings orientation.

Our working capital requirements continue to be less than the long-term capital of the firm — that is, its equity and long-term debt combined. We expressed that policy in September. It continues today and it will continue as long as this crisis continues. But it does provide the firm, its shareholders and its creditors with a degree of security.

The credit situation of the firm has improved since September. Our uncommitted bank lines have stabilized. In fact, we've won back some lines that were impaired. We have restored significant repo and securities borrowing lines. We've resumed the issuance of commercial paper as well as medium-term notes. And we continue to monitor very carefully the quality and liquidity of the asset side of the balance sheet.

I believe that our balance sheet is better understood and more liquid than at any time in our recent past. And I only refer to the subject because all else rests on that assumption....

Short-term earnings have been impacted significantly....

Maughan: It's quite clear that the scandal and all it's brought has had a significant impact on our earnings. I would analyze that in two broad groups: our customer business and our proprietary business.

Our customer business suffered most notably in equity underwriting in the U.S. The fourth quarter was a once-in-a-decade opportunity to underwrite stocks — $18.5 billion issued in the market vs. $2 billion and change the year before. We were on the bench — not of our own desires, you understand, but the facts speak for themselves.

Our share of underwriting slipped quite steeply, and there is a significant opportunity cost from our present situation. But boards of directors do feel reluctant to award us the lead managership while we're under investigation.

The debt side of our business — which is a quicker process — does not seem to be adversely affected. We did $1-1/2 billion with Coca-Cola Enterprises. We did almost $2 billion for GMAC recently as a lead underwriter. We did a deal for Italy last week. And we have lots of deals in the pipeline. We continue to act as a major underwriter of debt.

And if there is a silver lining in the cloud, it would be that in January we did begin to regain some market share in the public equity and debt markets of the U.S. — we ranked number four as a lead and number two as a co-manager.

It could have been much, much worse....

Maughan: The fourth quarter situation isn't ... acceptable to us. But we have to accept the present situation as reality. All I can say to you is that we are doing everything we can to preserve our client relationships and that once the investigations are resolved, I do believe that we can quickly improve on our situation.

Ordinary market trading businesses around the world — debt and equity in the U.S. and in Europe and Japan — have not been substantially impaired. We've won back the major clients who suspended business with us. We have re-established, in my opinion, our full distribution capacity.

There may be a shadow effect for some clients — doing somewhat less business than they might normally. It's true that we still can't enter bids for clients at auctions. All of these things have an effect.

But relative to my expectations, at least, we have come through in the secondary markets in remarkable form. It could have been much, much worse.

We're not impaired in terms of trading for our own account.

Maughan: On the proprietary side of our business, the issues are less ones of reputation — since we're trading for our own account with professional market makers — than it is of capital and credit. There is an impairment of our credit. We have been downgraded.

There are fewer people willing to do term swaps or derivatives with us in the present condition. There are clients who say to me, "Deryck, it doesn't matter. You can mark the swap to market. You can post collateral. I just don't want to have to explain all of this. Call me in April." So there is a real effect on our swap and derivative business worldwide.

But our arbitrage activities are much broader than simply swaps and derivatives and those engines of

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SALOMON'S WARREN BUFFETT,
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profitability continue to function well. They have not been starved for capital. The key traders have not left the firm. Our software has not disappeared. We are highly active. And I believe that the fourth quarter is just a reflection of what has been a traditional volatility in those books rather than anything structural in the firm.

The jettisoning of speculative U.S. stock trading a net plus.

Maughan: There is one area of proprietary trading that we no longer engage in — and that's speculative trading for our account of U.S. stocks. That is a net plus, based on recent experience, for both the shareholder and our creditors.

It does not mean that we will not provide capital to our client base. We are very anxious to provide liquidity in the secondary stock market and to underwrite more deals. The two are distinguishable.

There are even those who say that we have removed some area of conflict in the way we conduct our customer business here.

We're still very ready, willing and able to do business....

Maughan: Are we more risk averse? The answer's no. We're still running a balance sheet of a hundred billion dollars that is the largest of any U.S. investment bank. And it provides us with what we need to generate earnings. The commitment we have to our customer businesses has not changed. And our proprietary desks remain very important to us.

Where, then, did the balance sheet reduction apply? Between June and September of last year, we reduced the balance sheet by $37 billion. And essentially, $25-26 billion of that came out of a matched book. That has some earnings impact.

Buffett: You might define that, Deryck.

Maughan: The matched book is the firm borrowing and lending securities for a spread of 15 or so basis points. It's a bank operating within an investment bank. As you know, it's a classic activity of major U.S. investment banks. We cut back the matched book. It still operates, but it is smaller than it was....

The other $12 billion was sort of scattered around. But we retain the financial flexibility to respond to opportunities as they are presented to us. My view is that the balance sheet is high quality, highly liquid and well understood. Those assumptions were tested last September — and we have not yet forgotten those lessons.

So I do not believe we are risk averse. And I don't believe that our clients think we're risk averse. We continue to do a good deal of business around the world.

FIRST, WE'LL ELIMINATE DOUBLE LEVERAGE. THEN, WE'LL TAKE ADVANTAGE OF OPPORTUNITY....

No mismatch here. In fact, we avoid it like the plague.

Buffett: Do we have a mismatch of duration on assets and liabilities — borrowing short and lending long? It's not measured obviously the same way as it is in commercial banking. You can change it so fast around here by funding techniques or asset changes.

But I have no feeling that we get involved in significant amounts of duration mismatches.

Maughan: John, do you want to add to that? John Macfarlane is our treasurer.

John Macfarlane: In order to quantify the liability structure, we perform a pretty detailed analysis of the asset side of the balance sheet. And it involves a haircutting of all of the assets to determine how much working capital is required to support them — i.e., the capital above and beyond that which can be raised in the secured borrowing markets.

And then the term of that working capital is determined by the liquidity of the assets. For example, government securities are, of course, quite liquid and require only 2% margin. And one might reasonably assume that you only need that 2% margin for a period of thirty or sixty days — the period of time in which that underlying position could be liquidated.

So we very carefully maintain the asset side of the balance sheet, determine our working capital requirements and then overlay them with what we feel is an appropriate liability structure.

In fact, that was the core of our contingency funding plan which held us in very good stead during the very difficult months of September and October.

A business that we *haven't* been in and *won't* be....

Buffett: People saw an enormous positively shaped yield curve last year getting more positive almost by the month. So we could have owned a lot of long bonds — or even medium-term bonds — and financed far below the coupon rate on those bonds. On a marked to market basis, of course, we'd reflect the fluctuation of those bond prices.

But let's assume for the moment that there were no changes in the prices of the long or medium-term bonds. We could have had a large profit from the carry under those circumstances. For example, if we'd owned $20 billion of those bonds and had a 300 basis point positive curve, we'd have had $600 million of earnings just from carrying a position like that.

But we're not in that business. People sometimes have thought we might be in that business. And it would have been a good business to be in the last year or two. It would have produced enormous profits. But that isn't the game.

Of course, all you need is a modest change in long rates against you and all that positive carry gets wiped out very quickly. So that's not a business that we *have* been in or that we *will* be in. A large part of our earnings did *not* come from essentially that type of — of playing differences in the yield curve to finance a longer-term position.

Our financial discipline has been a positive experience....

Maughan: We're trying to find the right balance between making money and running a conservative funding program until the uncertainties we face are resolved. And we think we've found the right balance in the sense that our basic customer businesses and our large proprietary trading positions have not been impacted.

Our balance sheet is down in June, but we do not take June as representative. The balance sheet at the end of the

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SALOMON'S WARREN BUFFETT,
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year is equivalent to the three-year average looking back in time. And looking laterally to our competitors, we remain larger than them.

The traders have always liked our positions. But on the whole, the discipline that our balance sheet presently imposes has been a positive experience for us, I would say, rather than a negative one.

The vast majority of our credit is secured — & will be.

Buffett: The nature of the business has always been that overwhelmingly most of the financing is secured. When I came in in August, the balance sheet totaled $150 billion. And there may have been $20 billion in aggregate of equity plus unsecured debt of one sort or another — which means that essentially $130 billion was being financed one way or another that was largely secured. There were always some payables and a few other things in there.

But it's always overwhelmingly been a security financing type of business. And that's been true forever around here. It's just the nature of the business. It's true at our competitors.

But there is some level of unsecured financing. Right now, we have a self imposed limit of about $700 million on commercial paper. We've got about $7 billion, roughly, of medium-term notes and some listed debt outstanding. And we've got about $4 billion of equity capital.

But overwhelmingly, every night the great bulk of the asset side has been and is financed in a secured manner — which again is true of our competitors as well. And that will continue to be the case.

First, eliminate double leverage.

Buffett: As the business generates capital and pays it up to the parent, we'll first work toward the elimination of double leverage — and we've already done that to a significant degree.

I don't think it's wise for a parent such as Salomon Inc. or for that matter for a bank holding company, to borrow money at the parent level to sustain equity at the subsidiary level when the subsidiaries themselves are using significant borrowed money.

I've never been an enthusiast for double leverage. Double leverage has existed here. It's been reduced very significantly in the last twelve months.

We'll keep an open mind about business opportunities....

Buffett: When it's eliminated — or maybe even prior to that, but down the line — it's not inconceivable that there would be other business opportunities available to Salomon, Inc. So it is not a certainty at all that there will be only two major enterprises here five years from now.

Money may be used to repurchase stock. It can be used for a lot of things. But if we saw something that made sense for Salomon, Inc. shareholders to do and the double leverage question had been diminished or eliminated, we would not rule out another business or businesses.

The idea is to have an enterprise that with acceptable levels of risk does well for all three constituencies I mentioned. But I did not leave out shareholders.

WE NEED A RATIONAL COMPENSATION SYSTEM.
BUT MONEY ISN'T EVERYTHING. (WE HOPE.)

We don't want people to stay here only because of money....

Maughan: In terms of staff departures, like everything else, it relates to one's expectations. We've said all along that once we had paid our people in December, there would be departures — intended and otherwise — and that we had no desire to put in place a series of golden handcuffs. Our experience of the 1988 plan was such that we did not wish to repeat it.

Those handcuffs were unlocked yesterday. We want the people here because they want to be here, because they buy the vision, they buy the management and they are happy and proud to be at Salomon Brothers.

It is not my vision — and it is not Warren's vision — that people are paid to stay here irrespective of performance and that it's only the pay that keeps them here. Those are brave words and they entail some short-term costs, but for the long-term, it's precisely the firm that we want.

The real issue is keeping our best producers....

Maughan: The bigger issue isn't the golden handcuffs. The bigger issue is the very hostile competition that's flush with cash and brilliant at targeting our best people. And the issue isn't the guys who've been here for a hundred years. The issue is the guy who's not a managing director, who's an incredible producer, who we'd promote at the end of the year who the competition's trying to take out. That's the real issue.

We've had no mass walkouts or severe damage therefrom....

Maughan: Away from the ideology, what are the facts? Since August of last year to the end of January, 335 people have left the firm voluntarily. That compares to 326 during the same period last year.

None of this is necessarily statistically significant. What it shows is that Wall Street firms have turnover. It represents a 5% turnover of our total staff. If someone had said to me in September, "You'll retain 95% of your staff in February," I would have said, "Thank you."

Some of the people who have left are very valuable. Back in the fall, as I tried to look at the managing directors of the firm, I honestly classified them into three groups — who was essential that we retain, who was dubious, and who had already lost the faith. And we've not given out these numbers publicly, but we did anticipate that 35 of our managing directors would leave by the end of the year. And the press has tended to talk about 10 or 15. But we chose, I think correctly, to allow those people some dignity — time to find a job....

If you looked at the population today and how many of the managing directors are likely to leave, it may be 5 to 10, I don't know.... But we have enough staff here that we can replace them. And we will hire and have hired as necessary. But it is simply not true that there is any kind of mass walk-out....

It doesn't help me long-run and it doesn't help me with some clients, but from a cold short-run perspective and from a shareholder perspective, the departures have not affected those areas that have traditionally accounted for the bulk of our earnings.

(continued on next page)

SALOMON'S WARREN BUFFETT, DERYCK MAUGHAN ET AL
(cont'd from preceding page)

This firm badly needs a rational compensation system....

Maughan: What's happening with compensation? What's this talk about guarantees and minimums? Is this a knee-jerk response to a couple of guys leaving? Have we trashed our principles and opened the checkbook? The answer to all of the above is no.

This firm badly needs a rational compensation system that ties compensation to performance. We have mouthed those words often enough. We have now put in place a system that represents in concrete form what those words mean. The idea of defining target profitability for each major business group does not seem earth-shattering to me.

We've tied the compensation each group earns to its target profitability so that each group will be paid more or less depending on how it delivers relative to that target. That is a rational incentive system which aligns the interests of the employees and the shareholders. The board of directors knows what it's getting into and the people in the firm know what they're getting into....

We regard 1992 as a depressed year.

Maughan: Aligned with this budgeting and incentive — and incentive means downside as well as upside — system of thinking about pay, we have put in place what we call minimum compensation assurances. What that means is that if a given business underperforms in a given year, it still has franchise value to the firm.

We could define the franchise value by 1992 earnings. But that is not a good way to define the problem. We're trying to define the franchise value of our different businesses by their future earnings streams. And we regard 1992 as a depressed year.

Group minimums? Yes. Individual guarantees? No.

Maughan: What should our people be paid in a business that's currently depressed? We've put numbers on each of the businesses — what we would pay in terms of minimum compensation for the group of people who operate that business.

And the sum of all of the minimums is significantly less than was paid last year.

SEWER WORK IS PAINFUL. BUT IT'S NECESSARY — AND WILL ULTIMATELY MAKE OUR LIVES EASIER.

Maughan: Are we falling into a trap that in a good year we pay people a lot of money, but in a bad year we don't take it down? I think that there's been a bit of an industry trap that the minimum is viewed as the market level of compensation and then when things go well people expect to get very well paid.

What we've tried to do is to define minimum compensations for groups in the following way: That support staff should be paid industry rates of pay, that it tends to rise in line with inflation, that it's fairly predictable and that there's low volatility whether the company does well or poorly. Then there's a professional group whose compensation has to stay close to market, but has some risk attached to it. And then there are managing directors — and this has been very explicit this year — who assume most of the risk.

And without getting into details, we've repriced whole classes of managing directors to levels way below their normal expectation as to what they were paid last year and what they'll get in a normal year to more like a draw in a partnership — what they need to pay their bills.... The idea is that the partners who operate the business and are taking the personal risk will do very well on the upside.

The most interesting discussions have been with the management of each group as to whether they'll take the downside — because we're not in the business of granting free options on the upside. And it tells me a great deal about the confidence that the partners have in their own businesses as to whether or not they'll take the downside....

A direct stake is the only way to get really motivated mgm't.

Maughan: There'll be slopes, say a 20% slope, that could be higher in certain businesses and lower in others. Pay will rise and fall. And the partners will see their incomes coming in at a third of what they've been or maybe double.

But this is the only way that we're going to get really motivated management that goes out, brings in business and is serious about its expenses. They have a direct stake.

It's not a commission system because it's not a percentage of revenues. It's revenues less expenses. And it's not an individual system, but a group system.

Buffett: It's probably fair to say that there are 150 or so people who can have terrific swings and probably 500 or so who can have significant swings.

Maughan: It's a graded risk-return profile.

Buffett: But there might be 5,000 or 5,500 people on whose compensation the firm's profits or lack thereof will have essentially no impact. It's understood ahead of time which is very important. That's never been the case before.

The objective: to align mgm't, results & compensation.

Maughan: What we're trying to get is a system where we have alignment between the management, its business definition, its profit and loss and its pay system and where all of these things are coherent....

For the first time, we're defining the business dependencies and the accounting relationships between the business units.

Allocating expense — from passing the buck to concensus.

Maughan: Similarly, on the expense side, the game used to be to allocate expense and see if anyone objects.

The way to cut expenses was to reallocate them. Take research, for example. First, we ask a number of questions. How big a research department do we want? How many analysts are in it? What do they cost? And we get the departments to sign off not only on the total cost, but on their share of that business....

Sewer work is a nightmare & painful, but it's necessary....

Maughan: Pay went up for 10 years. Then Warren arrived — and it didn't go up. So we needed a different method for systems that don't provide eternally rising compensation. We've done a tremendous amount of sewer

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SALOMON'S WARREN BUFFETT,
DERYCK MAUGHAN ET AL
(cont'd from preceding page)

and pipeline work in the last 60 days trying to get agreement — which isn't always easy — on what the businesses are, on who falls into which business and on who runs that business.

Then you have the whole question of what the compensation arrangements should be in relation to the agreed targets. And then you have a whole nightmare of expense allocation and, "I never agreed to that expense." and "Who said we should be in this building?".

But it's necessary and it's painful and it upsets people. But if we can get it clean, it's going to make our lives so much easier because we can get back to what matters — which is our clients and our markets. We won't have to worry about all these internal things.

Money isn't everything — we hope....

Maughan: We could have come into this crisis and said, "There is no loyalty. There is no conviction. Let's just buy people." Other firms have responded in that fashion and other people have suggested that we should, too.

What we would rather go with, however, is a new management team and a more understandable business plan, correct losses where they're incurred, offer people some certainty business-wise regarding what shareholders are willing to put into it and provide both with some good understanding of how we participate in the event that we do better than planned.

The current plan isn't perfection. But it's a start....

Maughan: It isn't perfection. The '91 compensation arrangements were delivered under great stress. The '92 plan is delivered under great stress. We can improve it.

But we have to put something in place that the shareholders and the employees agree to that provides us with something we can hang on to as we ride down this rocky road. It will get better.

Meanwhile, these questions do occupy a great deal of our time right now.

A Tale of Two Cultures....

Maughan: I view this as the best of times and the worst of times. We're seven months through it. We don't have too much further to go....

COMPENSATION SYSTEM EVOLUTION: FROM DEBATE
(continued in next column)

TO CONTRIBUTIONS (& EVENTUALLY) TO ROE.

ROE not yet factored into compensation, but it will be....

Maughan: The targets that we've set for the various departments do not take cost of equity into account and are not based on an ROE benchmark. Some tell me that they're in there implicitly....

We're actively looking at the question of how much equity we consume, what it costs and the optimal allocation of our equity or risk capital. That's a very complicated question. And I don't have an answer for you in terms of specific departments right now.

Buffett: It's important to understand — and Deryck covered this earlier — but we'll have a dozen or so departments. And we do not have adequate information now to use a return on equity benchmark for each unit.

It would be inappropriate in this particular year in some areas to apply that. Certain businesses have been hurt far more than others because of something that they had nothing to do with. And in terms of setting minimums for those departments — and, beyond that, in terms of setting the slope both ways — we've tried to take those factors into consideration.

The old compensation system was based on debate....

Buffett: But prior to this year, to my knowledge, with the exception of one unit a year ago, there has been no understanding at all as to how compensation would eventually be determined at the end of the year. There was no yardstick and no understanding as to the degree to which it'd be shared between shareholders and employees.

It was essentially a system where the year went along and people tended to quite understandably argue for whatever yardstick at the end of the year worked best for their particular case — which is exactly what I'd have done under the circumstances. But it doesn't make a whole lot of sense in managing a business....

Ironically, we still don't know who uses how much capital.

Buffett: It will be an improvement — a significant one — when we can tie those numbers and expectations to employment of capital. It's rather strange, frankly, to me to think of a business like Salomon Brothers that employs close to $4 billion of equity capital not knowing exactly who is using what in measuring manager performance — but we don't have that now....

Given the risks, we better earn above average returns....

Buffett: In a business that does have some risk by virtue of both external and internal factors — we've seen how much the firm could be put at risk by simply one or two rogue elephants operating — certainly for shareholders to commit capital to such a business, they should expect returns over time that on average are higher than those of a water utility business or something of that sort.

I don't have any targets in mind. But I think shareholders have to evaluate over time whether it makes sense for their capital to be employed in a business. And I don't think that can be tested by 1992. But I think it can be tested by returns over a 3-year or 4-year period or something like that.

And it doesn't pay to stick a number on it. It will depend on what American industry earns as a whole. But

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SALOMON'S WARREN BUFFETT, DERYCK MAUGHAN ET AL (cont'd from preceding page)

in the end, there's no reason to leave a dollar in this business unless it's going to produce well over a dollar in market value. That's fundamental.

Salomon's incentive compensation plan....

Buffett: About 4.1 million shares were delivered in stock last year. The average price was around $110 million — or roughly 10% to 12% of total compensation. But it's done in a highly uneven way.

Maughan: We have a progressive schedule for the equity partnership plan which is determined as a percentage of earnings taken as stock. Above $500 thousand, it's 30%. Above $1 million, it's 40%. And it rises to a maximum rate presently of 75% at $2-1/2 million dollars.

Buffett: There's still an overall limitation of 50%, though. So these are steps. No one received more than half of their compensation last year in stock, although the higher-earning people did receive half of their compensation in stock.

More employee ownership is very important & desirable....

Maughan: At the end of December, Salomon Brothers and Phibro employees owned 12-1/2 million shares, or about 11%. And we view the equity partnership plan as very important and very desirable. The idea that depending on future earnings and the stock price and so on that this percentage will rise substantially is part of our vision to get more partnership back into the firm. And it goes back to the question of alignment between the firm and its owners.

So we're very supportive of the plan. In fact, there are a number of people in the firm who have come to me and suggested it should be more progressive rather than less....

There'll be no dilution from incentive compensation plans.

Buffett: All of that stock is bought in the open market and will continue to be. You will see some stock options that have been exercised in the past year and in the current year that were granted some time ago. But there have been no stock options granted recently, and, in effect, there won't be any shares issued that are not purchased in the market.

So there is some dilution present in outstanding options and some convertible notes as well as our convertible preferred. But there will be no [additional] dilution going forward.

Is Salomon disadvantaged vis-a-vis the partnerships?

Buffett: There obviously is one disadvantage through the corporate income tax. If this firm were 100% owned by its employees and another firm were 100% owned by its employees through partnership form, the net taxes imposed on each combination owner-manager group over a period of time would be dramatically less in the partnership form.

In a corporate form, we in effect have between state, local and federal a 40% partner in the U.S. Treasury and some other foreign treasuries that would disappear if we were in partnership form. And that 40% obviously comes out of somebody else's ownership.

Any firm in the investment banking business or elsewhere that can be structured as a partnership has a significant advantage under U.S. tax laws to a corporation. And that's something that I've thought about.

There's a time when various changes in our capital structure make sense. I'm talking about way down the line. But who knows what the tax laws and a lot of other things will be then? But it's certainly something that as an owner-manager you think about in this or any other business.

Any time you have lots of owners, it gets terribly complicated. And they changed the limited partnership rules a few years ago to make it even more difficult. So I'm not suggesting that there's any great panacea for it.

But I would say that if you had a relatively few number of people that could supply their own capital and you had a choice of which form you would operate in — in this business or in some other businesses — you would opt for a partnership form.

But Salomon isn't disadvantaged when it comes to earnings.

Maughan: Long-run, the competitiveness of this firm depends upon its ability to attract and retain highly talented people. And compensation is an important part of that.

But compensation is driven by earnings. And in terms of earnings, I do not feel necessarily disadvantaged against the private partnerships. We have tremendous earnings. And we make a lot more money than most partnerships.

We do plan to incorporate partnership advantages....

Maughan: However, I do see two distinct advantages from the partnership model that was an important part of our tradition and which we're seeking to recapture in some part through the EPP.

The first of these two advantages is what I'd term cooperation — that people's interests are defined in relation to the whole and not simply to themselves. I see that as a very powerful and necessary unifying force so that people in different groups — as we define their performance and their pay — have some other over-arching incentive that ties them to the firm. I think we need that.

The other advantage that I see in having a partnership is that it practically is your own money that's at risk. It's not other people's money. And without being drawn on the question of shareholder meetings and boards of directors, I do believe that when our people have their own money in this business, that there will be a greater sense of discipline and accountability. So I'm all for the EPP and getting the 10% [employee ownership] up to 30%....

SHAREHOLDER RELATIONS:
ALL SHAREHOLDERS ARE CREATED EQUAL....

All shareholders are created equal. No twenty questions....

Buffett: I should say a word about this meeting and how we plan to handle questions from the financial community. Most of you know Bob Salomon over there who's extremely knowledgeable about Salomon and about securities markets. By nature, he's a very friendly fellow. But I've put a little bit of a cap on his friendliness in the last few months for several reasons — one that's temporary and one that actually reflects a little more of my view about how contacts with shareholders and the financial community should be handled.

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SALOMON'S WARREN BUFFETT,
DERYCK MAUGHAN ET AL
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We're obviously in a particularly sensitive time regarding any comments on legal matters and we will be for a few months at least. But beyond that, particularly in a highly volatile business like Salomon or investment banking and trading businesses are by their nature, I am very averse doing what many firms do in the investor relations field — which is to guide people on earnings or ballpark. You know, "Am I going to be embarrassed by this number?" — the whole bit. I've done some of that myself in the past so I'm well aware of how it works.

We simply want to make sure that shareholders receive any material fact simultaneously when markets aren't open. I'm very sensitive to any material information even inadvertently being determined by body language, etc..

We really don't want to be in any business where somebody says, "Am I in the ballpark if I'm between X and 125 percent of X?" or something like that. Chances are that we don't know. And it would be a mistake — even by nods or squirms or whatever it may be — to give you guidance in one direction or another. You're going to have to read the figures at the same time everybody else reads the figures....

ABOVE AVERAGE RETURNS, SMOOTH OR LUMPY,
WILL BE RECOGNIZED IN THE MARKET.

Our proprietary trading operation is intact.

Buffett: In my opinion, [the earning power of our proprietary trading operation] has not been impaired.... It's made us a lot of money periodically. And I think there are some aspects of it that are definitely part of the franchise.

Proprietary trading has diversified by product & geography.

Maughan: It's a very significant business.... Over the last five years, the firm has done a good job of diversifying the nature of that business — both in terms of the products traded and in terms of its global application. In other words, it's not just a single group sitting in a single market.

The techniques, which were started really in the U.S. fixed-income market, have been applied to some extent to stocks here — and there's more opportunity there — but more importantly in Japan and in London, there are very important proprietary trading groups drawing on the technology that was developed here using local traders and databases and so forth. So I view the business as more established and more diverse than many people think of it.

Its volatility is overstated because of accounting distortions.

Buffett: It's very volatile. It's probably less volatile in what I would call its expected profitability. But in terms of marked to market accounting, if you looked at it on a weekly basis — just to make it extreme — you would obviously see exceptional volatility because most of the transactions do not have a long-term horizon.

One normally associates the word "arbitrage" with buying cotton in New Orleans and selling it in Liverpool like the old days. Everything had a quick physical delivery aspect to it in classical arbitrage. So there could be an association that these are very short-term strategies.

But actually, a number have quite long-term horizons — so that their interim profitability can bounce around a lot even though their long-term expectation is probably pretty solid....

Smooth may be nice — but not if it costs money....

Buffett: And we make no attempt — and won't in terms of operation decisions or accounting decisions — to smooth out that volatility. What we're trying to do is get the best economic result over time we can while running acceptable levels of risk. And that will mean volatility.

I'm in the insurance business. It's the same situation there. There are a lot of strategies you can follow — mostly economic, sometimes accounting — that will tend to smooth things out. But there's a cost. And we're really not interested in smoothing.

When you have a hundred billion dollar balance sheet and you mark to market daily, some unusual things can happen on specific days.

[Editor's note: Something we at *OID* have had to learn to live with.]

Lies, damn lies and income statements....

Buffett: I'll talk about a couple of hypotheticals ... so you'll understand how a given cutoff date can provide something entirely different than another cutoff date — which is far different than being in Coca-Cola's business or something of that sort.

We're often short and long enormous quantities of securities with very similar, but maybe not identical, characteristics. Maybe they're characteristics that will become identical over time as certain markets converge. But the pricing of those on any given date can be affected by items that will not affect the eventual convergence.

For example, if markets are unusually thin for any reason and you're pricing $10 or $20 billion of longs and $10 or $20 billion of shorts and the market widens out [i.e., the spread between bid and ask widens], there may be a significant penalty to earnings on that given date. That can happen because markets are unusually volatile — or unusually slow at a given time like holidays, for example.

We could be long tremendous amounts of futures or actuals and short futures or actuals against them. And in certain fast-moving markets, sometimes the futures will move faster — not than the direct actuals but than related actuals. And that could cause swings of $50-100 million in either direction in a matter of a day or two that are usually reversed rather quickly....

Franchise businesses & volatility not mutually exclusive.

Buffett: You just can't get out of volatility with a mark to market approach. But there are units whose earnings have been quite significant on average, even if imperfectly measured, in relation to equity capital over the years. We do know enough to know that certain units have produced returns for shareholders that would be excellent over a period of time. There have been other important units that have not, where we know that they're going to be part of the firm, where we're big players, but where we simply haven't made the money that we should have.

However, there are businesses I talked about as being franchise businesses which have earned returns which are franchise-type returns, but not quarter-by-quarter. They

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SALOMON'S WARREN BUFFETT,
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(cont'd from preceding page)

haven't done that and they won't.

Market will recognize franchise returns, even volatile ones.

Buffett: Can you have a recognition of franchise value as long as you operate in an industry or have a firm-specific condition with a lot of volatility? I think the answer to that is yes....

For example, if Salomon, Inc. earns a return on equity moderately above that of American industry, even if it were achieved in a volatile manner, I think you'd get a recognition in the market for it. You have to. The mathematics are pounded through after awhile — as long as people believe that the managers of the business are going to utilize those funds in the interests of the shareholders.

Everything else being equal, it's nicer to have a return that varies between 15-1/2% and 16-1/2% on equity over a long period of years and makes everybody feel very comfortable that they can not only predict the next quarter, but the next year and all of that. But as I've said in Berkshire's reports I'd rather have a lumpy 18% than a smooth 15%. I only hope that's the choice.

IF THE BOND BUSINESS FAILS,
WE'LL KNOW WHY....

Primary dealership is the hub at the center of our wheel....

Maughan: Apart from our primary dealership, do we view the bond business as a good business? The answer is yes.

Buffett: The question refers to a quote which I can't resist quoting again now — when management with a good reputation encounters a business with a bad reputation, it's usually the reputation of the business that remains intact.

And you can argue with several points in the premise of that. But the question is whether bond trading and bond underwriting are good businesses.

And I would say that considering the strengths of the firm's franchise — it's infrastructure and people — that those are good businesses. You don't have to be brilliant. Therefore, if for any reason they fail, you'll know where the problem has been.

Maughan: And I think being a primary dealer is important. And I think it's important not simply because of the status it implies and the ability to interreact with the Federal Reserve Bank. It's very important also in that it's connected to, in our opinion, access to the repo market and a whole series of funding vehicles. And that has not changed as yet....

And given the kind of firm that we are and that we operate in government bond markets around the world, it would still be, in my opinion, a significant perceptual problem in being simply a customer of the government bond market and not a primary dealer.

It has not been legislated out of existence. It's been modified. But it's still important.

Buffett: The bond business is enormously important and can and should be a very good business. But as Deryck says, it's conducted worldwide. And for this firm to be regarded by its own sovereign in such a way as to implicitly say that it's less than top-tier would be harmful not only in this market but in other markets. It's an endorsement that essentially we must have even though its technical value at any given time may not be huge.

Maughan: Second, could we divorce government bond trading and still be preeminent or important in mortgage trading or corporate bonds and so on? In my view, the connections are very intimate.

Quite apart from the profitability of auctions, the government market is the hub at the center of the wheel. And if you're going to underwrite corporate debt or trade mortgages, you have to be hedged against the Treasury market. That's how things are priced and that's how things are hedged. And the wheel's not going to work too well if there isn't a hub....

DON'T OVERREACT TO THIS CRISIS.
IT WON'T TAKE A MIRACLE....

Serving shareholders, clients and employees is possible.

Buffett: My vision and goal is of a firm that does well by shareholders, clients and the people who work there. And I do not think that it is impossible at all to create a firm that does very well for all three constituencies.

We will be in the proprietary business, we will be in the customer business and we will be in them with both feet doing as good and as big a job as we can in both areas. The dream around here is not towards products, but toward serving those constituencies well.

This firm has phenomenal earnings power....

Maughan: My view is that the firm has some very remarkable strengths and tremendous earnings potential. And I think that was demonstrated in the first part of last year. But we've also had some significant cash drains, what I'll call highly speculative trading, on occasion — the management of our ex-commodities business and our experience in merchant banking.

If we're able to exercise more discipline and more accountability, the earnings power of this company will really be something. It's phenomenal.

And if we can at the same time, through our actions and results, come to a situation where the market accepts that this company is worth more than its liquidation value, this stock price could really go up.

Buffett: Pour a little warm water on it....

Maughan: But I'm talking about the next five years, not the next five weeks.

Don't overreact to this crisis. We don't need a miracle....

Maughan: What's driven those earnings is the concept of a globally-competent, integrated investment bank. And what we're seeking to do is maintain our strengths and build the weaker businesses.

We never got so far away from our core strengths. We didn't buy a big retail chain that blew us up, we didn't pay too much for a British merchant bank and we didn't go crazy in real estate.... And it would be wrong to overreact to the present crisis and say that Salomon Brothers can't do this and can't do that. We have huge earnings power.

Warren's already said, and I'll simply repeat, that it's

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SALOMON'S WARREN BUFFETT,
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unthinkable that we'd exit the investment banking business; it's unthinkable that we'd give up underwriting; it's unthinkable given our presence and earnings overseas that we'd shrink to the domestic market; it's unthinkable that we'd stop trading for our own account since we're extremely good at it.

All we have to do is analyze it and do it better. It's not a miracle that we're required to produce.

PHIBRO'S EARNED HIGH RETURNS IN THE PAST & WILL IN THE FUTURE — AS PART OF SALOMON.

Our goal at Phibro is to move into high return areas.

Buffett: Speaking for Phibro, the goal is clearly as you've seen over the last few years to move in a significant way into areas of the oil business where we think can produce high returns — and I hate to use the word because somebody will bring back one of my quotes on it — but we might well have some synergy in our trading businesses.

We trade more oil than OPEC produces & have high hopes.

Buffett: Phibro is the largest oil trader in the world. I've been told that we trade more oil every day than OPEC produces. And we're a large refiner. And that business historically has earned very good average returns on equity — again with enormous volatility. That's the nature of the trading gains, the nature of refinery spreads and a whole bunch of things. But that business can have a very large future.

It has a balance sheet of its own that is $1.2 billion. It has a high degree of liquidity. My guess is that they might have $600 million in short-term liquid investments. It's a business with a lot of power and terrific management. They've done a great job of building it from a very small firm and they've earned very substantial returns.

So we have high hopes for Phibro.

Our annual report will be manager-to-owner style....

Buffett: Refining earnings will come down in the 1991 report. Incidentally, I think you will find the annual report quite informative this year in terms of numbers not only for the refining business, for example, but even for specific lines of trading with Phibro.

We're making a real attempt to try to write a report that's very much a manager-to-owner communication similar to what would be done if we just had one shareholder out there who'd put up all the money and really wanted to know what was going on around the place....

Large trading losses won't be a recurring problem.

Mike Castellano: I'm Mike Castellano, the controller of Phibro. Those 1991 losses in refined products trading were principally an international business separate from our U.S. refining and marketing organization that sells the products from the refinery. There were some bad positions that did lose us some money there. And that happened early in 1991 for the most part.

Steps have been taken to replace the management team and to reorganize that business. And since it has been reorganized — which occurred roughly around March of 1991 — it has not incurred losses....

Buffett: You can have reasonable assurance that almost anything can happen in a trade, but I don't think that that will be a recurring problem.

The joys of the refining business....

Buffett: The refining business historically has not been a very good business for the oil industry. Whenever there's overcapacity, refining spreads — particularly related to replacement value — have been generally poor.

In addition, it has a mandatory capital investment aspect to it where historical depreciation charges are probably not a good measure of earning power because you're forced to put a certain amount of money into the business every year — or almost every year — which is not minor and which probably doesn't change your competitive position vis-a-vis your competitors who are doing virtually the same sort of thing.

It's like everyone in the retail industry air-conditioning their stores and putting in escalators. It puts a lot of money on the balance sheet, but it doesn't do much else for you.

It's musical chairs in reverse. The last ones in win....

Buffett: We're in at a very low historical cost. In our view, there will be a reduction in U.S. refining capacity in the future. If there isn't, it's not going to be a very good business because its spreads over time will reflect the relative tightness of capacity.

I don't think you'll see it on the demand side in oil. So I think you're going to have to have a reduction in supply — which is refining capacity. You probably need a million-and-a-half barrels of capacity to essentially get shut down in this country before the business gets interesting.

And then the question is whether you're one of those who logically should be shaken out to make it good for the rest of the industry. Should you be one of the survivors?

And we are not, in our view, anywhere near that position or in the class that would make us the logical ones to close down. We have four refineries. And we believe that our refinery capacity as a whole is situated both physically and technically in a position where it is not logical that it should disappear.

Now the question is will other people try and sit it out even though they're the logical ones to drop. We'll find out. You've seen a fair amount of publicity in the last six months about people contemplating shutting down capacity or partially shutting it down. The capital requirements of the business are such that you can't defer addressing them. So before anyone decides to shove a hundred million dollars or so into a refinery, they should be thinking where that leaves them in terms of cost structure vis-a-vis the industry....

Don't make me use the "S" word, please....

Buffett: We have a little over 2% of the refining capacity in the U.S. The people at Phibro tell me that there are — and I won't use the word again — but they tell me that there are benefits to being in both businesses. And they always give me lots of illustrations.

Phibro management understands making money.

Buffett: We'll never have an exact sister organization

(continued on next page)

SALOMON'S WARREN BUFFETT, DERYCK MAUGHAN ET AL
(cont'd from preceding page)

that we can measure it against, but they're very smart people. Based on their record at Phibro, they're smart in terms of the oil business, they think through business problems well and they understand making money.

It does not have any institutional aspect to it, as may exist with some of the other players in the industry where things are done simply because they see themselves as being in the oil business and, therefore, have to spend $200 or $300 million doing this or that because their competitor does it.

I think they are very conscious of making good money up there. And the compensation of all the key players is dramatically tied to results. And results to me means return on equity.

Phibro will be an important part of Salomon in the future.

Buffett: Phibro is an important, independent unit of Salomon that's accounted for very significant earnings in some years. It's had an excellent return on invested capital on average over the years. It will be an important part of Salomon in the future.

From time to time, there have been rumors about it being spun off or disposed of or something. There are absolutely no plans for that.

LOTS OF UNCERTAINTY IN WHITE KNGHTS,
BUT HOPEFULLY SELF-INTEREST WILL PREVAIL.

The tax situation in Russia changes almost by the hour....

Buffett: Phibro's Russian joint venture involves production in Siberia. The tax situation there changes almost by the hour. But my understanding is that the Russians in the past month or so have instituted two taxes.

One is a $5 a barrel export tax. The second is a requirement that 40% of the proceeds from hard currency exports be converted into rubles. And my understanding is that the $5 would not be an offset in determining the hard currency proceeds. So for example, if you were selling oil for $17, there would be $6.80 converted into rubles and $5 dollars of export tax.

My understanding is that it's very much up in the air. In fact, there've been some statements made that these taxes may not apply to joint ventures already in place. There's a lot of confusion about it.

However, if both taxes were imposed, I think that they would be confiscatory. And in that case, I would think that it would be almost impossible to expect any western dollars to flow into Russia for development of anything. And that would seem so counterproductive to the needs of Russia that it's difficult for me to imagine that they will be codified or that the regulations will apply in the way I've described.

But I don't think anyone knows precisely what's going on at this moment or what's likely to go on in the next week or month about that. And it's a big question mark hanging over our oil operation in Russia now....

No one would do business there with the proposed taxes....

Mike Castellano: What we hope will happen is that we'll get a special concession for our venture. Our venture was formed and approved before these taxes were in place. And we think that the Russian government and our partner — which is a Russian concern — will work with us to come up with something reasonable.

We're working on something right now that we'll be presenting to the Russian authorities. And we believe — and they've mentioned it publicly — that they will cooperate with us in developing something that makes sense....

I don't believe that Russia will shoot itself in the foot.

Buffett: There's a lot of oil there. We've put about a hundred million dollars into the project through Phibro. And it would seem that the energy — oil and gas — would be one of the great hopes of Russia in terms of their whole economic situation and that western capital and, perhaps, management would be very important ingredients in realizing on that asset.

But it is about 99 percent a political question and about 1 percent a geological question. And you're probably in as good a position to evaluate that as we are....

INTERNATIONAL OPERATIONS:
THE SHAPE OF THE '90S....

It's very hard to crack new markets in Europe and Asia....

Maughan: There are great similarities and great differences between our American business built over 80 years, and the newer European and Asian businesses. It's very difficult to enter the market in Europe and Asia. The classic case is equity underwriting for corporations in national markets. It's very hard to displace the German universal bank that owns the stock and sits on the board. And the same is true in Japan.

When it comes to domestic underwriting — and, in some cases, international advisory work — the local institutions are tremendously well-established. And it would be wrong to discount the power and ability of Deutsche Bank, IBJ, Nomura and so on.

So when you go overseas, you compete where you can — where you're strong and where you have value to add.

Fortunately, we have some advantages....

Maughan: And what we've found is that in arbitrage, the American market is probably ahead of the local markets — although some of the locals might disagree with that. In secondary trading, we have a competitive position. And I think in terms of underwriting debt, we could do better in those markets if we were to commit more resources to them.

American houses, Salomon included, do have an advantage in terms of the quality and impartiality of their research. Again, the British might take exception to that. And I am trying to simplify. But the quality and impartiality of American research is very much sought after in Europe and in Asia. And I think that's a competitive strength.

The businesses in both centers have done much better in the last three or four years than they had before. And we have now established a local connection to regulators and to the client base that is of great intrinsic value. I think that we're as well positioned globally as any American investment bank.

And speaking as a European who worked in Japan, I think that American investment banks have an edge over their Japanese or European counterparts who are also

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SALOMON'S WARREN BUFFETT,
DERYCK MAUGHAN ET AL
(cont'd from preceding page)

attempting to go global. The American culture and management systems are, I think much more open than those of our European or Asian counterparts. And if our future is global — which I believe it is — and diversity is the issue, Americans are well positioned.

International earnings growth will be the shape of the '90s.

Maughan: So international operations have continued to grow and contribute more to our earning power. And I think that's likely to be the shape of the '90s....

WE HAVE LOTS OF PROBLEMS,
BUT NO SHORTAGE OF OPPORTUNITIES....

Significant global applications and opportunities remain.

Maughan: The other comment I would make is that the client applications of our proprietary technology are potentially very large. We've done a certain amount of it as it relates to the investor client base around the world.

But when it comes to advising corporations on their own balance sheets on how to hedge out various risks in their liability structures or their underwriting, there's a great deal more to do. So I do not view it as just one group with a market saturation problem. I see it as a global business with significant opportunities remaining.

Buffett: I believe that we're likely to have new [opportunities]. I've been surprised at the variety of applications. And we're likely to see new ones all the time. Proliferation of financial instruments, if nothing else, really changes that game as you go along....

We want to exploit opportunity, not bet on the market.

Buffett: As Deryck said, we will not be taking big, long-term equity positions. It doesn't affect at all how we feel about taking on a $200 million or $400 million block of stock to resell. But in terms of taking on $2 billion worth of market positions or something of that sort in equities, we would be quite disinclined to do that.

We have made and will make large — I wouldn't call them bets, but commitments — that involve arbitrage-like activity via a wide variety of instruments. And there's no diminished willingness to do that. But those aren't based so much on market direction as they are on relationships developing. And I'm not talking about pure risk arbitrage in announced stock deals, for example, although we're in that business, and will continue to be in that business.

But you have a worldwide business — a foreign exchange business, interest rate business, bonds trading — and there are opportunities to exploit differentials that in very large part do not represent making bets on markets, but simply may involve items that have to contractually converge at some point or that for other reasons are expected to converge.... And there's no diminished interest in engaging in those transactions on a very large scale. We're very well set up to do that. So there's no diminished interest in buying very large amounts of bonds, mortgages, or equities that we expect to resell in a short period.

However, to the extent that there has been just big bets on market movements — and I'm not perfectly conversant in terms of how big they've been over the years — I would say that there's less enthusiasm for that now.

To the extent that we have run a hedge fund, it has turned out to be a hedge against capital gains in the past....

Other important opportunities....

Maughan: When the scandal hit us, we were very concerned that people would, for reputation reasons, take their money out. That has not happened. On the other hand, it is very difficult for the people in the fund management business to attract new assets right now.

Buffett: But they have done so in some cases.

Maughan: In some cases, they have. It tends more to be personal money or a trust that knows the people in the firm particularly well. But for people who didn't know us, it's a little hard.

But it's grown well and is performing as projected. And when I look at the question of volatility of earnings and I think about this firm versus other investment banks, clearly, the fact that other firms have larger asset management divisions and established them sooner has helped them smooth out some of their volatility.

I think the same could be said for our high-end retail business. We have a nascent area — we call it PID for Private Investment Department. Our prime competitors have well-established high-end retail networks that have been very profitable and provide them with additional distribution.

These are things that we started late but offer what I think are important opportunities for us going forward....

WE DON'T LIKE COMPETITION,
BUT WE CAN COPE WITH IT....

The shelf life of good ideas is increasingly short....

Buffett: Some years ago, in our mortgage products, Salomon made a good bit of money because it developed a product early and it had a relatively long shelf life.

Now people react faster. And there are larger pools of capital willing to imitate any new product that might be developed or jump on any strategies that are proving successful. It probably is true that there is more money available to engage in some of the specialized techniques than might have been the case ten years ago.

It obviously would be nicer if once you develop something in this area you could patent it somehow, or keep the world from finding out what you're doing. Naturally, I'd rather it be longer. But if there's a shortened life span to the good proprietary idea, I don't think it's a huge negative.

The fundamental things apply — as time goes by.

Buffett: But there are a lot of opportunities that develop and there are little twists and turns on it. But they all involve the old basic principles. One technique that's used here is described perfectly in Graham and Dodd's 1934 edition of *Security Analysis* — but not in the editions after 1940.

They tend to be the same things, but they just pop up in different ways all the time. It will be a variation, but it will be the same principles with a variation in application three years or five years from now that's producing profits.

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SALOMON'S WARREN BUFFETT, DERYCK MAUGHAN ET AL
(cont'd from preceding page)

A GOOD BUSINESS SHOULD HIT YOU BETWEEN THE EYES.

Fixed income & equity investing are different....

Buffett: But when I made the investment in Salomon in 1987, was I given departmental figures or anything like that? No. I looked at the overall figures. I read the annual report. I didn't know anything more than anyone who was buying a hundred shares.

But I'm used to that — particularly in fixed-income investments. There's a different threshold of understanding or even conviction, required about a business in a fixed-income investment than in an equity investment.

If you must know minutia about a business, it's not great...

Some businesses are inherently much easier to understand than others. I didn't know the profitability by country of Coca-Cola even remotely when I went into it, but I understood Coca-Cola.

And usually, if you have to know all kinds of little facts about a business to know whether it's a good business, it isn't a good business. It should hit you between the eyes. The businesses you can understand best are the ones you can write out in a paragraph or two why they're good businesses.

Equity investment is a much different decision....

But there is a different threshold level for fixed-income investments versus pure equity investments. The real first question with a fixed-income investment is, "Are you going to get your money back?" and the second is, "What is your likely rate of return from that?" — which, with a convertible, can vary some — and "How does that compare to market rates of return?"

A pure equity investment is a much different decision.

I'D PROBABLY DO THINGS DIFFERENTLY... IT'S A QUESTION OF THRESHOLDS & PRIORITIES.

It's hard to know when to belch at the dinner table....

Buffett: Since I've made managerial changes when I went from being an outside director to a position of authority at the firm, should I have been doing something about it earlier?

In almost any firm where I've been a director, I've probably had ideas about how things could be done better. And I'm sure that the other directors of Berkshire Hathaway feel the same way about that company. But there's a question of threshold levels and priorities.

I'd probably allocate capital at every firm somewhat differently than they do. I might make decisions about a lot of things in a small way differently — including compensation. But that doesn't mean that every time I get in a situation where somebody is doing it a little differently that I think my views ought to be imposed.

I've said before that there's more than one way to get to heaven. I've seen a lot of firms that do very well not follow exactly the same principles I would espouse.

If it hits a threshold level of concern, certainly — if you get any suspicion of illegality or anything of that sort. But that's a different question.

Otherwise, they really relate to managerial decisions. In the fall of 1990, not only I, but the other two members of the compensation committee were quite upset about the principles of compensation that were being employed. In that particular case, I voted no on something — which is not something I do very often.

Normally, I'd talk to management. But I had talked to management. We were concerned well before the winter or fall of 1990. But it finally reached a level where I thought a vote was the only appropriate way to register the degree of discontent with the system. But it's a very tough question when you come in every couple of months what level of things warrant belching at the dinner table essentially.

A big acquisition is probably one of the toughest things — because usually by the time it gets to the board, there's enormous momentum behind it. It's usually been agreed to in principle subject to board confirmation. So in effect, you're making the management lose face enormously if they back off of it. And those are tough questions.

Again, it depends on threshold levels essentially. I have been on boards of companies that have made acquisitions that I certainly wouldn't make myself. And sometimes I may well have been wrong on some of those....

Circumstances leading to crisis were unique, not systemic.

Buffett: Would I speak to the difficulties of being an outside director? I might speak to the difficulties of being an inside director.

The situation here was very unusual. And I'm not sure you can generalize too much from it — because essentially you had directors not receiving quite important information from management last spring and early summer. That's not a common problem. And I'm not sure that you can build a system that answers that.

Although in this case, and I've seen other cases, it argues the merits of a non-executive chairman — because it can tilt the psychological balance in terms of the information coming to the board and even the weighing of the shareholder interest versus other interests. So there may be some lessons in that....

As long as I stay in this job, it will be interim....

Buffett: Berkshire did reasonably well last year so that they probably wish I'd taken this job on earlier.

But as long as I stay in this job, it will be interim. And I will be interim chairman of both Salomon Inc. and Salomon Brothers essentially until the matters with the authorities are dealt with — not the civil suits that Bob talked about, but essentially, the SEC, the U.S. Attorney and the Federal Reserve. Until those questions are essentially dealt with, I will be in the job.

And in the annual report, I'm going to lay out in detail what I think is a logical managerial structure for Salomon.

I hope I'm playing the back nine at this point....

I don't know how long the matters that Bob has talked about will last, but I have hopes that I'm playing the back nine at this point.

—OID

BERKSHIRE HATHAWAY'S
LETTER TO SHAREHOLDERS
(cont'd from preceding page)

In his most recent letter to Berkshire shareholders, Warren Buffett offers his latest lesson on identifying and valuing superior businesses as he and Charlie Munger learned it and practice it.

We strongly recommend that you read it, re-read it and re-read it, etc.:

OUR LAST BIG IDEA TURNED OUT
TO BE THE REAL THING....

Our Coke is worth more than we were when we bought it.

"Our outsized gain in book value in 1991 resulted from a phenomenon not apt to be repeated: a dramatic rise in the price-earnings ratios of Coca-Cola and Gillette. These two stocks accounted for nearly $1.6 billion of our $2.1 billion growth in net worth last year."

"When we loaded up on Coke three years ago, Berkshire's net worth was $3.4 billion; now our Coke stock alone is worth more than that."

Coke deserves a high P/E. But it won't jump each year.

"Coca-Cola and Gillette are two of the best companies in the world and we expect their earnings to grow at hefty rates in the years ahead. Over time, also, the value of our holdings in these stocks should grow in rough proportion. Last year, however, these two companies' valuations rose far faster than their earnings."

"In effect, we got a double-dip benefit, delivered partly by the excellent earnings growth and even more so by the market's reappraisal of these stocks. We believe this reappraisal was warranted. But it can't recur annually: We'll have to settle for a single dip in the future."

HERE'S WHAT WE LOOK AT.
WE RECOMMEND YOU DO, TOO....

It may not be GAAP, but it's the way we look at it....

"We've previously discussed look-through earnings, which consist of: (1) the operating earnings reported in the previous section, plus; (2) the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us...."

"Over time look-through earnings must increase at about 15% annually if our intrinsic business value is to grow at that rate. Indeed, since present management took over in 1965, our look-through earnings have grown at almost the identical 23% rate ... recorded for book value."

A look-through earnings focus keeps your eye on the ball.

"We also believe that investors can benefit by focusing on their own look-through earnings. To calculate these, they should determine the underlying earnings attributable to the shares they hold in their portfolio and total these."

"The goal of each investor should be to create a portfolio (in effect, a "company") that will deliver him or her the highest possible look-through earnings a decade or so from now. An approach of this kind will force the investor to think about long-term business prospects rather than short-term stock market prospects, a perspective likely to improve results."

"It's true, of course, that, in the long run, the scoreboard for investment decisions is market price. But prices will be determined by future earnings. In investing, just as in baseball, to put runs on the scoreboard one must watch the playing field, not the scoreboard."

FRANCHISES VS. BUSINESSES:
VALUATION IMPLICATIONS ARE TELLING....

Erosion of media companies' economic strength continues.

"In last year's report, I stated my opinion that the decline in profitability of media companies reflected secular as well as cyclical factors. The events of 1991 have fortified that case: The economic strength of once-mighty media enterprises continues to erode as retailing patterns change and advertising and entertainment choices proliferate."

"In the business world, unfortunately, the rear-view mirror is always clearer than the windshield: A few years back no one linked to the media business — neither lenders, owners nor financial analysts — saw the economic deterioration that was in store for the industry. (But give me a few years and I'll probably convince myself that I did.)"

"The fact is that newspapers, television, and magazine properties have begun to resemble *businesses* more than *franchises* in their economic behavior.

Can any idiot run it? If so, it's probably a franchise.

"Let's take a quick look at the characteristics separating these two classes of enterprise, keeping in mind ... that many operations fall in some middle ground and can best be described as weak franchises or strong businesses."

"An economic franchise arises from a product or service that: (1) is needed or desired; (2) is thought by its customers to have no close substitute; and (3) is not subject to price regulation."

"The existence of all three conditions will be demonstrated by a company's ability to regularly price its product or service aggressively and thereby earn high rates of return. Moreover, franchises can tolerate mismanagement. Inept managers may diminish its profitability, but cannot inflict mortal damage."

" 'A business' earns exceptional profits only if it's the low-cost operator or if supply of its product or service is tight. Tightness in supply usually does not last long."

"With superior management, a company may maintain its status as a low-cost operator for a much longer time, but even then unceasingly faces the possibility of competitive attack. And a business, unlike a franchise, can be killed by poor management."

The media industry has lost some of its franchise strength.

"Until recently, media properties possessed the three characteristics of a franchise and consequently could both price aggressively and be managed loosely. Now, however, consumers looking for information and entertainment (their primary interest being the latter) enjoy greatly broadened choices as to where to find them. Unfortunately, demand

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BERKSHIRE HATHAWAY'S
LETTER TO SHAREHOLDERS
(cont'd from preceding page)

can't expand in response to this new supply: 500 million American eyeballs and a 24-hour day are all that's available. The result is that competition has intensified, markets have fragmented and the media industry has lost some — though far from all — of its franchise strength."

Media companies resembled perpetual & growing annuities.

"The industry's weakened franchise has an impact on its value that goes far beyond the immediate effect on earnings. For an understanding of this phenomenon, let's look at some much over-simplified, but relevant, math."

"A few years ago the conventional wisdom held that a newspaper, television or magazine property would forever increase its earnings at 6% or so annually and would do so *without the employment of additional capital*, for the reason that depreciation charges would roughly match capital expenditures and working capital requirements would be minor. Therefore, reported earnings (before amortization of intangibles) were also freely-distributable earnings, which meant that ownership of a media property could be construed as akin to owning a perpetual annuity set to grow at 6% a year."

Modest shift in assumptions = major valuation implications.

"Say, next, that a discount rate of 10% was used to determine the present value of that earnings stream. One could then calculate that it was appropriate to pay a whopping $25 million for a property with current after-tax earnings of $1 million. (This after-tax multiplier of 25 translates to a multiplier on pre-tax earnings of about 16.)"

"Now change the assumption and posit that the $1 million represents 'normal earning power' and that earnings will bob around this figure cyclically. A 'bob-around' pattern is indeed the lot of most businesses, whose income stream grows only if their owners are willing to commit more capital (usually in the form of retained earnings)."

"Under our revised assumption, $1 million of earnings, discounted by the same 10%, translates to a $10 million valuation. Thus a seemingly modest shift in assumptions reduces the property's valuation to 10 times after-tax earnings (or about 6-1/2 times pre-tax earnings)."

"Dollars are dollars whether they are derived from the operation of media properties or of steel mills. What in the past caused buyers to value a dollar of earnings from media far higher than a dollar from steel was that the earnings of a media property were expected to constantly grow (without the business requiring much additional capital), whereas steel earnings clearly fell in the bob-around category."

"Now, however, expectations for media have moved toward the bob-around model. And, as our simplified example illustrates, valuations must change dramatically when expectations are revised."

Short-term & long-term damage to our media companies....

"We have a significant investment in media — both through our direct ownership of Buffalo News and our shareholdings in The Washington Post Company and Capital Cities/ABC — and the intrinsic value of this investment has declined materially because of the secular transformation that the industry is experiencing. (Cyclical factors have also hurt our current look-through earnings, but these factors do not reduce intrinsic value.)..."

In strong managements & sound balance sheets we trust....

"The intrinsic value losses that we have suffered have been moderated because the Buffalo News, under Stan Lipsey's leadership, had done far better than most newspapers and because both Cap Cities and Washington Post are exceptionally well-managed. In particular, these companies stayed on the sidelines during the late 1980's period in which purchasers of media properties regularly paid irrational prices."

"Also, the debt of both Cap Cities and Washington Post is small and roughly offset by cash that they hold. As a result, the shrinkage in the value of their assets has not been accentuated by the effects of leverage. Among publicly-owned media companies, our two investees are about the only ones essentially free of debt. Most of the other companies, through a combination of the aggressive acquisition policies they pursued and shrinking earnings, find themselves with debt equal to five or more times their current net income."

"The strong balance sheets and strong management of Cap Cities and Washington Post leave us more comfortable with these investments than we would be with holdings in any other media companies. Moreover, most media properties continue to have far better economic characteristics than those possessed by the average American business. But gone are the days of bullet-proof franchises and cornucopian economics."

SEE'S CANDY: A CASE STUDY IN FRANCHISE VALUE & PRICING POWER.

A lesson in franchise value for Charlie & me....

"We've just passed a milestone: Twenty years ago, on January 3, 1972, Blue Chip Stamps (then an affiliate of Berkshire and later merged into it) bought control of See's Candy Shops, a West Coat manufacturer and retailer of boxed-chocolates."

"The nominal price the sellers were asking, calculated on the 100% ownership we ultimately attained, was $40 million. But the company had $10 million of excess cash. Therefore the true offering price was $30 million."

"Charlie and I, not yet fully appreciative of the value of an economic franchise, looked at the company's mere $7 million of tangible net worth and said $25 million was as

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BERKSHIRE HATHAWAY'S
LETTER TO SHAREHOLDERS
(cont'd from preceding page)

high as we would go (and we meant it). Fortunately, the sellers accepted our offer."

"The sales of trading stamps by Blue Chip thereafter declined from $102.5 million in 1972 to $1.2 million in 1991. But See's candy sales in the same period increased from $29 million to $196 million. Moreover, profits at See's grew even faster than sales, from $4.2 million pre-tax in 1972 to $42.4 million last year."

The key: earnings growth relative to capital requirements.

"For an increase in profits to be evaluated properly, it must be compared with the incremental capital ... required to produce it. On this score, See's has been astounding:

"See's now operates comfortably with only $25 million of net worth, which means our beginning base of $7 million has had to be supplemented by only $18 million of reinvested earnings."

"Meanwhile, See's remaining pre-tax profits of $410 million were distributed to Blue Chip/Berkshire during the 20 years for these companies to deploy (after payment of taxes) in whatever way made most sense."

We've made lots of money from lessons learned at See's.

"In our See's purchase, Charlie and I had one important insight: We saw that the business had untapped pricing power."

"Otherwise, we were lucky twice over. First, the transaction was not derailed by our dumb insistence on a $25 million price. Second, we found Chuck Huggins, then See's executive vice-president, whom we instantly put in charge. Both our business and personal experiences with Chuck have been outstanding. One example: When the purchase was made, we shook hands with Chuck on a compensation arrangement — conceived in about five minutes and never reduced to a written contract — that remains unchanged to this day...."

"Charlie and I have many reasons to be thankful for our association with Chuck and See's. The obvious ones are that we've earned exceptional returns and had a good time in the process. Equally important, ownership of See's has taught us much about the evaluation of franchises. We've made significant money in certain common stocks because of the lessons we learned at See's."

THE JOYS OF THE AIRLINE BUSINESS
AND AIRLINE INVESTMENTS....

Technically speaking, we were right about USAir....

"Last year I told you that our USAir investment 'should work out all right unless the industry is decimated during the next few years.' Unfortunately 1991 was a decimating period for the industry, as Midway, Pan Am and America West all entered bankruptcy. (Stretch the period to 14 months and you can add Continental and TWA.)"

Courts' approach perfectly designed — to kill the industry.

"The low valuation we've given USAir reflects the risk that the industry will remain unprofitable for virtually all participants in it, a risk that is far from negligible. The risk is heightened by the fact that the courts have been encouraging bankrupt carriers to continue operating."

"These carriers can temporarily charge fares that are below the industry's costs because the bankrupts don't incur the capital costs faced by their solvent brethren and because they can fund their losses — and thereby stave off shutdown — by selling off assets. This burn-the-furniture-to-provide-firewood approach to fare-setting by bankrupt carriers contributes to the toppling of previously-marginal carriers, creating a domino effect that is perfectly designed to bring the industry to its knees."

The toughest job in corporate America.

"Seth Schofield, who became CEO of USAir in 1991, is making major adjustments in the airline's operations in order to improve its chances of being one of the few industry survivors. There is no tougher job in corporate America than running an airline:

"Despite the huge amounts of equity capital that have been injected into it, the industry, in aggregate, has posted a net loss since its birth after Kitty Hawk. Airline managers need brains, guts and experience — and Seth possesses all three of these attributes."

BUFFETT & KEYNES ON INVESTING:
SEARCHING FOR SUPERSTARS....

Our view is that money moves from the active to the patient.

"As usual the list [of our common stock holdings] eflects our Rip Van Winkle approach to investing. Guinness is a new position. But we held the other seven a year ago (making allowance for the conversion of our Gillette position from preferred to common) and in six of those we hold an unchanged number of shares. The exception is Federal Home Loan Mortgage ('Freddie Mac'), in which our shareholdings increased slightly."

"Our stay-put behavior reflects our view that the stock market serves as a relocation center at which money is moved from the active to the patient. (With tongue only partly in check, I suggest that recent events indicate that the much-maligned 'idle rich' have received a bad rap:

"They have maintained or increased their wealth while many of the 'energetic rich' — aggressive real estate operators, corporate acquirers, oil drillers, etc. — have seen their fortunes disappear.)"

Coca-Cola & Guiness have strong geographical similarities.

"Our Guinness holding represents Berkshire's first significant investment in a company domiciled outside the United States. Guinness, however, earns its money in much the same fashion as Coca-Cola and Gillette — U.S.-based companies that garner most of their profits from international operations. Indeed, in the sense of where they earn their profits — continent-by-continent — Coca-Cola and Guinness display strong similarities. (But you'll never get their drinks confused — and your chairman remains unmovably in the Cherry Coke camp.)"

"We continually search for large businesses with understandable, enduring and mouth-watering economics run by able and shareholder-oriented managements."

(continued on next page)

BERKSHIRE HATHAWAY'S
LETTER TO SHAREHOLDERS
(cont'd from preceding page)

We aren't smart enough to make money flipping businesses.

"This focus doesn't guarantee results: We both have to buy at a sensible price and get business performance from our companies that validates our assessment. But this investment approach — searching for the superstars — offers us our only chance for real success."

"Charlie and I are simply not smart enough, considering the large sums we work with, to get great results by adroitly buying and selling portions of far-from-great businesses. Nor do we think many others can achieve long-term investment success by flitting from flower to flower. Indeed, we believe according the name 'investors' to institutions that trade actively is like calling someone who repeatedly engages in one-night stands a romantic."

If at first you do succeed, quit trying....

"If my universe of business possibilities was limited, say, to private companies in Omaha, I would, first, try to assess the long-term economic characteristics of each business; second, assess the quality of the people in charge of running it; and, third, try to buy into a few of the best operations at a sensible price. I certainly would not wish to own an equal part of every business in town."

"Why, then, should Berkshire take a different tack when dealing with the larger universe of public companies? And since finding great businesses and outstanding managers is so difficult, why should we discard proven products? (I was tempted to say 'the real thing.') Our motto is: 'If at first you do succeed, quit trying.' "

Di-worse-ification doesn't reduce risk or increase return....

"John Maynard Keynes, whose brilliance as a practicing investor matched his brilliance in thought, wrote a letter to a business associate, F.C. Scott, on August 15, 1934 that says it all:

" 'As time goes on, I get more and more convinced the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes.' "

" 'It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence... One's knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put *full* confidence.' "

MISTAKES OF THE SECOND 25 YEARS:
THE FIRST INSTALLMENT....

I don't want my backlog of mistakes to get unmanageable.

"In the 1989 annual report I wrote about 'Mistakes of the First 25 Years' and promised you an update in 2015. My experiences in the first few years of this second 'semester' indicate that my backlog of matters to be discussed will become unmanageable if I stick to my original plan."

"Therefore, I will occasionally unburden myself in these pages in the hope that public confession may deter further bumblings. (Post-mortems prove useful for hospitals and football teams; why not for businesses and investors?)"

Errors of omission aren't as visible, but they're expensive.

"Typically, our most egregious mistakes fall in the omission, rather than commission, category. That may spare Charlie and me some embarrassment, since you don't see them; but their invisibility does not reduce their cost."

"In this mea culpa, I am not talking about missing out on some company that depends upon an esoteric invention (such as Xerox), high-technology (Apple), or even brilliant merchandising (WalMart). We will never develop the competence to spot such businesses early."

"Instead I refer to business situations that Charlie and I can understand and that seem clearly attractive — but in which we nevertheless end up sucking our thumbs rather than buying."

Your chairman's $1.4 billion mistake....

"Every writer knows it helps to use striking examples, but I wish the one I now present wasn't quite so dramatic: In early 1988, we decided to buy 30 million shares (adjusted for a subsequent split) of Federal National Mortgage Association (Fannie Mae), which would have been a $350-$400 million investment."

"We had owned the stock some years earlier and understood the company's business. Furthermore, it was clear to us that David Maxwell, Fannie Mae's CEO, had dealt superbly with some problems that he had inherited and had established the company as a financial powerhouse — with the best yet to come. I visited David in Washington and confirmed that he would not be uncomfortable if we were to take a large position."

"After we bought about 7 million shares, the price began to climb. In frustration, I stopped buying (a mistake that, thankfully, I did not repeat when Coca-Cola stock rose similarly during our purchase program). In an even sillier move, I surrendered to my distaste for holding small positions and sold the 7 million shares we owned."

"I wish I could give you a halfway rational explanation for my amateurish behavior vis-a-vis Fannie Mae. But there isn't one. What I *can* give you is an estimate as of year end 1991 of the approximate gain that Berkshire *didn't* make because of your chairman's mistake: about $1.4 billion."

IKE FRIEDMAN
[1924-1991]

"My friend and partner, Ike Friedman, CEO of Borsheim's, died last September. Ike was a business genius and showman, and these qualities enabled him to take a hole-in-the-wall store his family purchased in 1948 and from it build a retailing phenomenon of national reknown. His most outstanding attribute, however, was a big, warm heart that will forever be remembered by all who knew him."

—OID

BRANDES INVESTMENT MANAGEMENT'S
CHARLES BRANDES AND GLENN CARLSON
(cont'd from page 1)

the Morgan Stanley World Index.

Here are Brandes' annual performance figures after all fees and expenses alongside those of the S&P 500 and the MSWI Index. (All performance figures were provided by Brandes Investment Management.)

Year	Brandes Inv Mgmt Total Return	S&P 500 Total Return	MSCI World Index
1978	+8.7%	+6.6%	
1979	+30.3%	+18.4%	
1980	+34.3%	+32.4%	+25.7%
1981	+13.6%	-4.9%	-4.8%
1982	+29.9%	+21.4%	+9.7%
1983	+39.9%	+22.5%	+21.9%
1984	+7.1%	+6.3%	+4.7%
1985	+35.6%	+32.2%	+40.6%
1986	+20.9%	+18.5%	+41.9%
1987	-2.5%	+5.2%	+16.2%
1988	+26.0%	+16.8%	+23.3%
1989	+13.1%	+31.5%	+16.6%
1990	-11.9%	-3.2%	-18.4%
1991	+36.6%	+30.5%	+15.6%
1978-91	+19.1%	+16.1%	
1980-91	+19.1%	+16.7%	+14.9%

With slim pickings domestically for old fashioned bargain hunters and one contributor after another proclaiming the more attractive valuations of selected international markets, we thought it was only natural to give Brandes a call.

Your editor had the pleasure of speaking with Brandes and fellow portfolio manager Glenn Carlson by telephone at their San Diego office. We found our conversations nothing less than facinating and believe you will as well.

DOMESTICALLY, IT'S TOUGH TO FIND BARGAINS.
OVERSEAS, IT'S GENERALLY A LOT CHEAPER....

OID: Long time, no speak. How are you?

Brandes: I'm doing great. How are you?

OID: Befuddled, bewildered and confused.

Brandes: Talking to Seth Klarman again?

OID: Not since last issue. But ever since, we've been looking at put options more than stocks.

But isn't Klarman right? Aren't things expensive?

Brandes: Most things are. But some things aren't.

OID: I know you're never supposed to think about "the market". But haven't cheap stocks tanked along with everything else in declining markets of the past?

Brandes: Oh yeah, they will. That's true. It's history. However, market timing is very, very difficult to do.

And long term, I'm really bullish about what's going on around the world. It's great stuff. So I want to be invested.

OID: Why can't you be a bull long term, but a chicken short term?

Brandes: You can. However, you can get into trouble doing that. I could give you lots of cases of people not getting back in and missing out on the big gains.

Over the long run, high cash levels don't help you.

OID: Maybe not over the long run, but don't the statistics strongly suggest that sub-3% dividend yields are the equivalent of the kiss of death to equity returns?

Brandes: Yes. Of course, Ken Fisher suggests that dividend yields aren't all that low relative to interest rates. And earnings are near cyclical lows and likely to improve.

Plus, there's so much good stuff happening around the world — for example, the free trade agreement with Mexico and Canada. The future looks really bright.

OID: Agreed. But don't job loss fears encourage a new round of protectionism? And don't these wonderful developments around the world require capital? And isn't that likely to force interest rates up?

And Julian Robertson points out that short-term interest rates are higher in Germany than here — which is absurd.

Brandes: It's true. Interest rates *will* be coming down in Germany, of course.

OID: And going up here.

Brandes: Yeah. But that's all the more reason for going overseas. And fortunately, I'm finding some things that are reasonable — although many of them are not out-and-out bargains. But if you make a few assumptions about the future, some of them are pretty attractive.

In general, they're more growth-oriented than absolute 4 or 5 times earnings, 50%-60% of book value, 2 times cash flow bargains. Very few of those are around.

OID: Is this Charles Brandes?

Brandes: You have to be flexible in life.

But we're finding cheap stuff overseas — and a few things domestically, too. Most of it, though, is overseas. In fact, I'm the highest percentage overseas that I've ever been.

OID: I imagine that Buffett might be able to say the same thing about Berkshire's portfolio.

Brandes: And it's easy to see why. Overseas markets are generally a lot cheaper than the U.S. market in terms of P/E ratios and so forth. They're especially cheap based on cash flows. And we think that cash flow is a good, simple way to adjust for the different accounting.

For example, European markets are generally selling for half the valuations cash flow-wise of the U.S. today.

You may just have to become a foreign rag for awhile.

OID: Agreed.

Brandes: And I don't think there's anything wrong with that. You go where the values are.

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BRANDES INVESTMENT MANAGEMENT'S
CHARLES BRANDES AND GLENN CARLSON
(cont'd from preceding page)

THERE'S A GREAT DEAL TO BE OPTIMISTIC ABOUT IN HONG KONG, CHINA AND ELSEWHERE....

Brandes: Other areas of the world are undergoing such dramatic changes — moving toward free enterprise and especially free trade. Free trade is so important for a country's growth and development. And privatization is the third thing that's going on that makes the rest of the world quite exciting.

And these dramatic things are happening in markets that are already very reasonably priced. Honestly, we're running out of markets that are just *extreme* bargains. There are very few of those left. But there are still some that are very reasonably priced. So we're excited.

OID: That makes two of us at least — especially when you consider that if privatization works over there, they may try it over here.

Carlson: That's exactly what they were saying at a recent conference on Mexico that I attended. In 1992, they expect to have a budget surplus. And they suggest that the immigration problem at some point may go the other way.

OID: It already is in places like New York and Detroit.

Brandes: You talked about Hong Kong last issue. Well, I'm about as bullish on Hong Kong as you can get. The things going on there are just unbelievable.

Deng Xiao Peng is doing it the way that it was done in South Korea and Singapore.

OID: In other words, dollar democracy first.

Brandes: That's right. If you go into Singapore now chewing gum, you're thrown into jail.

OID: It's been suggested to us that such an approach may be best — that the political freedom first approach can all too easily fail.

Brandes: That's right. And that's exactly what Russia and Eastern Europe are coping with right now. And Deng Xiao Peng said that the Russians did it wrong and that the Chinese are going to do it completely opposite. They're going to liberalize economically *before* liberalizing politically.

He even observed how stupid they were in Russia and how that led to the downfall of the communist party there. But I need to come up with something different — because you talked about Hong Kong last time.

OID: Nothing wrong with repetition. You echoed Buffett and Noel in 1990 on Freddie Mac. And that worked out OK.

Brandes: Fantastic is more like it. With the benefit of hindsight, your reputation continues to grow.

OID: Let's leave our publication schedule out of this.

Brandes: No, you've been pickin' em — Freddie Mac, Philip Morris and Telefonos de Mexico among others.

OID: On behalf of Robert Noel, John Constable, John Templeton and yourself, thank you.

But if our contributors have been picking 'em, then why aren't we rich?

Brandes: You have to invest in them.

OID: I knew we were forgetting something....

Speaking of regrets, you mentioned Telefonos de Mexico to us in 1990. I understand that it's done OK?

Brandes: Since then, it's up about 6 times.

FOREIGN TELEPHONE COMPANIES.

OID: Do you have any great bargains for us today that we can regret not having bought in future issues?

Brandes: Sure. We like the foreign telephone companies. They're cheap. And it's been recognized generally, but especially in emerging countries, that you don't let the government do it. You give people the freedom to do it.

The number one thing that you *have* to have for economic development is a modern telephone system. You absolutely *have* to have it. For example, about 5 years ago a major Japanese manufacturer was looking at Mexico because he thought it might be a place to move his company's manufacturing operations.

But he had to keep calling back to Japan to report what he was doing. And at that time, he could never call home. So he concluded that despite all of the good things, they couldn't do business in Mexico and he went home.

OID: Boy, has that changed.

Brandes: It sure has. And many countries — including emerging countries such as Brazil, Argentina, Chile, other Latin American countries, the Philippines, Indonesia, Thailand and others — have realized that the telephone system is very important.

And with reforms going on in these countries, if you can get them cheap, the phone companies are the safest and best way to participate. And they give you good potential, too. That's all there is to it.

So we're fairly heavily invested in telephone systems around the world.

TELEFONOS DE ESPANA — THE CHEAPEST OF THE GROUP.

OID: But isn't that yesterday's idea? Isn't everybody looking for the next Telefonos de Mexico?

Brandes: Maybe. But we think that four or five of them are pretty interesting. For example, one we're buying is Telefonica de Espana — the Spanish telephone company. It has ADRs traded on the New York Stock Exchange — symbol TEF. It's probably the cheapest of the group.

OID: A terrific start. Tell us about it.

Brandes: They have all the telephone service in Spain — both domestic and international. They're a monopoly. We're buying it here at $33 — which is roughly 5 times earnings using U.S. GAAP accounting principles. It's more like 12 times earnings using Spanish accounting because depreciation is expensed much, much faster there.

And the last few years, Telefonica's been doing a large

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BRANDES INVESTMENT MANAGEMENT'S
CHARLES BRANDES AND GLENN CARLSON
(cont'd from preceding page)

amount of spending for infrastructure which has increased its depreciation very, very substantially. That, of course, is hurting them a great deal using Spanish accounting. And Telefonica just announced that they're going to be slowing down their spending.

OID: Very interesting.

Brandes: Also, because of all of this spending, Telefonica has not increased its dividend. And the market hasn't appreciated that. So it's been selling at these low P/E ratios for awhile.

But now they've announced that they're going to start increasing their dividend in line with their earnings growth. And their growth in earnings should be pretty good — at least 15% per year. The market's going to get a little more excited about the stock if they increase the dividend.

Also, as they continue to reduce their capital spending, their earnings in Spanish accounting are going to get closer to their U.S. GAAP earnings. And I've seen some analyses that say that within 3 or 4 years, the Spanish and U.S. numbers are going to be the same.

OID: Of course, we thought we'd be rich by now.

Brandes: Those analysts are competent. Anyway, the markets don't seem to look through Spanish accounting. And the majority of the market for Telefonica is in Spain.

Eventually, it's going to be recognized that this stock is dirt cheap at 5 times earnings. It's just ridiculous given the potential growth in Spain and the Olympics in Barcelona coming along this summer. Telefonica's international business will probably double this summer just because of the Olympics.

OID: What's Telefonica's book value?

Brandes: Telefonica's book is currently around \$45 or \$46 using U.S. GAAP — including about \$3 of intangibles. Subtract that out and you have about \$42. That's still well over today's \$33 stock price.

OID: What kind of growth are you expecting over the next 5 years?

Brandes: I think they'll easily do 15% per year. Between '90 and '91, they've done that.

OID: Despite paying out roughly a third of earnings in dividends during that time.

Brandes: I personally think that 15% is conservative. Incidentally, they are not currently up to the standards of most of the rest of Europe — especially the Germans and the British. But they're getting there. They're certainly a lot closer than the Italians. But they've done so much investing over the last 4 or 5 years that there'll be a slowdown anyway.

OID: Where's fair value?

Carlson: I think fair value would be what the world's telecommunications companies are selling for on GAAP — which is about 14 times earnings.

OID: Or about 3 times the current stock price.

Brandes: That's right.

THE KEY TO TELMEX'S RAPID EARNINGS GROWTH:
MORE ATTRACTIVE RATE REGULATION....

OID: However, aren't Telefonica de Espana's returns on equity much lower than Telefonos de Mexico's?

Brandes: They're regulated differently.

OID: What is Telefonica's regulatory environment like?

Brandes: It's fair to middling. Telefonica's rates are based on rate of return on book value or invested assets. TelMex's are based on price cap — which is a hell of a lot better system.

OID: Price cap?

Brandes: Rates are based on today's prices plus an adjustment for inflation.

OID: That's wild. Doesn't it get cheaper and cheaper to provide the service over time?

Brandes: You've got the key. That's why we loaded up on TelMex when they first announced it.

When the Mexicans were first looking at privatization and building up and modernizing their infrastructure, they asked Southwestern Bell and France Telecom how they should regulate the rates. And Southwestern Bell said, "Don't regulate it like they do in the U.S. where there's no incentive to reduce costs. Do it this way." And they did.

As soon as I saw that, I started buying the hell out of TelMex because I thought it'd go to the moon.

OID: And it did.

Brandes: And TelMex's earnings are continuing to grow at a tremendous rate.

OID: But you can't count on it staying that way — until they change their minds. Right?

Brandes: In the case of TelMex, they're going to take another look in 1996.

OID: What are the odds that it stays that way?

Brandes: I can't put odds on that.

Carlson: In the current political environment in Mexico, I think it's a pretty safe bet that they would allow it to continue. I've listened to the head of Mexico's Office of Privatization, their Economics Minister and a lot of other senior officials for the last couple of days. And they're all still extremely positive about what's going on.

OID: Of course, that's their job....

Carlson: The question that kept coming up was, "What's going to happen once Salinas is gone? Is it going to change?" And they said that they couldn't envision that it would — because you can't argue with success. And the simple fact is that people's standard of living is being raised. You're seeing economic growth where you haven't seen it for years and years. Not every single dime is being paid to support foreign debt loads anymore. They're actually able to put some money into public works projects and things like that.

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BRANDES INVESTMENT MANAGEMENT'S
CHARLES BRANDES AND GLENN CARLSON
(cont'd from preceding page)

With that kind of environment, I'd say that it's pretty likely that they'll allow price cap regulation to continue.

Brandes: It's always possible that the average man in the street will see how much money Telefonos de Mexico has made. We complain about the post office here. Everybody likes to complain about the telephone company in Mexico. So there might be some political pressure to change things.

Telefonos de Mexico is no longer quite the bargain that it was, but we believe that it's still a bargain today. Because of the way that its rates are regulated, earnings should keep growing nicely and expenses should continue to decline.

Their 1991 earnings surprised everyone, although they didn't surprise me all that much. *Value Line*, for example, was estimating that Telefonos would earn $3 in 1991. Well, they actually earned $4.26.

And in 1992, I expect them to earn $5.50 — at least. So you're talking about a stock selling at 10 times earnings.

OID: Why is growth so fast right now?

Brandes: Because their base was so low, there's just so much room for improvement — not only in the growth of revenues, but the reduction of expenses. It's incredible.

OID: What's your sense of growth after 1992?

Brandes: It's going to slow down. But we value guys aren't earnings projectors.

OID: Please don't make me beg.

Carlson: I think it would be extremely conservative to assume 20% earnings growth. That's the kind of dynamic that's going on there.

Latin America and Mexico may be where East Asia was thirty years ago in terms of its industrialization process. It's *just starting*. They have 83 million people and there are 10 lines per 100 people — vs. 80 or so in the U.S.

And these are people who want to grow and work hard. The old stereotype of the sleepy Mexican just isn't true. Mexico just has *huge* potential. I've seen GNP estimates of 6% per year growth for the '90s.

OID: So it's up over 25 times in the last 5 years and still may have tremendous growth ahead. Amazing.

Carlson: It has a huge discount from a typical world phone company — despite having much greater potential.

OID: And your average cost?

Brandes: We've bought it several times. We first bought it in the mid-'80s at about $2 and sold it at $8 adjusted for new ADSs. Then when this privatization thing came along and this rate structure was put into place, it had already gone up another 50%-60% — but we bought it back anyway.

OID: Have you bought any at current prices?

Brandes: We have. And we still like it. But again, it's just not the bargain that it used to be. Of course, when you've bought it at 3 and 4 times earnings, you get spoiled.

OID: That's what I hear. But I'd like to experience it myself at some point.

AN OFFER THEY CAN'T REFUSE:
UNDERPRICED AND UNDER BOOK.

OID: Where's the next Telefonos de Mexico?

Brandes: The next one, maybe, is in Italy. The name of the company is STET. That stands for Societa Finanziaria Telefonica. STET's a government controlled holding company in Italy. And its subsidiaries are all companies that trade publicly. And STET owns a majority of their stock.

One of them is called SIP. Don't ask me what that stands for. SIP is a domestic telephone company for Italy. And it generates a majority of STET's revenues, but not a majority of its profits.

The other public company STET owns is Ital Cable. It's Italy's long distance monopoly.

OID: Can you run us through their fundamentals?

Brandes: STET has an ADR. It's trading around $18 right now. You're looking at trailing earnings of $1.80 — so that it's trading at only about 10 times trailing earnings and at slightly over book.

The Street is anticipating very little earnings growth in 1992. I've seen estimates of 7% or so.

OID: Why is this the next Telefonos? Are they making consumers an offer they can't refuse or what?

Brandes: There's talk right now about reforming the tariffs in Italy. But I don't know exactly what's going on with that at the moment. However, there is also talk about a price cap mechanism like that of Telefonos de Mexico's. And we think something like that will happen.

The reason why is that they know they're way behind the rest of the European Economic Community in terms of lines per people and the quality of their system. They know that the only way they'll be able to compete is to do something about it. And it could be very interesting.

Carlson: Also, all utilities in the European Economic Community have to come in line with EEC standards. And STET's tariff structure is too low.

OID: In other words, they don't charge enough.

Carlson: That's right. I can't tell you exactly how it's going to work. But we understand that earnings will bounce 10%-15% just from bringing their rates into line with the rest of Europe.

OID: What are the odds of Italy going to a price cap regulation mechanism?

Brandes: Maybe 50/50.

OID: So heads you win, tails you win big.

Brandes: That's right. And Italy only has about 35 lines per 100 people — or less than half of the U.S. The U.K., Germany and France all have about 50 to 60 per 100.

OID: It sounds excellent, but not like another Telefonos. Could you quantify growth prospects?

Brandes: You keep asking that. I imagine you're

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BRANDES INVESTMENT MANAGEMENT'S
CHARLES BRANDES AND GLENN CARLSON
(cont'd from preceding page)

talking 15% growth without a price cap tariff and, maybe, 20% to 25% with a price cap tariff.

TWENTY PER CENT PER YEAR EARNINGS GROWTH AT 5.6 TIMES 1992 EARNINGS....

OID: Any others?

Brandes: Sure. Another one that's really interesting is Philippines Long Distance. But you just wrote it up.

OID: What's your investment rationale?

Brandes: Penetration is unbelievably low in the Philippines — around 2 per 100. It's the lowest in Asia. They've got a *long* way to go.

And the Philippines government has more or less said that one of their top priorities is the telephone system. So you'll see very dramatic increases in Philippines Long Distance Telephone's earnings for a long time.

OID: We're all ears. Tell us about the fundamentals.

Carlson: Philippine Long Distance Telephone (PLDT) is an ordinary share on the American Stock Exchange.

Brandes: Earnings in 1991 were up by 48% — to 4,722 million pesos. That's up from 2,971 million in 1990. The Street was estimating around 5,200 million for 1992, but I think 5,800 to 6,000 million is more likely.

OID: I assume that that's for PLDT as a whole. Could you give us the per share figures?

Brandes: Sure. Earnings in '92 should be about 132 pesos per share. At roughly 27 Philippine pesos to the dollar, that's about \$4.88 per share. With PDLT selling at around \$33-1/2 on the Amex, it's selling at a little over 7 times earnings.

OID: And you think it's worth more than 6 times earnings?

Brandes: Philippine Long Distance's equity is going up something like 40% per year. And we're expecting about 30% earnings growth in 1992.

OID: I assume that means yes.

Carlson: It's an aggressive number.

Brandes: But it was 48% in 1991.

Carlson: The 30% earnings growth assumes earnings per share of 132 pesos — which is very reachable. However, the Street is estimating 127 pesos or something like that.

Brandes: But the Street's been wrong on it before.

OID: Could you run us through its historical earnings progression?

Brandes: In 1991, earnings per share were 101 pesos.

OID: So even if it's 127 pesos in 1992, we're still talking about rapid growth. But are those figures in pesos or dollars?

Brandes: Pesos.

OID: So that we ought to give it a haircut for inflation.

Brandes: That's right — although PLDT does adjust its rate base for inflation.

OID: And after 1992, what's normalized growth?

Brandes: They've got a long, long way to go with 1-1/2 lines per 100 people. I don't have a crystal ball. But depending on Filipino politics, I wouldn't think that 25% per year would be unreasonable. Earnings should grow by at least 15% to 20% per year for a long, long time.

OID: Is that nominal or real growth?

Brandes: Real.

OID: That would be mighty fast. What's the book at PLDT?

Brandes: Its book value is 17,461 million pesos. There are 45,550,000 shares outstanding. So PLDT's book is roughly 383 pesos per share or \$14 per share.

OID: It sounds like Philippine Long Distance is selling at a very low P/E, a high multiple of book and earning huge returns on equity. What accounts for that? And is it sustainable?

Brandes: It's very interesting. Asian utilities have what's called a "scheme of control". And under the Philippines' scheme, they're permitted a rate of return of 12% of the average revalued fixed assets plus 3 months of operating expenses.

That's very interesting — because it's not rate of return on equity, but rate of return on fixed assets.

OID: Revalued, no less.

Brandes: That's right. It's also adjusted for inflation. And this company is growing assets like gangbusters. Their expansion programs are incredibly large. And it's the policy of the Philippines government to get the telephone company up to snuff. So they're going to spend money like mad for new equipment.

That scheme of regulation is why PLDT's earnings are exploding. It's trading today at 8-1/2 times historical earnings and 6 times estimated 1992 earnings.

OID: If it continues, it's almost like a TelMex situation.

Brandes: Absolutely.

OID: But what is the regulatory environment like? And at 2-1/2 times book, aren't you at risk of it changing?

Brandes: I'm not that worried about it right now because it's the outright stated objective of the Philippine government to get this phone company up to snuff. And I don't think they're likely to create a major problem with its profitability because their investment program is huge.

Also, it's fairly leveraged. Their debt to equity is around 1.6 to 1. Therefore, in order to finance the needed development, they'll have to generate the profits. So I don't think that the Philippines will shut them down.

OID: Assuming rational behavior, of course.

Brandes: There's talk that NYNEX will take a stake in Philippines Long Distance and that they'll shoulder the cost

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BRANDES INVESTMENT MANAGEMENT'S
CHARLES BRANDES AND GLENN CARLSON
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for some of these huge expansion programs. There hasn't been anything announced yet, but they're in the process of talking with NYNEX.

Carlson: And based on TelMex — where Southwestern Bell bought a big stake — and Telefonos de Chile — where Telefonica de Espana bought something like a third interest — these foreign telephone companies are ready to jump in. And they're excited about it. They're going to be willing to pay up to get their stakes too. So companies like Philippines Long Distance should be able to sell big stakes at higher multiples.

OID: So you don't think the regulatory environment will deteriorate anytime soon.

Brandes: That's right. Also, the Philippines social security system owns 9.9% of Philippines Long Distance. And the government under an outfit called the Philippines Telecommunications Investment Corporation owns 25%.

I don't foresee any changes coming anytime soon.

OID: Say no more. But why then is the P/E so low?

Carlson: It's located in the Philippines.

OID: Might you be a tad more specific?

Brandes: The Philippines is having major difficulties getting its act together.

Carlson: Philippines Long Distance should sell at a discount to other telephone companies because there's above average political risk in the Philippines — period.

Brandes: The Philippines' democracy is along the lines of a U.S. democracy.

OID: Exactly what First Philippine Fund's Kit Rodrigo told us last issue.

Brandes: He's right. They can't get anything done. There are eight guys running for President. They look like our list of presidential candidates.

OID: I didn't realize you guys sold short.

Carlson: There are also active communist guerillas over there. And you have a very aggressive army that takes care of these guerillas in what some would call very undemocratic fashion — which generates very negative sentiment in the Philippines and around the world.

(continued in next column)

Brandes: Although they're not much of a factor anymore.

Carlson: Except for the fact that they get a lot of press and people think about them. Also, you have a less stable political structure there. It seems to be getting more stable — but you never know.

Finally, they have a tremendous need for capital. And how it's financed is a question.

OID: Of course, one answer is through good returns for Philippines Long Distance.

Brandes: That's right. If they come up with the right answer, it'll be fine. But you never can tell for sure.

OID: You've bought closed-end funds at deep discounts in the past. Any thoughts on First Philippine Fund?

Brandes: We haven't done anything with it, but I own it in my personal account. We generally don't like to buy closed-end funds for clients unless they're trading at a pretty good discount.

OID: Isn't a discount of more than 20% pretty good?

Brandes: It is. I think it's really interesting. But one of First Philippine Fund's biggest holdings is Ayala. And I don't know if I want to own that.

We do, of course, want to own Philippine Long Distance — which is around 30% of his portfolio.

OID: Why don't you want to own Ayala?

Brandes: I have a prejudice against land developers no matter how great a discount they may be selling at.

TELEBRAS — A POTENTIAL NEW TELMEX
AT LESS THAN 1 TIMES BOOK....

OID: Any others?

Brandes: One of the very best bargains out there today is Telebras — the Brazilian telephone company. It has the potential of being a big winner. It already has been a winner — having gone from $2 to $33 over the last 8 or 9 months. But it has a long way to go yet, I think.

I think there's more potential in Brazil than in any other South American country right now. Of course, there's still more risk too. Brazil hasn't gotten its act together yet. They're not nearly as together as Argentina, Chile or Mexico.

They're still having inflationary difficulties. Collor doesn't know how to free up the economy. They have a new finance minister, however, who may be able to pull it off.

But there's still so much political resistance in Brazil. What Salinas did to overcome it in Mexico has not yet been accomplished in Brazil. But you've got to be early. We were really early in Telefonos de Mexico before it took off.

OID: Nobody's perfect.

Brandes: But the potential of Brazil is just staggering. They have vast mineral resources.

Best of all, they have a very, very cheap stock market.

OID: How cheap is it?

Brandes: Brazilian earnings are a little bit nebulous.

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OID: No problem. Nebulous earnings are our specialty.
Brandes: But I would guesstimate that the Brazilian market is selling at about 6 or 7 times earnings.

OID: And that has to be 6 or 7 times depressed earnings — which is another of our specialties.
Carlson: Yeah. Brazilian earnings are all depressed — including Telebras' earnings.

Brandes: But I think they're going to get themselves halfway straightened out towards what Argentina has done. Argentina, of course, is their next door neighbor.

And I can't put a number on it. But the potential is just so great that I think it's worth a bet the same way that we bet on the potential of Mexico — where it worked out quite well.

OID: A mild understatement. And this one does sound awfully similar....
Brandes: Yeah.

Carlson: It sure does. And it's important to realize that Brazil's hand is being forced to do the right things. South America is starting their own free trade zone called Mercosur — which means "southern market". I can't remember all of the participants, but it includes Argentina, Chile, Venezuela, Uruguay, Brazil and the rest of them. And they're all getting together and talking about reducing tariffs and exploring the possibility of having some free trade go on between them.

And in order to do that, telephone and other utilities will have to be placed on an even keel. And that just forces Brazil's hand to get its act together.

The problem is that Brazil has had great potential for 25 years now. They've never lived up to it.

Brandes: But things are changing.

Carlson: There is change of thought and reform going on. And Mexico is the leader. But they're not the only ones doing it. Everyone else is jumping on the bandwagon.

Brandes: Right at the moment, there's no political consensus in Brazil to go in this direction. And there are still a lot of vested interests who are very interested in protectionism, mercantilism and not reforming very fast.

OID: And in a nutshell, that's why the market is so cheap — plus the crippling policies of Collor?
Brandes: That's right. And we're just saying on the other hand that we don't know for *sure* that these problems will be solved. But if they do, the potential is explosive. So let's put part of our portfolio down there.

OID: Good old fashioned risk/reward ratio.
Brandes: You've got it.

OID: Tell us about Telebras' fundamentals.
Carlson: They haven't raised rates for 6 or 8 years or something like that during a horrendous period of inflation. As a result, their system is in terrible shape. And you can spend all day doing nothing but trying to get a dial tone.

Brandes: So you won't see Telebras' earnings power right away because they don't hardly charge anything for domestic telephone services in Brazil. Its 1991 earnings were $2.50. So Telebras is selling at about 13 times 1991 earnings. And on estimated 1992 earnings of around $3.50, the P/E's only about 9. The current stock price is $33.

And those earnings have the potential of being *a hell of a lot* higher — depending on what happens and whether or not they get their act together.

OID: Could you quantify "hell of a lot"?
Brandes: We're expecting 50%.

OID: Five zero!
Brandes: Yeah. And it could continue for awhile if they want to pull off what TelMex has done. But it's a pretty volatile situation to determine precisely.

But who cares? Let me give you some statistics that we find fascinating compliments of BEA — who's coming out with a closed-end Brazilian fund:

Mexico's population is 85 million versus 150 million for Brazil. TelMex has 9.6 lines per 100 people versus 9.3 for Telebras. TelMex's market capitalization is $30 billion versus $1 billion for Telebras. And price to book for TelMex is about 5 times versus 1 times for Telebras. Those figures are as of year end. So both of them would be higher today.

PORTFOLIO REPORTS estimates the following were Brandes Investment Management's largest equity purchases during the quarter ended 3/31/92:

1. CHINA LIGHT & POWER LTD ADR
2. HSBC HLDGS PLC SPONSORED ADR
3. HANSON PLC ADR
4. SALOMON INC
5. SANDOZ REGISTERED SHARES ADR
6. JARDINE MATHESON HLDG ADR
7. BRITISH STEEL PLC ADR
8. TELEFONICA DE ESPANA SA ADS
9. LIBERTY BANCORP INC
10. HUTCHISON WHAMPOA ADR

OID: Anything else we should know about Telebras?
Brandes: Just buy it. That's all you need to know.

OID: How does one buy it?
Brandes: Brazil just opened up. Before that, foreigners couldn't buy there. Now they're operating under what are called 144-A rules which is the only way that a U.S. investor can buy it. Those rules basically require that you be a qualified institution.

OID: And qualified to be in an institution won't do?
Brandes: I'm afraid not.

Carlson: As I understand it, you have to meet the $100 million minimum and either be regulated by the SEC, a stock exchange, the NASD or the Department of Labor.

Telebras is probably going to be coming out with an ADR offering around the world underwritten by Merrill Lynch. They're talking about it happening around the end of the year. If they're smart, they'll copy TelMex altogether.

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But we can't know that yet.

OID: But you get that impression.
Brandes: We sure do. And the stock is cheap today. Whether it's cheap on the ADR offering, we'll just have to wait and see.

Carlson: Telefonica de Argentina came out under a 144-A ADR issuance at 24 times trailing earnings...

Brandes: And 18 times prospective earnings.

Carlson: There was no way to measure Telefonica de Argentina's operating results prior to 11 months ago. However, that didn't stop it from coming out at 24 times earnings — which just shows the high level of enthusiasm for what's going on in Latin America in general.

Earlier in 1991, Telebras was trading at a discount from prospective earnings.

OID: At less than 1 times earnings!?
Carlson: That's right. Prospective earnings were \$2.50 per share. And Telebras was selling around \$2.

OID: And you didn't even call?
Carlson: We started looking at it around \$6 and started buying it around \$8. Unfortunately, we were very limited in terms of the accounts for which we could buy it because it's a 144-A situation.

But we started buying it wherever we could for \$8 or \$9 a share. Now, it's trading at \$33 a share. And that's just from the fourth quarter of 1991.

And a lot of that's on the news of their plans to float it and speculation that the Brazilian government hopes to get a pretty penny for it. So they're probably going to clean it up, change the rate structure and float it at a decent price.

OID: What are the odds that they use the TelMex model — price cap pricing and all of that?
Carlson: Mexico's the leader in Latin American reform. And everybody's starting to follow their example.

OID: Talk about a bullish omen.
Brandes: Argentina has already gone a long way in following the Mexican example. Brazil has not.

Carlson: But Brazil's in big trouble. And they're being forced to do things right because of the success in Chile, Argentina, Venezuela and, most of all, Mexico.

OID: When you first mentioned telephone companies, I set aside some extra caffeine to help me stay awake. But instead, I'm trying to figure out how to qualify as a purchaser under 144-A rules.
Carlson: If things go right, the sky's the limit for Telebras. It's the best way to participate.

OID: Investment merits aside, is the price cap mechanism good for society or does it leave too much on the table?
Brandes: I think it makes a lot of sense. It gives the companies an incentive to reduce costs instead of paying them essentially the same return no matter how efficient or inefficient they are. So consumers ultimately wind up with lower cost service.

Carlson: Not to mention the fact that it results in more efficient service and better access to service.

OID: How is the initial rate set?
Carlson: They start from their previous base. And that has typically been done based on assets. Then starting from there, there are incentives for the operator. They have an opportunity to make a profit. But they can only raise their rates by the rate of inflation.

They can always make more money by increasing efficiency though. It seems awfully win/win to me. In the long run, I'd think that it would be good for society.

I just spoke with a Latin American guru a few days ago. What he said is that what's going on throughout Latin America — not just in Mexico — is that you're starting to see a deconcentration of economic and political power. Previously, it was concentrated in a few hands. Now you're seeing true reform.

I asked him if Brazil was getting serious about it, too. And he said that they have no choice. Brazil has a tougher and longer road, but they have to do it. And the way that they're going to start is with Telebras. And it's dirt cheap.

OID: Any others you can tell us about?
Brandes: That's the story from a valuation standpoint. Some of the other telephone companies are overpriced — including Telefonica de Argentina, New Zealand Telecom and Telefonos de Chile.

UNDERLEVERAGED, DISCOUNTED SAVINGS BANKS
WILL BE TAKEN OVER AT BOOK — OR MORE.

Brandes: You mentioned how skeptical you were when you heard telephone companies. The next area where we're finding bargains is one that sounds equally boring at least on the surface — small savings banks.

OID: Are you sure that you don't want to stop while you're ahead?
Brandes: We made a lot of money last year in small savings banks. Ours were up something like 70%. But we're still very interested in them. They're still cheap. They have lots of potential. And, in fact, I think that some of them are slam dunks.

OID: We pride ourselves on being open minded. But you're certainly putting us to the test.
Aren't the savings banks boring and mediocre?
Brandes: You be the judge. The savings banks we're interested in are those with real solid loan portfolios and lots of equity trading at 60%-70% of book and so forth.

OID: What are they worth?
Brandes: The good ones are worth slightly over book — although we'd be happy to sell them *at* book.

OID: I'll bet.
What's their typical return on equity?
Brandes: They aren't great right now, although they're

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expanding. You're probably talking 10% to 15%.

Carlson: ROEs aren't wonderful in these things because they've got a lot of "E".

OID: In other words, too much equity.

Brandes: That's right.

Carlson: They haven't leveraged themselves much. And ROEs hopefully will go up as they leverage themselves prudently.

Brandes: And what's interesting about having a lot of "E" is that eventually a lot of these will be taken over.

OID: For their leverage potential.

Brandes: Exactly.

Carlson: Absolutely. And it makes sense. There are thousands of savings institutions with maybe six branches. And why should one of the bigger ones build from scratch when they can buy existing ones for book or a slight premium?

Brandes: They don't mind paying a slight premium to book so long as they're paying in stock and not cash. They come out looking pretty good — so long as their own stock is selling at a premium to its book. And that's going to happen again.

OID: At what price do you think they'll be taken over?

Brandes: Today, they'd be taken over at something between book and 110% of book. Back three or four years ago, they'd have been taken over at two times book on average.

OID: Do we detect a trend?

Brandes: Six months ago they wouldn't have been taken over at any price. So the trend is on the upswing.

Incidentally, the Mexican banks that are being privatized started out going public at 3 times book. The latest one went at 4-1/2 times book. They have seven more Mexican banks to privatize — and some people are talking about prices of 5 times book.

It's ridiculous. And it will be a problem for Mexico.

OID: A problem most U.S. banks would like to have.

A WELL-MANAGED, OVERCAPITALIZED BANK
AT A 30% DISCOUNT TO BOOK.

OID: I assume that you're going to name names — whether we like it or not.

Brandes: That's right. Liberty Bancorp, symbol LBCI is traded OTC. Based in northwest Chicago, it's a two-office savings bank with 8.2 million shares outstanding. Its book is $19-1/2. And its stock price is $13-1/2.

OID: That's a discount all right — over 30%.

Brandes: Its equity to assets ratio is 13%. Insiders own 25% of the stock.

OID: Not bad — for a bank.

Brandes: And non-performing assets are .13%.

OID: What kind of ROA and ROE have they maintained over the years?

Brandes: It just converted from a mutual association so we don't know. Their present ROE is about 7% — which, of course, is pretty poor.

But they could leverage up nearly 3 times and still meet the requirements. So they could be earning nearly 20% if they leveraged up.

OID: Is that the way the math works? Doesn't the leverage cost you something?

Brandes: No. We're talking about a positive spread. It's not like they'd be borrowing money to leverage. They'd just be investing the equity. For example, they could simply send stockholders a $5 per share dividend.

Carlson: That'd be a nice way to do it.

OID: In other words, just distribute cash that they don't need as footing for the business.

Brandes: That's exactly right. Earnings would decline slightly, but not nearly as much as their equity. So they'd dramatically increase their return on equity.

OID: So the 20% ROE number might not be that far off.

Brandes: It's not that far off. They won't leverage up quite that close to the requirements. Maybe they'll double their leverage and their ROE — you'd be at a 14% ROE at 7% equity-to-assets. And they'd still be a very safe bank.

OID: Have they thought about just buying back shares?

Brandes: That's another way to do it. And a lot of banks are doing just that. Liberty isn't doing it yet — because again they just converted. I haven't gotten any indication whether they will or not. But you can be sure that I'll be talking with them about it.

VSB BANCORP: AGGRESSIVE SHARE REPURCHASES
& SHAREHOLDER-ORIENTED MGM'T AT 40% OFF.

OID: Any others?

Brandes: Another one — buying back as much stock as possible — is VSB Bancorp. VSBC is the symbol.

They're trading at $9-1/2. And they have a book value of $16.

OID: Wow. A 40% discount? What's the problem there — embezzlement?

Brandes: No, they're in Closter, New Jersey. That's what's wrong. And they've got new management in there. But prior management did some commercial development and equity participation development loans. Like everybody else, they got their rear ends handed to them.

However, a guy named Allen S. Green has taken over the reins. He's gone right back to the basics, gotten rid of their commercial and development positions, written them all down and substantially reduced expenses. It's been cleaned up completely. So today, they're plain vanilla.

So the answer is that nothing's wrong with them.

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OID: And they're aggressively repurchasing shares?

Brandes: To the extent that they're allowed. Regulations only allow them to buy back 10% of their shares each year — which they're doing. And they'll keep doing that as long as their shares sell at a deep discount. That's the whole plan.

Actually, there is one more part to the plan — which is to sell the bank — which they will do.

OID: Sounds shareholder-oriented in spades.

Brandes: Oh, yeah. The guy running the bank right now, Allen Green, was part of an operation of Zohar Ben Dov. He's the guy on a farm in Virginia who did a lot of semi-value-type investing. A few years ago, they bought a lot of these savings banks at deep discounts. And VSB was one of them.

VSB was being run very poorly. So when VSB got into all of this trouble with these commercial development loans, Allen Green got on the board by way of a proxy fight, pointed out to the other board members that the president of the bank wasn't running it properly and explained what they ought to be doing. So the board fired the other guy and made him president. And he's straightened it out.

So he came from the outside about a year ago with the idea to get this bank sold for book value or better. And his objective is still the same.

OID: Very interesting.

Brandes: The market still isn't good enough today to find a buyer for the bank. Meanwhile, he's going to continue buying in shares.

He has other options, too — including increasing the bank's leverage. It's 11.2% equity to assets right now.

OID: So he could more or less double it.

Brandes: That's right.

OID: I don't see it in my trusty S&P Stock Guide. Is it very small?

Brandes: That's right. It's real small. There are only about 2 million shares outstanding.

WEBSTER FINANCIAL: A 33% DISCOUNT TO BOOK
WITH REALLY GOOD MANAGEMENT.

OID: Any more like that one?

Brandes: There are lots of them. And there's one more I'd like to tell you about — Webster Financial Corp., symbol WBST. Webster's based in Waterbury, Connecticut. Its stock price is $11-1/2. They have more leverage. Equity to assets is 7.2%.

But they're trading at 57% of stated book with a very conservative and good loan portfolio. They're buying the FDIC crap. For example, they just bought some assets from a Suffield bank under FDIC control. And they get some pretty good deals on some of this stuff.

They've increased their leverage some by going out and buying deposits. So their earnings could be expanding at a pretty good clip.

OID: Tell us about their fundamentals.

Brandes: They only earned about a $1.07 in the last 12 months. But if they leverage out, I figure that they could earn as much as $2.50 per share.

OID: And they're selling at all of 5-1/2 times that.

Brandes: That's not what I'm expecting them to earn this year, mind you. That's core earnings potential assuming an equity to assets ratio of 5% to 6% and after they get rid of their current problem loans.

OID: How good is management?

Brandes: They're really good. They didn't get into the trouble that every single management in New England did. But their non-performers still went up over the last couple of years. Right now, they're 2.3% — whereas they were substantially under 1%. But that's a damn good performance considering the environment.

OID: How far back does management go? And how have they done historically in terms of ROE, earnings growth, etc.?

Brandes: James C. Smith, the President, joined the bank in 1975. They converted from a mutual in 1986. For five years, asset growth has been 8% per year, there's been no earnings growth and average ROE has been 6%. It's not been very impressive but remember, this is New England.

HONG KONG — SELLING AT A DISCOUNT,
BUT DESERVING A PREMIUM....

Brandes: Glenn just got back from Hong Kong and China. He can tell you what we're doing there.

OID: Terrific. John Templeton and Mark Holowesko can't say enough good things about it. We're all ears.

Carlson: We talked about the Philippines earlier. And their stocks should be given a pretty significant discount because of the political risk.

Well, that's the perception of Hong Kong held pretty much worldwide — so that Hong Kong stocks are selling at a discount, too. But we strongly believe that it's a mistaken impression. In our opinion, it's improperly analyzed and absolutely misunderstood.

We would go one step further. We believe that instead of selling at a 50% discount to the world's markets, that Hong Kong probably deserves a premium given its tremendous potential.

But the world sees the possibility of Hong Kong ending in 1997 once China takes over.

OID: But being eternal optimists, you prefer to see it as communism beginning.

Carlson: We prefer to see it as a continuation of what's been going on the last 5 years.

OID: Fear?

Carlson: It's been mostly fear in the newspapers and occasionally lots of fear — like during Tianamen Square. However, the reality is that China has two faces. They have

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a political face which is extremely harsh with a hard line. And they have an economic face which is pragmatic.

How much fear does it indicate when Hong Kong companies have almost completely transferred their manufacturing operations outside of Hong Kong into the bordering province of Guangdong?

OID: Not much — assuming it was done by choice and not by coercion.

Carlson: What happened is that Deng Xiao Peng decided to try spicing things up with an experiment in economic reform. And that experiment was in the form of setting up special economic zones where a free market would be allowed to run and where capital from outside of China would be allowed to come in that would utilize the labor and other resources of China.

And it's been a very symbiotic relationship. Hong Kong businessmen were running out of space and labor. China had a whole lot of space and labor, but didn't have any capital, management know how, distribution systems or financial expertise.

OID: A match made in heaven.

Carlson: And it's worked out that way so far. There were 2 million manufacturing jobs in Hong Kong. Now there are 700,000 manufacturing jobs in Hong Kong and 3 million people in China directly employed by Hong Kong companies.

OID: And plenty more where they came from.

Carlson: You're not kidding. Guangdong's population is about 65 million. And there's an economic zone bordering the new territories called Shenzhen and another bordering Macau called Zhuhai that have just been phenomenally successful.

Deng Xiao Peng recently visited Guangdong and said, "The experiment has been successful beyond our wildest dreams. We need to move these special economic free trade zones into the provinces *throughout* China — not just Guangdong."

OID: Incredible.

Carlson: And he made a big parliamentary statement that economic reform should be the government's prime mission for the next 100 years. That means a lot of good things for people who are already doing business in China, for people who have a common cultural background, a common language and yet who know how to run a business — and that's Hong Kong.

OID: I understand that even the hard-liners are talking about free market policies.

Carlson: That's right. And Deng Xiao Peng has started to bring in economic reformers and kick out the hard-liners. There's a big fight between Deng Xiao Peng and Li Pong. Li Pong was the heavy in Tianamen Square. And he just came out and said, "Yes, I support economic reform — absolutely. But we're also going to keep the screws on really tight with respect to political reform."

So even Li Pong — the hard liner of all hard liners — is supporting economic reform. And the reason it's happening is the phenomenal success of Guangdong Province. In fact, they just allowed the province in its entirety to become a free zone.

OID: The implications are mind boggling.

Carlson: They are. The growth that is going on in Guangdong is *unbelievable.* I just recently returned from a two day visit there. I was on a train for 8 or 10 hours — going all through this province. And everywhere I looked, another factory was being built. *Everywhere.*

And they weren't wearing the grey Mao suits in Guangdong. They were wearing Reeboks and Nikes. I saw more than one BMW and Mercedes Benz. And they weren't owned only by government officials.

OID: I understand Western goods are very popular.

Carlson: Absolutely. You see a lot of western tennis shoes and I saw a fair share of Izod shirts.

OID: I always wondered where they'd gone.

Carlson: I have no idea what percentage are counterfeits — although I would guess that it's a reasonably high percentage. But they're getting the issue of intellectual property rights straightened out, too. And farmers are even allowed to make profits off their land.

I saw 4-story beautiful homes. The standard of living in Guangdong is four times that of the rest of China. It's incredible.

That wasn't the case ten years ago. It's all because of this really wonderful relationship between Hong Kong and China that was built over the last 12 years, but really has accelerated over the last 5 years.

You mentioned all the fear. Well, six months after Tianamen Square, Hong Kong businessmen invested more in China than they had during any other period in the past — six months *after* Tianamen Square during the *height* of the fear. They realized that Tianamen Square was a bad political judgement, but they were confident that the Chinese leadership wouldn't turn out the lights.

OID: Despite the widespread perception otherwise.

Carlson: And the profits generated by the Chinese subsidiaries of these Hong Kong companies have just been fantastic. Some people are calling it Guangdong Kong — because they really are one now.

OID: So Guangdong Kong has rung your gong despite Li Pong — and you've gone long Hong Kong?

Carlson: Could you say that again?

OID: I doubt it.

Carlson: It's very hard to get hard economic data out of China. But it's estimated that Guandong Province has grown between 13% to 16% *per year* over the last 5 years.

OID: Amazing.

Carlson: It's unbelievable. And this is in China — allegedly the most closed economy in the world. But the fact of the matter is that the Chinese leadership realizes that if they're going to maintain political power, they better have a strong economy and they better be able to feed and

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clothe people, give them something to do and educate them — which means they have to generate real economic results.

OID: In other words, they're one step ahead of what passes for leadership over here.

Carlson: Exactly. And their state run industries are in terrible shape with an estimated 30% of them bankrupt — just bleeding money. They're generating very little of benefit for anyone. And a huge portion of the real tax revenues being sent to Beijing are generated in Guangdong.

OID: Truly amazing — and an awfully important point.

Carlson: So Hong Kong is a way to participate. And integration has gotten to the point where you can spend your Hong Kong dollars in Guangdong — and actually get change back in Hong Kong dollars. That just amazed me.

It's not widely realized, but Hong Kong is becoming an economic force. And they're doing it via their relationship with China. There have been tremendous ties made between Beijing and Hong Kong.

There'll no doubt be some occasional saber rattling. But the reality is that these things are in place, they're extremely successful, Deng Xiao Ping can't say enough good things about them and they're going to continue to happen.

And again, the reason we were interested in Hong Kong in the first place is that it's one of the cheapest markets in the world. Hong Kong's trading at 13 times 1991 earnings and 11 times 1992 earnings.

OID: And it certainly wouldn't be a shocker if it surprised people with higher than expected earnings.

Carlson: Absolutely not. In fact, one analyst calls the Hong Kong/Guangdong relationship "the world's most successful economy" — whether it's in terms of generating trade surpluses, budget surpluses, corporate profits, economic growth, you name it. It's just fantastic.

And you can invest in the world's most successful economy at 11 times earnings. And you're not buying schlock businesses. Hong Kong businessmen are terrific. They run their businesses with no debt.

OID: Is that possible?

Carlson: Debt is not a part of a Hong Kong businessman's life. These are terrifically run businesses that are extremely bottom line-oriented. Most Hong Kong businesses tend to have very high returns on equity — but without debt. If they leveraged themselves a bit, it's hard to imagine what they might do.

OID: Maybe even develop into the Chinese equivalent of Donald Trump or Robert Maxwell.

Carlson: Hong Kong's one of the higher yielding markets in the world. It has one of the lowest P/E ratios. It's located in a part of the world that's going great guns.

And that's not even including the possibility of the rest of China opening up and becoming a consumer market. It's been suggested that China could even become the largest electronics consumer in the world before this decade ends. The potential is fantastic.

But even ignoring that potential and focusing on the here and now, the Hong Kong/Guangdong relationship continues to grow and expand. There's no shortage of labor for a long time to come. China continues to beg Hong Kong businesses to come in. It's probably the most exciting story in Asia right now — possibly in the world.

OID: Possibly in a long, long time.

Carlson: It's been suggested to me that if everyone could get over their misplaced worries about China taking over Hong Kong, the Hong Kong market could triple in only a few years.

That's a little bit aggressive. Expectations are that Hong Kong businesses will grow their earnings at 20% to 25% per year for the foreseeable future. So he's assuming P/E ratios will more than double.

But is it outlandish if the Hong Kong market does half or three quarters of that? I don't think so.

OID: What's the price to book?

Carlson: Price to book is pretty cheap, too. I think the Hong Kong market is selling at all of about 1.3 times book. And that's after it went up 42% last year and 16% this year. So I'm not sure that cheap prices are going to be around for the next 5 years in Hong Kong.

Again, Hong Kong is very exciting. And what's even more exciting is that you can buy terrific businesses at terrific prices.

THIRTY PER CENT HISTORICAL GROWTH
AT 10 TIMES DEPRESSED EARNINGS.

OID: Might we trouble you to get specific?

Carlson: Sure. One of the businesses that we like a whole lot is run by one of the Hongs of Hong Kong. It's Jardine Matheson — a trading house founded in 1832.

It's involved in a wide array of businesses. It has the Mercedes Benz dealership in Hong Kong, for example. And, by the way, Hong Kong Mercedes Benz sales in the month of December increased 50% over the year before's figure. Another piece of trivia — something like 13% of all cars sold in Hong Kong are Mercedes Benzes. And Hong Kong has more Rolls Royces per capita than any other country in the world.

Jardine Matheson also owns Jardine Fleming — the big Asian fund management and stock brokerage outfit. They own a lot of insurance companies, insurance brokers, reinsurance companies, etc.

And they own a hotel chain called Mandarin Oriental Hotels. They have a very famous hotel in Hong Kong, but they also have branches in San Francisco, Singapore and Malaysia.

They also own restaurant franchises — for example, Sizzler's Restaurants — throughout Asia.

OID: Including the franchise for China?

Carlson: That's right. And they own the rights to Pizza Hut as well.

OID: Imagine the value of that franchise once Chinese living standards have ratcheted up for awhile.

Carlson: It's incredible. And they own a big piece of

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CHARLES BRANDES AND GLENN CARLSON
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Dairy Farm — which is one of the world's largest grocery and supermarket operations. They have 60% of the market share for supermarkets in Hong Kong. They have about a 10% share of the market in Spain and a big market share in Taiwan, New Zealand and Australia as well.

They're also a significant owner of Hong Kong Land — which is *the* blue chip property owner and developer in central Hong Kong. They own *the* name properties.

They also own the security guard services for the Hong Kong airport and other airports throughout the world.

And they have a big interest in construction. And they're distributors of branded wines and spirits.

OID: Talk about synergy...

Carlson: They do a whole lot of things, but they do a whole lot of things very well.

I don't know yet what their '91 results will be. They say that they expect "healthy double digit growth". But for the last 5 years, their earnings per share have grown at about 30% per year — as have their dividends per share and book value.

OID: We could live with that.

Carlson: Early last year, Jardine Matheson was going through a scandal with the Hong Kong Stock Exchange. Jardine Matheson wanted to have its primary listing in London and have a secondary listing in Hong Kong. The Hong Kong Stock Exchange said, "No. If you're going to have a Hong Kong listing, it must be your primary listing. We want to have control over you in Hong Kong." And they were fighting back and forth.

And for some reason, the market hated it. It absolutely thought that it was the worst thing in the world — the fact that it might not be listed in Hong Kong anymore and only in London.

OID: It doesn't sound like a tragedy of biblical proportions.

Carlson: Who gives a damn. Earnings are earnings are earnings. At one point, Jardine Matheson was trading at 7 times earnings. The stock was trading at about HK$30 in the fourth quarter of last year. Today, it's at HK$47. Our cost is about HK$36.

OID: Can you tell us about their fundamentals?

Carlson: In 1990, they earned HK$3.53. In 1991, they could come in as high as HK$4.20. In 1992, they could easily earn HK$4.80.

OID: So that they may be selling at less than 10 times prospective earnings?

Carlson: That's right. And they've had improved results in a lot of their businesses — especially the unquoted parts — like insurance, stock brokerage and fund management.

OID: How many shares outstanding?

Carlson: They have 626 million shares.

OID: Or HK$29 billion.

Carlson: And if you multiply that by 12-1/2¢ per Hong Kong Dollar, it comes to about $3.7 billion U.S.

OID: That sounds pretty low for their collection of businesses.

Carlson: We think so. And incidentally, they were allowed to have a trading listing in Hong Kong and a primary listing in London. But interestingly enough, the quoted portions of their business — the Dairy Farm, the Hong Kong Land, the Mandarin Oriental and the Jardine International Motor Holdings, which is the Mercedes Benz distributors — really did pretty crummy last year. And they don't have wonderful expectations for this year.

So you're looking at depressed earnings.

OID: So not only is the P/E low, but earnings are depressed, too.

Carlson: That's right. Take Hong Kong Land. It's suffering because commercial rents dropped in 1991. And they're expected to continue dropping in 1992 — or, at best, to just stay reasonably flat.

But you're talking about *the* blue chip properties in a part of the world that is growing in tremendous fashion. When you do business, you do it in Central Hong Kong. And there's not that much land there. Everything's pretty much built up.

Or take their supermarket side — Dairy Farm. They were having trouble in Spain, Australia and New Zealand. But they're going to make money.

Dairy Farm is a terrifically well run business. It's just that the market's reasonably negative on the expectations for Dairy Farm near-term. Once these businesses recover, it'll be clear that this thing was trading real cheap.

OID: What's Jardine Matheson's book?

Carlson: It's HK$41 vs. a HK$47 stock price.

OID: Which sounds like a mighty low price to book ratio for this company.

Where's most of the value in this firm?

Carlson: It is well diversified. And all parts of their business are very well run.

OID: There's no preponderance of value in two or three segments?

Carlson: They're diversified business-wise and geographically. I think most of their value is that they have significant Hong Kong and Asian operations. And those things make a ton of money.

They keep diversifying outside of Hong Kong and Asia — because they want to be prudent and safe and so forth. But Hong Kong earnings keep growing so that they remain 50% of their earnings. The real value is from their exposure to Asia and Hong Kong.

People are betting that Jardine Matheson will do about HK$4.80 per share in 1992 — despite the fact that big pieces of their businesses aren't doing well. Earnings could come in as high as HK$4.20 for last year.

OID: So that 1992 could easily come in at HK$5.00 — which would mean that it's selling at 9-1/2 times earnings. That's very cheap.

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Carlson: Especially for a company that's extremely well positioned. On my trip through China, it was fascinating to see the open air markets, but it was also disgusting. Nothing was refrigerated. And the conditions are not exactly what you would think of as sanitary.

As Guangdong develops a consumer economy, supermarkets are going to come in. And Dairy Farm will be there. Dairy Farm is already putting in ice cream shops. And people are eating ice cream like it's going out of style. They can't put enough ice cream shops into Guangdong.

OID: Of course, as standards of livings rise, discretionary income rises even faster. Dairy Farm first, then Pizza Hut, then liquor and, finally, Mercedes.

Carlson: Exactly.

OID: You mentioned that they'd compounded earnings, dividends and book value 30% per year over 5 years. What about over 10 years or more?

Carlson: They had some trouble during the early '80s. What happened was that during the late '70s and early '80s, they got a little over-aggressive in their diversification — as many people have — and over-leveraged themselves. They got into some trouble and had to sell some things off. But I think they've learned from their mistakes.

OID: What do you think they'll manage in the future?

Carlson: As I see it, they're seeing the trees rather than the forest in Hong Kong and China. And while they're putting a lot of money in Hong Kong, they're also divesting. And that's going to dilute earnings growth — because they just can't get the same kind of growth in Australia, New Zealand and elsewhere. For example, they own the Beverly Hills Mercedes Benz dealership.

OID: You don't expect the same kind of growth in Beverly Hills as Guangdong?

Carlson: What a shocking thing to suggest — that Guangdong is a much more attractive place to invest than Beverly Hills. They can match the rate of growth that people are projecting for the typical Hong Kong business — which is 20% per year — over the next 3 to 5 years. If they stuck to their knitting and focused on Hong Kong, I think they'd do better still.

And the results could be much better than I described if the other parts of the business that haven't been doing very well started perking up. There could be a big change in their numbers.

OID: Have you calculated either its private market value or its intrinsic value?

Carlson: We haven't. But most of their businesses are quoted separately. If everything were sold tomorrow at its current stock price — not what they're worth — they would sell for around HK$55 per share.

OID: Amazing.

And how would you rate the managers on a scale of 1 to 10?

Carlson: High 8, maybe. They'd be a 10 if they would stop diversifying away from Asia. Aside from that, they're terrific managers. I'm not sure that you could find better managers anywhere.

They know that they've done some things poorly. But they generate lots of cash. And they're not going to wildly diversify. They're paying down debt. They'll be almost exclusively an equity-financed business.

They're also level-headed and they have very realistic expectations.

OID: How much insider ownership is there?

Carlson: About 10% of the company is owned by the Keswick family.

OID: And how much debt is there?

Carlson: Jardine Matheson has shareholder equity of HK$11 billion and long-term debt of HK$6 billion.

OID: But again that's Hong Kong dollars. Divided by 8 to get U.S. dollars, it's not a big number for these guys.

Carlson: That's right and they're paying it down fast.

A WELL MANAGED HONG KONG BANK
AT 6 TIMES NORMALIZED EARNINGS.

OID: What else are you excited about in Hong Kong?

Carlson: Something that we were more sanguine about before this week — although we still like it very much — is HSBC Holdings aka Hong Kong Shanghai Banking.

OID: Why the change?

Carlson: A week ago, they came out with their results. Their earnings per share growth in 1991 was 83%. Granted, it was from a very low level because 1990 was a terrible year.

Upon announcing those results, analysts asked them, "You've had these tremendous results. Things are going great guns in Hong Kong and in Asia. You've stopped the bleeding mostly in Australia. You're making a little money in Canada. It looks like the bleeding is slowing down or stopping with Marine Midland. And as regards your 15% ownership of Midland Bank in the U.K., the bleeding seems to have slowed down or stopped there as well."

"What are your expectations? Are you going to continue to buy or take a full position in Midland Bank in the U.K.?"

OID: Those analysts are pretty long winded, huh?

Carlson: It's an occupational hazard. In any case, Hong Kong Shanghai Bank's management said, "No. We don't expect to be doing that. Midland doesn't have the kind of European exposure that we're looking for. We'll probably use a joint venture relationship with them."

So the analysts were relieved. Well, one week later they announced that they were purchasing Midland Bank.

OID: Aren't they entitled to change their minds? And, more important, how was the price?

Carlson: They're going to pay a slight premium over book — which is a lot better price than they paid for their

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50% stake a few years ago. And Midland Bank could turn out to be a decent long-term investment because the U.K. banks have gotten as beaten up as the American banks. Midland Bank was following the Citicorp mold — you know, write-offs and big trouble. They weren't in danger of going bust by any means, but their profits were just decimated.

OID: What kind of profits and earnings growth has Hong Kong Shanghai managed historically?

Carlson: I only have the numbers from '87 with me. And they did way better before that. They earned HK$2.34 in '87, HK$2.72 in '88, HK$2.99 in '89 and HK$1.93 in '90. Their earnings declined in 1990 because their Australian subsidiary was the biggest lender to Alan Bond — and Marine Midland did terribly. Basically, everything outside of Hong Kong did terribly while Hong Kong continued to be incredibly robust.

And in '91, analysts were estimating that they'd earn HK$2.90 to HK$3.00. Well, Hong Kong Shanghai earned HK$3.48 in '91. Our '92 earnings estimate is HK$4.90.

If they can stop the bleeding in these other areas, you could see earnings in 1993 of HK$7 to HK$8 a share.

OID: How likely is that?

Carlson: That's only 4% above Street estimates. And last year, the Street was low by 16%.

OID: What's the book value?

Carlson: That's an interesting question. Hong Kong Shanghai Bank trades right now for about HK$41. Current book value is about HK$25 or HK$26 per share.

However, Hong Kong banks have this thing called inner reserves. Every year, they take something out of earnings and put it into this black box category. And what it does is to help them smooth earnings in tough times. It's estimated that Hong Kong Shanghai's inner reserves total around HK$30 per share.

So its adjusted book would really total around HK$55 per share. And with the Midland Bank acquisition, they'll have to publish their hidden reserves, which they've heretofore been reluctant to do, to meet U.K. requirements. So the market will see exactly what they are.

OID: Interesting. And if those estimates are correct, based on current prices, we're talking a 25% discount to book.

Carlson: Exactly.

OID: What kind of ROE do you anticipate from these guys going forward?

Carlson: It's difficult to say. But again, they could earn HK$7 in a couple of years. That's pretty quick growth.

OID: Hard to argue with you there. And after that?

Carlson: They could earn HK$10 within the next 4 or 5 years. And that's 4 times today's stock price for a bank in an incredibly fast growing part of the world.

Historically, these banks have made a ton of money. And 20% normalized earnings growth is very possible in this part of the world because of all the dynamic things that are going on.

OID: At 6 times normalized earnings, it's hard to resist. And your cost?

Carlson: About HK$32. It's the cheapest bank in Hong Kong. Here's a statistic for you. HBSC Holdings owns 66% of Hang Seng Bank. Well, Hang Seng currently sells for 14 times earnings.

If you value HSBC's interest in Hang Seng bank and their other Hong Kong earnings at a 14 P/E and add to that a very reasonable estimate of non-Hong Kong operations, you come up with a valuation of HK$57 per share. And that's without including anything for the hidden reserves.

Meanwhile, Hong Kong Shanghai's trading at HK$41.

OID: Sounds cheap all right.

Carlson: And Hong Kong needs capital. Where are they going to go? Hong Kong Shanghai Bank. They really know how to run the business.

They've made some really stupid moves in an attempt to diversify. But hopefully, they've learned their lesson.

OID: And the Midland Bank acquisition?

Carlson: They believe they understand Midland Bank. The Midland acquisition will be somewhat dilutive to earnings short-term. But if you're ever going to buy a bank in England, now's the time to do it. It's certainly depressed. It's just gone through a tough time. It's an awfully blue chip bank. And it's not a terrible price.

We're not pleased that they purchased it, but we can live with it.

OID: These guys aren't like Deutsche Bank with all of the hidden value in equity stakes in other companies, are they?

Carlson: They do have other things — like James Capel, the big Hong Kong brokerage and fund manager. But the lion's share of their earnings is from banking. And the biggest piece of it is Hong Kong banking.

OID: You know how fond I am of banks generally. But it does sound terrific.

Brandes: And they've been a lot more profitable than they've been reporting over the last 10 or 15 years. And their earnings are going to be growing something like 50% per year for the next 2 or 3 years.

Carlson: At least not including the impact of the purchase of Midland Bank — which we can't determine until we know more details.

However, Midland Bank was trading at £2.90 before the offer. And book value — what they call net asset value — is £3.20. And Hong Kong Shanghai is expected to bid £3.30 to £3.50. But I saw one worst case scenario that calculated that even if they paid £5.00 and used all stock to completely dilute their earnings per share, Hong Kong Shanghai's earnings would still grow an estimated 25% next year and 30%+ the year after.

OID: And thereafter?

Carlson: We think you get back to the whole Asia story. To us, the fact that they're diversifying away from Asia is a negative. Some people, however, point out that

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you don't get too many chances to buy one of *the* top quality U.K. clearing banks at book value. That's a once-in-a-century kind of offer.

OID: And if you can resist it...
Brandes: I wish they'd resist it.

Carlson: But you've got Asia. And you've got China. And Hong Kong Shanghai Bank is the pseudo-central bank in Hong Kong. They're the ones who print the money — along with Standard Chartered Bank.

OID: Rich or poor, it's good to be able to print money.
Carlson: What's going on in Hong Kong and in Asia is just so exciting. And it's not Japan. It's Hong Kong, it's Indonesia and it's Malaysia. Long run, things look very positive for that region.

OID: And five years from now?
Carlson: That's an impossible call really. But I would be very comfortable saying that we're going to see HK$11 a share in earnings. That would make it a HK$110 stock.

OID: And there's nothing written in stone — no matter how hard it may be to imagine it today — that says well managed banks can't sell at 15 times earnings.
Carlson: And, in fact, in Hong Kong they do.

Brandes: In fact, a pure Hong Kong bank trades at 18 times earnings. But a worldwide bank like Hong Kong Shanghai Bank is selling at 12 times depressed earnings.

OID: It's an intriguing idea. But do you have anything that isn't a bank?
Brandes: We've got banks and telephone companies.

OID: And I'm listening to you?
Brandes: It's really unbelievable when you think of it — banks and telephone companies. My God!

Carlson: The exciting things used to be computer companies. I don't recall where I saw this. But someone observed that computers are the toasters of the '90s. They're giving them away at banks now. One bank is giving them away for free if you open a $5,000 account.

OID: How times change. It wasn't that long ago that you could buy a toaster and get a bank for free.
Carlson: That's true.

TOMEI HOLDINGS: METEORIC GROWTH
AT 7 TIMES 1992 EARNINGS.

OID: Any other bargains you can tell us about?
Carlson: Sure. You can get a double bang for your buck by going smaller cap in Hong Kong. Historically, small caps have traded at a premium to the big caps. Right now, however, it's reversed.

The reason why we primarily own bigger companies, however, is that it's easier to get information. And we think they're a bit easier to understand and then to follow.

OID: Challenge us, please.
Carlson: A small cap play in Hong Kong right now is Tomei Holdings. It's a very interesting little company. And it's made more interesting because it has a black box aspect to it. They do some venture capital and private placement stuff — which is hard to discern.

But this is a really intriguing company.

OID: Tell us about it already.
Carlson: Tomei is trading at about 7 times earnings. It's the purest exposure we know of to the Guangdong Province. Tomei utilizes the abundant cheap labor there to manufacture very low-end consumer electronics — headphones for walkmans and things like that. They're manufacturers for people like Panasonic and Sony who can't manufacture it cheaply enough anymore in Japan.

So they give it to a Hong Kong company who turns around and makes it in China, re-exports it to Hong Kong who gives it to Japan who sends it to the U.S.

They make tremendous money. They've been very successful taking positions in other companies. They're sort of doing their own version of the Japanese keiretsu. They take positions in their suppliers. And then they float these suppliers in the market and make lots of money.

OID: Fascinating.
Carlson: But that's the part of the business that we're a little scared about — because it relies on something other than manufacturing expertise. But it seems like they should have an understanding of what's going on since these companies are their suppliers.

OID: No kidding.
And how much of their business consists of this venture capital stuff?
Carlson: About a quarter of their current earnings.

OID: But if they're trading at 7 times total earnings, if you discount the quarter from venture capital entirely, it's still only trading at 9-1/2 times earnings.
Carlson: That's right. And the fact is that people believe that the ownership that they have in some of these private placements are worth a ton.

Tomei's argument is that they're no longer going to be exporting to Canada, the U.S. and Europe through Japan — that they're in the middle of what will eventually be the biggest consumer electronics market in the world. Instead of making products for Sony and Panasonic, they plan to make their own private label stuff and make a ton of money selling it directly in Guangdong — you know, the walkmans, the watchmans, transistor radios and stuff like that. Tomei is the third largest walkman and CD manufacturer after Sony and AIWA.

OID: But don't they lose good customers and take on very tough competitors in the process?
Carlson: They have terrifically low labor costs. And don't forget that they're selling it in their home market. Also, this is very low tech stuff.

Brandes: It's a lousy business, too. It's a commodity business. However, they have a great advantage being able

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to manufacture in China. And I think that advantage will last for awhile. But it won't be an advantage forever. Manufacturing can move — as we know.

OID: Because China won't always be one of the lowest cost producers. But it's sure nice for Tomei while it lasts.

Brandes: Exactly.

OID: How sharp is management?

Carlson: Extremely sharp. To give you some idea of just how aggressive these guys are, they were recently quoted in the press as saying that they don't like doing business in Hong Kong because it's gotten "too civilized". In other words, they have to pay things like health insurance, social security and the like. And the tax rate in Hong Kong is way up there at 16-1/2%.

They're really aggressive.

OID: They'd just love New York and California.

How well has this guy done? And how far back does his track record go?

Carlson: You can get numbers back to 1986. They've done unbelievably well. Their operating earnings growth has been well over 40% per year — even *more* recently.

OID: Not too shabby.

Carlson: And the stock's *really* cheap.

OID: In spades. But why?

Carlson: The big reason why it's so cheap is fear about Congress yanking most favored nation status from China. If that happens, Tomei's business will be crushed — in the short run anyway. Again, most of the products that are being built in Guangdong are shipped to Hong Kong and re-exported to the U.S. If most favored nation status were taken away from China, Tomei would clearly be *the* most hurt by it.

OID: How likely is that?

Brandes: Taking away China's Most Favored Nation Status would be the stupidest thing that they could do. I think the odds of it happening are very remote.

Carlson: We don't think it's likely at all. Bush has said that he's steadfastly in favor of China retaining most favored nation status.

OID: Are you still reading his lips?

Carlson: His argument is that by yanking most favored nation status, you'd be hurting that part of China that's starting to provide reforms, bring improved standards of living for their people and bring in our Western ideals. And that would be the worst possible thing to do.

But that fear exists. If it were to happen, then Tomei's not going to make much money for awhile. But it wouldn't be yanked forever. If you bought the stock now and most favored nation status was not granted, you'd be negative on the stock price for a year or two. But down the road, I think you'd be very well served by owning that stock.

OID: What's the current stock price?

Carlson: Tomei sells for HK$2.20 — which is equivalent to 25¢ to 30¢. It's really kind of a pain in the neck to buy the shares because you have to buy so many. And the result is high transaction costs.

But Hong Kong companies tend to trade really cheaply. Chinese individual investors are like individual investors here. They don't want to pay $8,800 per share. They want to pay $8 per share.

Of course, we couldn't care less about the stock price as long as the fundamentals are sound.

OID: Speaking of fundamentals, what can you tell us about Tomei?

Carlson: Earnings in 1991 will probably be about HK25¢ or HK26¢ a share. It's a crapshoot for 1992, but we're guessing HK30¢ to HK32¢ a share.

OID: Are you expecting their meteoric growth to continue?

Carlson: Absolutely. I suppose our numbers assume that most favored nation status will not be yanked. Over the past 8 years, operating earnings have grown by roughly 50% per year — although share and rights offerings diluted their earnings per share to "only" 18% per year.

OID: But isn't that the nature of the beast in such a capital intensive business?

Carlson: They've got a lot of excess capacity right now.

OID: How many shares outstanding?

Carlson: Tomei has 646-1/2 million shares.

OID: That's only HK$177 million of equity capitalization. That sounds ridiculously low. Is Tomei heavily in debt or something?

Carlson: No. Its balance sheet is extremely sound. They have total capital of HK$523 million. And shareholders' funds represent HK$492 million.

It does include a valuation reserve. Some of these non-U.S. companies revalue their properties up or down — generally up.

OID: What sort of insider ownership is there? And how shareholder-oriented are they?

Carlson: The yield's about 4.5%. So that says something right there.

It's a really cheap company. Another difference between most Hong Kong companies and most U.S. companies is that the guys who run Hong Kong companies tend to own a big piece of their companies. And Mr. Johnny Lau and the directors own something like 30% of the stock. So when they're making bets, they're making bets with their own money.

MONEY IS ON EVERYONE'S MIND.
THEY'RE JUST DOING BUSINESS CONSTANTLY.

OID: How do you buy Hong Kong shares?

Carlson: We use a U.S. stock broker who has a sub-custodial relationship with a Hong Kong bank. Usually it's

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Hong Kong Shanghai Bank.

Brandes: And there are a lot of Hong Kong ADRs. For example, Hong Kong Shanghai Bank is an ADR as is Jardine Matheson. Tomei is not.

You know this, but it bears repeating — the Hong Kong dollar is pegged to the U.S. dollar. You don't have any currency risk when you buy in Hong Kong.

Carlson: In fact, if it were allowed to float — which is highly unlikely since they view the pegging as sacrosanct — the Hong Kong dollar would shoot to the moon. So you've actually got tremendous currency potential there if they ever were to allow it to float.

OID: Does that mean that Hong Kong companies enjoy a tremendous trading advantage?

Carlson: You bet.

OID: But don't you have to worry about the quality of information outside the U.S? The SEC isn't all bad after all.

Carlson: You don't get the divisional sales information that you do here. And there aren't quite as many disclosure requirements in Hong Kong. However, it's pretty close. The information's pretty darned good — especially when you invest in high quality issues like Jardine Matheson, the Hong Kong Shanghai Bank and China Light and Power. And there's movement more and more toward international accounting standards.

Another interesting fact that we should point out is that Hong Kong has a high inflation rate — around 12% — whereas their discount rate's around 4%.

Brandes: Which is still another reason why we like Hong Kong banks. Their spreads are really wide.

Carlson: They're lending money at 10% to 11% and only paying around 4%.

OID: A nice spread all right.

Carlson: In fact, the authorities have had to curtail mortgage lending activities in Hong Kong because residential real estate prices increased something like 50% last year. So they've tightened loan to value ratios. But despite that, prices have so far remained extremely strong.

Brandes: I expect that to be a temporary phenomenon. The Hong Kong real estate stuff is wild.

Carlson: Except where are the people getting the money to do this? It's from all the wealth that's being generated from this Hong Kong/Guangdong relationship.

In fact, one negative is that on my trip I was hearing the same kind of stories about Hong Kong real estate that I used to hear in Southern California — that real estate is a slam dunk, it never goes down and it's such a precious commodity that it can never go south.

But when you consider that in 1997, the border will become essentially meaningless and it's only an hour away and that people will commute to save money... I'm not sure what makes Hong Kong property all that valuable. They'll soon have all of China to move into.

People who believe that Hong Kong properties are forever going northward are not looking at reality.

OID: Buy the stock and sell the real estate.

Brandes: And you should be aware that a sizeable portion of the Hong Kong stock market consists of real estate companies.

Carlson: I don't know what the exact percentage is — maybe 20% to 25% of them. But I don't expect Hong Kong real estate to fall out of bed — because people have money. You're not getting to the point where people can't afford to buy them. They're lining up around the block.

Brandes: And, as I mentioned before, 13% of the auto market in Hong Kong is Mercedes.

Carlson: In fact, every cab is a Mercedes.

OID: What accounts for that? Is it simply wealth?

Brandes: They love Mercedes.

Carlson: They're extremely status-conscious. They love the name brands. They love the labels. They love conspicuous consumption.

Hong Kong is just a thrilling place. Money is what's on everybody's mind constantly — how to make more money. Everybody's walking around with a cellular phone. In fact, I went to a bar in Hong Kong. And get this — there were more cellular phones in the bar than drinks.

These guys are just doing business constantly.

TAMSA — A LOW COST COMPETITOR AT 50% OF BOOK AND 7 TIMES EARNINGS....

OID: Before we call it a day, are there any other bargains you can tell us about?

Brandes: I'd like to talk a little bit about Mexico.

OID: I'm surprised to hear you say that. At his latest annual meeting, Templeton suggests that it's too late — that the Mexican story is out. And you just got finished telling us about Mexican banks coming public at 4-1/2 times book.

Brandes: Templeton is absolutely right. And we backed off Mexico somewhat.

OID: But you have some overpriced stocks that you'd like to sell our subscribers?

Brandes: Not exactly. It's going to be such an exciting place for quite a few years that we're going to be watching Mexico very carefully. And we're going to be picking up stuff when the market's weak — which will happen from time to time.

OID: If you'd like to assure that, you can buy some Mexican stocks in my name.

Brandes: I said weakness, not crash. Anyway, we've backed off Mexico except for Telefonos de Mexico, which is our biggest holding and one thing that we're buying — Tubos de Acero de Mexico — also known as TAMSA.

OID: As I recall, it used to be in Value Line. But the fact that it's not anymore is certainly a plus.

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BRANDES INVESTMENT MANAGEMENT'S
CHARLES BRANDES AND GLENN CARLSON
(cont'd from preceding page)

Brandes: They shouldn't have taken it out. But the fact that they did is a *great* sign.

TAMSA, believe it or not, is a steel company. They make seamless pipe for the oil industry. So it's an oil play.

OID: Talk about a great business in a hot industry.

Brandes: That's why we value guys like it. On the other hand, it has a very strong balance sheet and a modern plant in the right location. And, most important, it's very cheap on current earnings.

The kicker is that PEMEX will be increasing its exploration and related capital expenditures by a very considerable amount.

Carlson: I was at a conference last week. PEMEX's finance director told me that they'd be investing $20 billion over the next 4 years. So I asked him exactly where he'd be investing it. And he said that the vast majority of it would be in exploration.

Brandes: Over the last 5 years, PEMEX has been doing hardly any exploration at all. Mexico's been growing so fast that it's been estimated that if they don't do some more drilling fast that they'll be an importer of oil within about a year.

OID: Didn't it come out recently that Mexican officials had been fabricating the amount of Mexican reserves for years to keep what little credit they had?

Brandes: That's right. And that's one of the reasons for weakness in TAMSA stock.

OID: I'll bet.

Carlson: Here's the story as it was told to me. Mexico claimed to have about 65 billion barrels of proven reserves — which they say equals 50 years of production. Then an article came out saying that they had been overestimating their reserves.

However, we're told that those reserves are available.

OID: Only not in Mexico?

Carlson: Close, but no jalapena pepper. It's just that not all of the 65 billion barrels are economically viable for them to drill at current prices.

OID: Couldn't you say the same thing about oil shale in the U.S.? And we don't count those as reserves.

At what price are the Mexican reserves economic?

Carlson: What we've been told is that 75% of the 65 billion barrels of reserves is currently economically feasible.

OID: Wow!

Brandes: Whether it's 50 billion or 30 billion barrels, however, doesn't make a whole lot of difference near-term. Mexico needs it.

And PEMEX was talking only a few months ago about spending $12 billion. Now it's $20 billion. They're really starting to feel the pressure. They can't afford to sit around anymore either. Their country is just growing *so* fast.

OID: And the only way to tap those reserves is with an aggressive drilling program — which requires lots and lots of pipe?

Brandes: That's right.

OID: But isn't this the worst kind of commodity business?

Brandes: Almost. However TAMSA's the most efficient producer of large diameter seamless pipe in the world. And they're located right in Vera Cruz — which is right next door to the Mexican oil fields.

Also, they're only running right now at about 70% of capacity. So they have a lot of room to grow. And TAMSA has very little in the way of debt and the most modern plant in the world.

In 1988, they had a total restructuring. They got rid of a lot of debt and turned it into common — so that their long-term debt is around 20% of capital today.

OID: Are pipe prices depressed as well?

Brandes: They are. However, the average well in Mexico is 4 times the depth of the average well in the world. And it requires a very high quality pipe. For that reason, TAMSA produces high alloy corrosion resistant pipe especially designed for deep drilling.

The pipe for deep drilling costs something like $3,000 a ton vs. $600 a ton for the average carbon steel grades. So it costs roughly 4 or 5 times as much.

OID: Gotcha.

Brandes: However, what I like as a value investor is that not only is TAMSA's future bright, but it's cheap today. It's trading at $8-1/8 on the American Stock Exchange. In 1991, they earned 74¢. That was with PEMEX increasing its purchases considerably. TAMSA delivered about 108,000 tons of pipe to PEMEX — vs. 28,000 tons in 1990.

In 1992, a very conservative estimate is that they'll deliver 125 to 130 thousand tons of pipe to PEMEX. And I think it could be a lot more depending on how quickly PEMEX gets its act in gear. But conservatively, earnings should be $1.10 to $1.20 this year.

OID: So TAMSA's selling at all of 7 times earnings.

Brandes: Exactly. And in 1993 and 1994, you could see some very considerable growth if PEMEX continues its drilling — which they're going to have to do.

OID: Is there such a thing as normalized demand? I know that it's a feast or famine industry.

Brandes: That's exactly right. In 1985 or 1986, I believe that TAMSA was selling around 200,000 tons of pipe to PEMEX. So I don't know what it's going to average.

However, I would think that we'll see the big push over the next two or three years and that it will then level off. Whether it'll average 150,000 or 200,000 tons, I can't say.

Incidentally, they don't sell only to Mexico. They sell around the world. But it's not nearly as profitable to sell outside of Mexico because of transportation costs and because it's not the high quality pipe.

They sell a lot of pipe to Russia. And that, of course, has been cut down quite a bit. If Russia ever gets its act together, that could mean a lot of business for TAMSA. But that's way down the road.

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BRANDES INVESTMENT MANAGEMENT'S
CHARLES BRANDES AND GLENN CARLSON
(cont'd from preceding page)

OID: What's TAMSA's book value?

Brandes: Tamsa's book value is around $16 a share. So it trades at around half of book.

OID: Not half bad.

Brandes: And their book is solid. They're integrated. They buy scrap, produce their own steel and make it into pipe. And they do it pretty efficiently.

Also interesting is the fact that the price of scrap is coming down considerably — because Eastern Europe is a big producer of scrap these days. Scrap prices are about as low as they've ever been.

Carlson: So they have all of this beautiful new plant and equipment that's not being fully utilized and a relatively clean balance sheet. If orders go up, a lot more earnings could go through to the bottom line.

OID: As the low-cost producer in a cyclical, commodity business, is there such a thing as a normalized return?

Brandes: It's not all that attractive a business. It'll be extremely cyclical. But at 50% of book and 7 times depressed earnings, I can live with it.

Also, the North American Free Trade Agreement would be a positive for them because they're restricted right now from selling in the U.S. The tariffs on exports to the U.S. are very high. So as the low-cost producer, TAMSA would be very competitive.

OID: And your cost?

Brandes: We started buying it around $5. And we've been buying it all along. Our average cost is around $6.50. And we've paid today's prices.

HISTORY REPEATING ITSELF: WARREN BUFFETT, ROBERT NOEL & BRANDES INVESTMENT....

OID: Last year, you pounded the table for Freddie Mac along with Robert Noel and others. But I haven't heard any comments from you about Salomon.

Brandes: It's funny you should ask about Salomon. We're buying it.

OID: When did you start buying it?

Brandes: After your writeup and Buffett's third quarter report.

OID: May we ask your average cost?

Brandes: We're buying it right here. We didn't buy it at $22 where all these brilliant guys bought it.

OID: And your rationale?

Brandes: We don't know anything more than anybody else. Basically, it's Buffett doing stuff that's profitable and not doing the unprofitable stuff anymore. I don't buy the Wall Street opinion that Salomon had to do all of this unprofitable stuff to get the profitable stuff. That's the main reason why Salomon isn't well thought of at the moment.

Carlson: The most interesting thing to us is the restructuring of their esprit de corps with everybody working for the shareholder, too.

OID: In other words, alignment of interests between employees and owners.

Carlson: That's right. It's so beautiful in its simplicity and it's so right.

OID: You aren't worried about Salomon losing its government charter or being hit with criminal charges?

Carlson: I think Buffett saved 'em. The white knight came through. Nobody else could have pulled it off. He brought them so much credibility. It's one of the most wonderful Wall Street businesses out there.

OID: I'll assume that's meant as a compliment.

Carlson: It does retain some measure of franchise, I think. And if Buffett can implement the changes he's working on, it will be a pretty attractive play — and even a better place to work.

OID: Where do you guys expect ROE to settle?

Carlson: We don't know.

Brandes: I think the key to Salomon — or at least the way I think about it — is that their total assets at year end were $97.4 billion whereas their total shareholders' equity at year end was $3.3 billion. What you have here is a significantly leveraged business. It's leveraged even more than the typical bank.

OID: A frightening thought.

Brandes: Indeed. And in your Salomon roundtable, you asked each contributor what kind of return on equity this thing should get. Boy, I would say that looking at those two figures, if they don't earn 25% to 30% on equity, they're not doing it right. You'd have an unsuccessful business.

And honestly, I wouldn't consider them to be superstars if they earn 25% to 30% on equity — because it goes back to their leverage. They *better* do that. That should be fairly ordinary with that much leverage.

OID: In one word — risk.

Brandes: Yeah, it's a risky business. If you ever lose 3% of your assets, you're wiped out. Therefore, it's extremely important that they know what they're doing. They have to minimize risk. However, it's always there. Therefore, if they're not making those rates of return on equity, they shouldn't be in business.

If you look at their return on equity the last five years — from 1987 to 1991 — their best year was 14.6%. And for several of those years, they had returns in the single digits. That's clearly unsatisfactory. It makes no sense at all.

The best thing for Salomon shareholders was Gottfreund's departure because they weren't earning satisfactory returns during his watch.

OID: One of our contributors wrote a wonderful letter to his clients. It went something like,

"Dear Client:

Effective immediately, your advisory fee has been increased to 75% of profits. Thank you for your trust.

Sincerely yours..."

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BRANDES INVESTMENT MANAGEMENT'S
CHARLES BRANDES AND GLENN CARLSON
(cont'd from preceding page)

Of course, it was a very clever way to make the point that a disproportionate share of Salomon's gains was being distributed to employees. And it turns out that the 75% figure wasn't that far off.

Brandes: Yeah. I think that there are opportunities here for Salomon to make a lot of money. And I think that the risk is reasonable because the return could be so high. I do think that they've got the right guys running it now — especially with Buffett running it. I think he understands this business.

OID: Whatever most journalists and investment bankers may think.

Brandes: That's right. This is the type of business I really want to own — because they can make an awful lot of money if they run it correctly. I think Buffett is very much on the right track.

OID: At Salomon's last meeting, I gathered from Buffett's comments that they're very sensitive to avoiding mismatches and bet-the-ranch-style positions.

Brandes: They can't take those kinds of risks. And I don't think that they are. That's why I would own the thing in the first place. And Salomon is reducing leverage. At one point last year, they had $137 billion in assets. From there to $97 billion is a pretty substantial reduction.

OID: Buffett's announced that he's not going to remain at Salomon once the government situation is settled. You're just confident that he'll pick a suitable replacement.

Brandes: I have a degree of confidence there. But I do worry about some of the statements that Buffett made about Gottfreund in the past. If you look at his record since 1987, you would question some of the superlatives that he used in describing Gottfreund. Buffett isn't perfect.

OID: Of course, no one is — present company aside...

I imagine that you're expecting returns to be pretty volatile?

Brandes: Oh, yeah. There should be years in this type of business where they make 50% and years where they make very little. Again, the thing they have to avoid is the big losses.

OID: Do you have a sense of Salomon's intrinsic value?

Brandes: If I'm right that they'll earn 25% to 30% on equity and it's demonstrated that their risks are very properly handled, then you have a franchise-type business. On the other hand, it will never be as good a business as Freddie Mac. So if Freddie Mac is worth three times book, then Salomon properly run might be worth two times book. And I think that book is a good figure to use for valuation of a financial institution.

Book was $28.77 as of December 31, 1991. And Salomon is not worth two times book right now. But I hope that it will be. And, of course, if they're earning 25% to 30% on equity each year, book is increasing pretty rapidly, too.

Carlson: We're looking at it pretty simplemindedly. It's just a case of pretty attractive management changes and a stock that's relatively cheap. If things work out, we'll make money. But I can't begin to guess how much.

We're just looking for relatively conservative ways to get a double in 5 years. We've been able to do better than that in the past. And we think that the ideas we're coming up with today are going to do better than that. But if we can manage a double in 5 years, we're happy.

OID: I'll be surprised if some of these ideas don't do a whole lot better than that.

Carlson: Me too. The world's changed a lot. It's no longer a bipolar world. I think that there really should be more optimism out there than there is.

OID: You've certainly made us more optimistic.

I get the impression that you guys compliment each other very nicely.

Brandes: I think that's right. We're a good team.

Carlson: And it's a lot of fun.

OID: How so?

Carlson: I think Charles tends to be more focused on the number crunching and ripping apart the businesses. I think I tend to take a step back a little more and look more afield business-wise, industry-wise and country-wise.

OID: It seems that there's been a bit of a change in the type of businesses you buy. You seem to be buying somewhat higher quality businesses than in the past.

Brandes: That's right. That's exactly what we're doing.

Carlson: Although the focus always gets back to price. We're not willing to pay whatever it takes to buy growth. But we may be willing to pay up a little bit more than we were a few years ago to get high quality at a reasonable price.

But you're right. We don't have to buy everything at 6 times earnings and below book.

OID: What accounts for that — reading too much OID or what?

Brandes: Glenn's influence, the market's influence and the fact that near-term net-net current asset situations are few and far between.

OID: In other words, you had no choice.

Brandes: Exactly.

OID: Thank you for bailing us out of our idea shortage.

—OID

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FPA PARAMOUNT FUND'S
BILL SAMS
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period.

Here are Sams' return figures alongside those of the S&P 500 for each of those 21 years. (Figures were provided by First Pacific Advisors and *Ibbotson Associates*.)

Year	Annual Return	S&P 500 Total Return
1971	+43.6%	+14.3%
1972	+18.0%	+19.0%
1973	-42.5%	-14.7%
1974	-15.3%	-26.5%
1975	+34.2%	+37.2%
1976	+27.8%	+23.8%
1977	+28.6%	-7.2%
1978	+23.5%	+6.6%
1979	+45.4%	+18.4%
1980	+45.0%	+32.4%
1981	+20.4%	-4.9%
1982	+46.3%	+21.4%
1983	+31.3%	+22.5%
1984	+10.1%	+6.3%
1985	+18.8%	+32.2%
1986	+5.4%	+18.5%
1987	+21.9%	+5.2%
1988	+19.8%	+16.8%
1989	+22.6%	+31.5%
1990	+1.6%	-3.2%
1991	+24.3%	+30.5%
1971-91	+18.3%	+12.0%

The above represents the performance of Pace Fund for the years 1971 through 1981 and that of FPA Paramount Fund from 1982 through 1991.

Lest you worry that his success has gone to his head, Sams lives in a modest, middle-class home and works with only a single assistant (who, incidentally, has been with him for 17 years). He wears house slippers around the office and keeps a coat and tie around only for special occasions.

With his heavy Southern accent and long-term record of success, Sams reminds your editor and other observers of the late Senator Sam Ervin of Watergate Fame. Sams is a good ol' southern boy just about as much as Senator Ervin was just an old fashioned country lawyer.

We knew from past conversations and *Portfolio Reports* that Sams has been a heavy buyer of energy stocks recently. With energy one of the few out of favor industry groups around today, we thought it might be interesting to give Sams a call and get his current perspectives.

And we weren't disappointed. The following excerpts were selected from several recent conversations with Sams. We hope you enjoy them as much as we did:

THE ONLY CHEAP STOCKS NOW
ARE THOSE WITH PROBLEMS....

OID: The last time we spoke, you said that you feared another bull market had started. It looks like you were right. Have you thrown in the towel yet?

Sams: Believe it or not, I'm still 41% in cash.

And what I'm telling people — right or wrong — is that this market has had a huge move by any historical measure. I see the interviews in *OID*. It seems like anyone who has experience or common sense or any kind of value orientation has to see things today as being out of control.

And we all know why. It's low interest rates.

OID: Absolutely. As Roger Engemann told us, P/E ratios and interest rates are nearly mirror reflections of each other.

Sams: That's right. So you certainly don't want to be in health care or any growth-type company with wonderful earnings momentum. There's entirely too much money chasing earnings momentum and not enough money chasing value stocks — what you might call problem stocks.

Value investors are buying problems. The only thing cheap now is something with a problem. It's real simple. It's either management, product, industry, no earnings momentum, balance sheet or whatever — it's got a problem.

And therein lies my old philosophy that if you're a value manager, you spend 80% of your time depressed and 20% of your time euphoric. The earnings momentum guy is exactly the opposite. He spends 80% of the time feeling like he's got the world by the short hairs and 20% of the time looking for a job. Right?

OID: Usually true.

Sams: He knows no fear. If a guy is holding a stock now that sells for 35 or 40 times earnings, chances are that he's not going to sell it until something goes wrong. I'd have sold it at 20 times earnings — and watched it double again after I sold it. And I'd have gone through all the pain again. But the difference is I'd have kept my job.

OID: And the client may have kept his money.

Sams: That's exactly right. If you're a value manager — it's just a lot of pain.

OID: You make it sound almost as horrible as newsletter publishing. What causes the pain?

Sams: The constant disappointments in companies and analysts telling you that management's bad, that the industry outlook's bad and that earnings won't be good. And they're usually right. It always take longer to get the thing turned around.

That's what's frustrating. Buffett's approach is so simple. If you buy a business that can control its prices, control its own destiny and has excellent management and all of that, you can have a beautiful growth situation.

But my companies tend to have lousy businesses and bad managers. And that's tough.

OID: Then why don't you buy Buffett-style companies? You select them after all.

Sams: I'd love to. But the only time I could buy them

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FPA PARAMOUNT FUND'S
BILL SAMS
(cont'd from preceding page)

is during a 1987 or 1973-style market. Right now, all I can find is problems.

You show me a well-managed company that has its niche, has a good balance sheet, good profit margins and has everything going right for it and I'll show you a stock that's historically overpriced.

This has been the time for the growth boys though. And they've won for a pretty good extended period of time. But I feel comfortable where I am and where my stocks have been. I ask myself, "Bill, if you got rid of your stocks, would you pick up the growth stocks that look good fundamentally and all like that?"

And I think, "No, absolutely not — considering where their prices are." It's easy to have 20/20 hindsight and wish you'd bought 'em when they were a lot lower. But that's just not me.

But I am kind of an oddball guy for you to talk to — because I have a mutual fund and then I have these private accounts that get run separately. I'm one of the few guys who does things like that.

And in my mutual fund, you'll see all these value stocks. But in some of these other accounts, you see things like Wang Labs and the go-go stuff. And that's where you see the performance.

OID: You buy go-go stuff in your private accounts?

Sams: Yeah. I get into all of that stuff. I even get into new issues. I've been playing the new issue market for over a year now.

OID: Your secret's safe with us. But why so much difference in the stocks you buy in each account?

Sams: If I can only buy $800 thousand or $1 million worth of a little stock because of the smallness of the float, I may put it into one account. If I spread it out, each account would have way too many stocks. It wouldn't have impact. Each account would have 60 stocks.

OID: How many positions would you like to have in each account?

Sams: Ideally 15 stocks or less. Unfortunately, my mutual fund's too danged big.

OID: Until we publish this interview, anyway. But how big is it?

Sams: For me, it's big. It's $270 million.

OID: That's tiny. How big are the private accounts?

Sams: They vary. My total money under management is $670 million. So it's $400 million in 13 private accounts.

OID: And you run each of them like separate accounts — not trying to homogenize the holdings?

Sams: Right. My top account was up 73% last year. But it was a $1-1/2 million. And the new issues did that.

OID: What was your worst account?

Sams: Up 17%. FPA Paramount was my second worst account — up 24%. I tell my clients what I do. It used to bother them, but it doesn't anymore.

OID: I understand that your FPA Paramount Fund is closed to new investors. Are you accepting separate accounts or are you closed there, too?

Sams: For all practical purposes, I'm closed.

OID: What does that mean?

Sams: I'll take on a special situation-type account — someone who says, "Bill, I just have to have a piece of you. I understand what it is that you do. I'll leave you alone. You don't have to make any airplane trips. You have the account for at least 3 years. Do what you want. Good-bye."

If I think they're sincere, I'll consider it.

OID: Do you require references?

Sams: In fact, I just took on a new account last year.

And I very seldom hear from my accounts. I've had one account since 1982 — and I've never met the people.

OID: A lot of money managers would no doubt like to say that.

Sams: That's right. A lot of managers would *crawl* to be in my shoes. I buy and sell exactly what I want to exactly when I want to. And I don't pay any attention at all to quarterly performance — although if I get two bad years in a row, I do feel the pressure.

OID: I don't remember hearing the telephone ring the last time we spoke. Are you guys expanding?

Sams: I probably should expand, but I won't. And the Peter Principle continues — where you rise to the level of your incompetence. I can't handle the money I manage now. So I've already reached my level of incompetence.

This damn phone rings every 3 or 4 minutes. And the reason it does is because I'll talk to brokers — because you never know when they'll have some information or help that you can use.

This industry is very arrogant. So many managers look down on brokers and traders and are a little too smart for their own good — especially when they get on a roll and start doing well.

OID: Probably not the best time for a broker joke.

Sams: I'm hunkered down all the time and scared. That's just me. And part of the reason for my success is that I'm a nice guy. So I get a lot of calls.

But it does drive me crazy. When I'm in a good mood, I love it. When I'm in a bad mood, I feel like the damn thing's out of control.

But I have no personnel problems. It's just me and Mary. And she's been with me for 17 years. L.A. takes care of all the back office and does the reporting. So I don't have to think about it. I just like to manage money for my clients and me. And I like to perform.

So I take off when I want to with no people problems.

OID: Do you run your own money any differently than that of your clients?

Sams: I kind of run it like that of the clients. But as you accumulate wealth, you become more conservative. In the old days, it would have been very wise to demand that I put my own money into my fund. But it wouldn't be so wise

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FPA PARAMOUNT FUND'S
BILL SAMS
(cont'd from preceding page)

today because I've gotten too cautious in my own account. So my own account's lagged performance-wise lately.

Today, my own account has very little cash — 10% to 15% — and I'm 53% in the energy area. I should have been up 60% last year — and I was only up 27%.

OID: What do you mean?

Sams: My fear just ruined me last year. I owned the right stocks. But I couldn't understand the market running up like it did. Everything I sold just flew on the upside. It's unbelievable.

If I'd just held on, I'd have been up 60% last year or more — probably more.

OID: Isn't hindsight wonderful?

Sams: And I've got to be careful. I can't try to play catch-up. I can't say, "Oh, my God! I should have done better last year. So let's jam it to the floor this year and catch up." That would be dangerous.

CURRENT PORTFOLIO ALLOCATION: CASH, ENERGY & COMMODITY CYCLICALS.

OID: So how are you coping?

Sams: In Paramount, I'm about 41% cash and about 27% in energy. So there's 68% without much downside. The cyclicals have kept me from being totally embarrassed. And they total about another 27%.

OID: Which accounts for 95% of your portfolio.

Sams: Then medical stocks represent about 2.3%, growth stocks about 2.3% and consumer stocks about 1.3% — consisting of one retail stock up in Canada. So that's where I am.

I feel good about my downside. With 41% cash and 27% energy, I'd beat the competition on a relative basis if something went wrong and the whole market went down. The negative is that I can still get into trouble on the upside.

OID: How do you mean?

Sams: It seems to me that most people are managing money looking primarily at the reward side. It's as if they're thinking that stocks only go up and their primary concern is not to look bad.

I'm not talking about the ones you speak with because you speak with a lot of smart value guys. But most money in this country, by far, is chasing earnings momentum. And therefore, they think, "What kind of earnings multiple can we get up to?"

They don't ask themselves, "How far can this stock drop?" or "What happens if a Democrat gets elected?" or "What happens if interest rates go up too fast?" or "What happens if we can't get the recession under control?" That's what I mean by focusing on the downside.

EVERYBODY'S GIVEN UP ON ENERGY. THERE'S NO HOPE. THAT GETS ME EXCITED....

OID: Nevertheless, according to Portfolio Reports, it looks like you're finding bargains in the oil stocks.

Sams: That's right. But being in energy so heavily, I better not have high expectations because things look very bad near-term. Everybody's given up. There's just no hope.

OID: You're getting me excited. Where there's no hope, there may be opportunity. Tell us more.

Sams: I've never seen it any worse than it is today. The gas bubble was supposed to end when — 1988, 1989?

OID: For what seems like forever.

Sams: Exactly. So now, what are they doing? They've decided that it's never going to end.

There's a joke going around where somebody asks God whether the gas bubble is ever going to end. And God says, "I have good news and bad news. The good news is yes. The bad news" God says, "is not in my lifetime."

OID: Great joke.

Sams: I think that pretty much sums it up. If you talk to people in the energy patch, they'll tell you they can't see the light at the end of the tunnel for at least two years. So therein enters William Sams.

I also like things like that. But I have a pattern whereby I enter these things too early. I try to work on it because I know that's my fault. But my gut tells me to buy — I just get so excited when I see things fall out of bed.

But the reason they fall out of bed is that real bad fundamentals are coming.

OID: Robert Noel says that his purchase of a company's stock is usually the kiss of death. The company's fundamentals usually go to hell for awhile. And I can closely relate to both of you.

Sams: I know it's coming. But in this day and age, there's so much emphasis on earnings momentum. You see what stocks do if earnings just fall short a little — they just open down 50%. They take them apart.

The energy area's just suffered gradual erosion. They were never grossly overpriced in the last few years. And now they're just eroding away.

A guy called me the other day and said, "Bill, I've got 70,000 shares of Coastal Corp." — which is a natural gas pipeline company, a processor, a refiner and a coal company. And it's a pretty well run company.

The stock was around $33 early last year. And it was around $23 when he called me recently. He said that this guy who has 70,000 shares needs to sell it before he could buy another stock.

So I said, "What's the other stock he's buying?" And the guy said, "He's buying Caterpillar."

I like to know those things because it lets me know what's going on in these guys' minds. Why would they dump something that's gone down over 30% that's a good company to buy something that's OK, but not as good?

OID: And the answer?

Sams: Very simple. He's doing it because he sees earnings momentum coming more quickly to Caterpillar

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than to Coastal. And therefore, that keeps feeding on itself.

But I want to keep buying Coastal. I keep looking to see if I'm missing something. Is what's going on really serious? I understand that you have all of these bond agency ratings — *Moody's*, *S&P* and so on — downgrading all of these natural gas pipeline companies because they see their earnings slipping and because the outlook for natural gas is foggy over the next few years. You know what that means to a lot of people. People just sell and sell and sell.

I don't really expect any immediate turn. You can usually buy them in February, March, April or May when all the good news is out. You have to wait until people start to think about the next winter.

But many times, people start buying them in the summer thinking, "I better buy 'em before the others do." And you get a 20% pop when you least expect it.

These aren't growth stocks. They're trading vehicles. These stocks make good moves once or twice a year. And you can see why they're near their low point now. The winter's over — the warmest winter since 1895. And 9 out of the last 10 winters have been warm.

OID: And you're not concerned that we're in the middle of a long-term, global climate change?

Sams: I'm not concerned one bit. It doesn't bother me at all. In the context of history, 10 years is nothing more than a gnat on an elephant's ass. It's nothing.

NATURAL GAS & REFINING ARE IN THE DUMPS. AND COASTAL'S STOCK PRICE REFLECTS IT....

Sams: Again, I want to emphasize *risk*/reward ratios. My expectations aren't very high right now. And I'm trying to keep them that way. Therefore, I'm buying Coastal, Enserch and Champion International.

In my opinion, each has excellent risk/reward ratios. I believe all three will be star performers on a relative basis. And I don't think that they'll do poorly on an absolute basis. They'll go down like everything else. But on a relative basis, I think that they'll do very well.

But I want to be sure that I'm in that type of stock more than high multiple stocks that have already done well. For example, I've been buying Coastal for a few months now. It ended today at $22-5/8. As you might suspect, that's below my cost of $24.41. I own 918 thousand shares.

And it'd be fine with me if it were to drift even lower. In fact, I'd like that a lot.

OID: If you'd like to insure that, you can buy a few shares in my name.

Sams: If I start selling short, I'll give you a call. Meanwhile, I feel like I'm sticking my neck out not so much with downside risk as I am with the timing of my upside. It could take several years. That's the risk.

In my opinion, the recent erosion in the stock price is nothing more than the fact that it's the time of year when investors normally sell these stocks — if not earlier.

Anyway, I'm comfortable with a Coastal or an Enserch. And as long as they're real companies, as I know these are, I'll just keep averaging down and buy more and more.

OID: Tell us about Coastal.

Sams: It's in the gas pipeline business, in distribution and in the coal business in a small way. However, it's primarily known as a natural gas distributor — and gets a nice play when natural gas is in vogue. Coastal has six refineries including a big modern one on an island outside the country.

Of course, refining's been a rough business. More and more people are buying fuel efficient small cars. So demand for gasoline goes down and margins are under pressure. Plus there's the recession. But as we come out of it, demand will grow.

And the EPA won't let you build another refinery — because of environmental problems. It's almost impossible to even shut one completely down. Instead of shutting them down, I understand that they tend to just run them real low and do their best to keep them out of trouble. So no more refining capacity is coming onstream.

And they're going to shut down some refining capacity. There's no question about it. They've already shut down some. It's estimated that the industry will lose a significant amount of refining capacity over the next five years.

So as the economy recovers over the next few years, demand will grow and supply will decline.

OID: A nice combination. And frankly, I was surprised to hear Buffett say that Phibro had historically earned high returns on its refining operations.

Sams: I was too — since it's so commodity-oriented. And Buffett's avoided that kind of company in the past.

But I just know that the time is not right today for the refinery business. And that's reflected in the stock price. That's one reason why it's down. Therefore, I'm interested.

And I'm satisfied that it's just a matter of time before it rights itself — because I've seen a lot of these cycles in this refinery stuff. That's why this is a high beta stock. When the analysts finally decide that the refining margins are turning, Coastal will be up $2-1/2 points that very day.

But right now, no one cares. And they haven't quite bottomed yet.

OID: Do you have a sense of intrinsic value for Coastal?

Sams: No, I really don't. It's just so out of favor. For example, assume that we do have a normal winter or suppose that we have a real great, cold winter. You can almost be assured that all of the natural gas equities will have a nice trading bounce regardless. I just can't imagine otherwise. How much I can't know.

But as long as you buy 'em in here and buy 'em down, I don't see much risk at these prices. Again, the risk is simply time — and not making any money for awhile relative to the market.

OID: Do you have a sense of normalized earning power for Coastal?

Sams: Coastal's earnings power is $3.00 to $3.50. That's assuming that the refinery business becomes profitable and that gas prices return to normal levels.

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OID: So you're looking 10 years out.

Sams: Not exactly. The cycle in the refinery business is supposed to be going right because the cost of the environmental regulations should result in about 10% of the country's capacity shutting down. So one of the main reasons that you buy Coastal is their nice refinery niche.

They also have a very nice gas pipeline niche that gives them steady earnings. And they're leveraged pretty good — which is fine as long as you have pretty steady earnings. And the pipeline gives Coastal exactly that.

OID: What's your sense of asset value?

Sams: I don't have a real good feel for that.

OID: Where would you consider Coastal fully valued?

Sams: Let me answer that this way. A year ago, Coastal was at $32. It's had a high of close to $40. And in '88, it was close to $24.

I see it declining in an up market — obviously because of problems in the gas area, refining is still under pressure and so forth. So at $23, I thought it was terrific value. And I really loaded up on the thing.

OID: Where would you sell it?

Sams: We're estimating earnings of $1.60 for Coastal. Six months ago, we were looking for earnings of about $2.25 for 1992. And you still have downward pressure on Coastal's earnings.

However, knowing what I know now, I'd probably sell it in the low $30s or at least start lightening up at that price. If it gets to the low $30s, you can be sure that most people will come up with a reason why it's going to go up another $3 or $4.

I'm looking for a $30 to $38 stock in the next 18 months. And that'll be a good return considering where the market's been. If you compare that to the stock market at that time, I think you'll be pleased.

OID: I suspect you're right.

But this is what happens to me. I start buying something. And things are really much worse than I realize — and the stock goes to $20. But I keep buying. And then it does eventually work — and I start selling at $32 or $33. Before you know it, it gets on a super-cycle, goes to $45 and makes me look like a monkey.

That's why I'm in the dumps 80% of the time. If it breaks $20, I'm going to think, "God, something's really wrong here." And I'll be all distraught.

But it'll just be a case of people not wanting to own anything with declining earnings. They'll just blow it out.

OID: Many of them because they don't want to show a "loser" in their portfolio at the end of the quarter.

Sams: Absolutely. The longer I'm in this business, the more value-oriented I get. And, maybe, part of that is age.

But part of it is experience. I've owned some wild stuff — and still do. I still own some pretty aggressive stuff. And I've made a lot of money that way.

But I can't see growth stocks doing a lot on the upside. That's the reason why I'm not very depressed right now. And I know that I don't want my money in any wonderful company that's done real good — because it's overpriced.

OID: Certainly sounds like you don't risk any resemblance there with Coastal.

ENSERCH IS AT A 10-YEAR LOW
AT 50% OR LESS OF BREAKUP VALUE.

OID: You said that you also like Enserch. What's the story there?

Sams: Enserch is a more complicated company. It's the gas utility of the Dallas/Forth Worth area — which is an OK area to be in — under the name of Lone Star Gas. It has an extensive pipeline system in the north Texas area.

And the current stock price is $12.

OID: Which is near its 5-year low.

Sams: It briefly bottomed at $10-3/8s a few weeks ago. But for all practical purposes, the low was $10-3/4. And then it bounced to $12 where it's died.

OID: According to Value Line, from 1981 to date it's never been that low.

Sams: That's right. And if you see where it came from — the high $20s — you wonder how it can be a utility.

OID: Although the book has declined, too.

Sams: Yes, it has. It's declined to $10.

It's a utility that has another pretty good-sized division — oil and gas production, but mostly gas, with very good reserves. It has expected future revenues of approximately $1.1 billion.

Then there's one other division called Ebasco — an engineering construction company. They do cogeneration plants, environmental stuff and during the old days they did nuclear plants — dealing with electrical utilities and all like that. That business is kind of down and out right now, but its backlog is around $1.1 billion.

OID: How would you rate management?

Sams: I've met with management directly because it's here in Dallas. I think they have much too much of a utility mentality. Management owns less than 1% of the company. They don't seem to pay much attention to the shareholders and to maximizing the value of the stock, although a lot of it's out of their control — like the warm winter, for example.

So here's a $12 stock. There's an 80¢ dividend that's somewhat questionable. And its cash flow is around $2.50. Now what they've done is said that they're going to pay the dividend. All that they've done is cut back on their oil and gas exploration expenditures. And they can, therefore, pay their dividend. They think that that's important because they've got a utility side.

What intrigues me about it is that no one likes it. Analysts frankly have a disdain for management.

OID: Sounds lovely so far.

Sams: However, the utility division is worth an estimated $11 a share. The oil and gas division during normal times, which we're not in right now, is worth at least

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$10 a share. Then Ebasco, the engineering firm, is probably worth $280 to $350 million. The lowest estimate I get is $225 million. With 65 million shares outstanding, that's another $5 or so per share.

So Enserch's breakup value is at least $25 per share — double the $12 it's selling for today.

OID: And what will make the discount narrow?

Sams: It was selling at $20-3/4 at year end '90 and $13-5/8 at year end '91. What I wish they'd do is sell the engineering firm. But they have to wait and find someone who wants to pay the right price for it. If you deduct the $300 or so million they'd get for it from their long-term debt of $800 million, it'd put them in pretty good financial shape.

Several things could happen. A change of leadership in the company is going to take place in May of '93. The current president, David Biegler, will become the CEO. Although most analysts would like an outsider to come in, they all appear to like this guy. But what they're concerned about is whether or not he'll have a free hand to run the company. For example, they'd like to see a much more aggressive board of directors — preferably with new blood. The current board members are mostly chums with the current chairman and CEO.

The analysts would really like to see a change here. The real problem is that the company's neither fish nor foul. Some shareholders want to own a utility and are primarily concerned with the dividend. Others are more concerned with the appreciation potential of the oil and gas company. Clearly, the best thing for shareholders would be for Enserch to spin off the holdings into separate companies and sell Ebasco. But I'm afraid management wants to run a big company.

OID: Not exactly an uncommon sentiment.

Sams: Some of the analysts believe that this new fellow may be pretty bright. And they hope that he'll bring a new flavor to management. So it may be a positive — although it's not widely perceived as such.

It certainly can't be any worse than it is now. And knowing Wall Street, they'll find a way to like this stock. Some of the analysts will no doubt say, "Hey, this guy is refreshing." So it could be a positive, although I'm not counting on it.

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OID: What are you counting on?

Sams: What I'm counting on is the same old thing. Eventually, the oil and gas situation will get better. And when it does, Enserch automatically goes up several points. It's easy enough to see that.

If we had a cold winter next year that ended a string of warm winters, people might conclude we're back to normal weather. It's the type of thing that before you know it, Enserch could be at $16.

OID: Why is it so low? We're not talking here about an annual low, but a 10-year low.

Sams: It's because they're paying out a dividend that they're not earning. And their book value is down to $10.

OID: And their interest coverage is pretty puny, too. According to Value Line, it's only 1.3 times.

Sams: Yes, but I saw *Standard and Poors* upgrade their rating from negative to stable.

What gives Enserch stability is the utility itself. They have stable earnings. It's not just wild shoot-em-up.

And meanwhile, for whatever it's worth, I'm going to withhold my proxy to try to communicate the fact that there are holders who aren't happy.

INVESTORS HAVE THROWN IN THE TOWEL.
EVEN BETTER, PEOPLE AREN'T DRILLING....

Sams: Another reason Enserch's stock price is so low is that the price of gas is $1.10 per MCF. It hasn't been there in a long, long time. For example, it never touched $1.10 during the '80s. Yet, it recently hit $1.00 in the spot market. And people are very pessimistic.

I see that as a positive. Investors have thrown in the towel. Even better, most oil and gas people have thrown in the towel, too. People just aren't drilling anymore.

OID: A mighty important point.

Sams: What really made the gas bubble continue on so much longer than anyone thought is the coal seam gas credits in New Mexico and Texas. For two years, you could get a tax credit for drilling coal seam gas. It comes out fast. And the production companies just went in there and really drilled the hell out of those wells in '91 and so far in '92.

That's more gas in the market when demand isn't the greatest thing in the world. However, demand hasn't been all that bad — it's been steady. But still, it's more supply and more reason to conclude that the gas bubble is never going away.

Another reason is Canada. Will they be allowed to flood the northeast with gas? And where does coal fit into this thing? Under this new Clean Air Act, gas is supposed to be the fuel of the future.

OID: And may always be.

Sams: And that's what I'm worried about right now — because there's plenty of coal, the price is steady and utilities can get long-term contracts.

Right now, there's a problem getting long-term contracts for gas. If you want to build a cogeneration plant and you have to have a long-term contract, how can you get a long-term contract when producers don't want to sell it at

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these prices? And the guys who want to buy the contract don't want to pay an above market price.

I don't know why they can't work something out, but they can't seem to at this point. So I'm trying to find out what the problem is out there if any.

On the positive side, I can come right back at you and tell you that gas usage was up 3-1/2% last year. Why in a mild winter across the whole country and a recession was gas usage up 3-1/2% last year? I'm amazed at that. That's very positive.

And yet, natural gas prices have gone down because supply has increased more than usage.

OID: You don't see that continuing.

Sams: Heck no. What's happened is that gas drilling has virtually come to a halt. And you can see why. There's no reason to drill now. I think there's 300 rigs in the whole country drilling for gas now. So I think you'll see supply decline.

If I'm wrong, I might have dead money for a year or so. It might take two years. But I can't see it taking more than two years.

And if I'm right, maybe I'll get fortunate. Who knows? The stock market could act funny in a recovering economy and energy stocks might have a nice 20% to 30% pop.

OID: And it could be more. I see that Enserch was selling at $28 in 1990.

Sams: Unfortunately, what I think got it up that high was that they were out drilling in the Gulf and they thought that they'd hit a big oil discovery.

Now they still think they have a pretty good discovery, but it's not as good as they thought.

OID: For years, investors pointed to the far lower cost per BTU of natural gas relative to oil. Now some are saying that they should have been using coal as the benchmark because that's the alternative for the main buyers of natural gas — i.e., utilities.

And compared to coal, natural gas looks overpriced even at today's levels.

Sams: It's a good point. And it might be one of the problems here. It seems to me that coal's doing awfully well in competition against gas here. And I'm looking into what percentage of these cogeneration plants are using gas and what percentage are using coal. Is coal winning out or what?

But if coal is winning out, why did gas usage increase 3-1/2% last year? I haven't read any report yet that explains why.

I've been told that under this new act, the advantage to gas doesn't kick in until 1995 — but that it really starts kicking in then. So, maybe, that's part of it.

But remember that analysts are quick to point out the positives when everything's going good and the prices of gas stocks are high. Then they come out with all of this stuff about gas being the energy of the future and so forth. When something goes wrong, like it has today, they just get quiet.

Don't get me wrong. I'm concerned about it. But we're down here near the bottom. And you know how people usually get at that point.

For example, one analyst suggests that what's really happening is that Canada's flooding our market and that our government's looking the other way.

Well, I don't buy that. And I hope it's not happening.

OID: What impact do you see Canada having?

Sams: That's certainly one of the things that Canada will export. There'll be more pipelines built to export gas into the northeastern market — and maybe to the Chicago market, too. And that's a negative for Texas gas and a negative for Enserch, I'd think. But gas imports from Canada are unlikely to represent more than about 10% of the market.

We have two fuels that we have plenty of domestically. One is natural gas and the other is coal. We're running out of oil. Certainly in the lower 48 and even in Alaska now, those fields are declining quite rapidly. We need to convert everything we can from oil to natural gas and coal for our balance of payments.

I don't read many positive things about why you have to buy coal stocks. A gas company executive tells me that

PORTFOLIO REPORTS estimates the following were FPA Paramount Fund's largest equity purchases during the quarter ended 12/31/91:

1. ALCO STD CORP
2. ENSERCH CORP
3. BOISE CASCADE CORP
4. RYDER SYS INC
5. MAXUS ENERGY CORP
6. WEYERHAEUSER CO
7. COASTAL CORP
8. CHAMPION INTL CORP
9. TRANSCO ENERGY
10. HANSON PLC ADR

the environmental laws bite into coal usage pretty hard starting in '95. It makes it real tough to use coal. But natural gas seems to have a very exciting future. And yet, their stock prices don't reflect it one bit.

Anyway, I'm continuing to do my work. If I'm wrong, I don't think I have much risk.

I asked Enserch's president, "What's causing this horrible gas situation and what will it take to change it?" He said, "A lot of little things, but nothing real big. Only one thing will help gas. We need a cold winter or two. And that will sop up a lot of the supply. That aside, demand for natural gas will increase only slowly and gradually."

MITCHELL ENERGY: AN EXCELLENT VALUE AT 50% OF TODAY'S DEPRESSED PRICES.

OID: What about Mitchell Energy?

Sams: It's an excellent value. It's a natural gas and natural gas liquids company plus a real estate development company principally located in Houston.

OID: Talk about out of favor....

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Sams: My cost is $11.33. And the stock's at $14-7/8. That's the good news. The bad news is that I've owned it for three or four years.

I started buying this stock at $9. And I watched it go to $24. I did do some selling, but obviously not nearly as much as I should have. And then it went back from $24 to $17 and just died. For the last 18 months, it's gone down.

It's an excellent value at the current price.

OID: So far, so good.

Sams: The problem with Mitchell Energy is that it's looked upon as George Mitchell's plaything. He owns a majority of its stock — it's his company.

He's done so much for his hometown of Galveston, Texas — to the point where it's come back quite a bit. But I don't know how good that is for shareholders. He seems to spend a lot of time on that and not as much time on the company as many would like. And Mitchell's just not as aggressive as I'd like it to be.

But it's got good value. And every once in a while, you hear these rumors that he's going to split the real estate company and the gas company apart and that the sum of the parts would sell for more than the current price — which is true.

OID: How much more?

Sams: I think that this company's probably worth $28 to $30 a share. If he announced today that he was going to liquidate the company within a year or so, I guarantee you that the stock would really run. But I don't think that's going to happen.

OID: And that $28 to $30 assumes that those assets would be sold in today's depressed market.

Sams: Yes, it does. It's a very good value. What's going to probably really make this work and have a nice $18 to $20 stock is the same thing that makes all of these other energy stocks work.

Something will cause gas prices to shoot up. And Mitchell Energy will move quickly from $15 to $18 or $19. Then everyone will be recommending it at $18 or $19.

MAXUS ENERGY IS NOT ANOTHER TRITON,
BUT IT'S A GREAT TRADING VEHICLE....

OID: What's the story with Maxus?

Sams: Maxus is a great trading vehicle. It's a low priced stock with tremendous liquidity. And it's a real company with excellent exposure exploration-wise overseas.

In our last interview, you reported that Triton Energy was our second largest purchase. Well, we went bananas with Triton Energy and roughly tripled our money. Now everybody's trying to do another Triton.

Well, Maxus has some exploration potential in Colombia. And Occidental Petroleum has done the same thing. They have some big concession now in Colombia.

When anything good comes out — rumors or things like that — these stocks spike percentage-wise quite a bit, especially Maxus.

OID: I always wondered who started those rumors.

Sams: And each time it does, I sell into them — because the chances of them hitting something big relative to their capitalization is not very good.

OID: And your cost?

Sams: I kept buying it all the way down from $7 to $6. And then it popped to $8 in 2 days. I owned about 2 million shares. So I sold about 500 to 600 thousand of them.

OID: In order to do that, however, I'm sure that you have some thoughts about underlying value.

Sams: Oh yeah. I think it's a can't miss situation. I thought that $7 was a good price to buy it at. It's currently at $6-1/2. But as usual, they always go lower and higher than you think.

OID: Let's just say that you're 50% right....

Sams: I've owned it before. And I've seen it go to $10 several times. The bulls say it's worth $12. And most people who aren't excited about it say it's worth $9. But that's what energy is to me — excellent trading situations rather than long-term growth buys.

Energy stocks will have their move next because they're economically sensitive, too. As the recovery in the U.S. goes on, people will start driving more, there's more truck usage, fuel usage, airplane travel, the plants are operating more, more natural gas usage and all of that stuff. So energy's a soft play on the economy and usually lags the cyclicals. After the cyclicals, energy gets its play.

OID: You seem to invest in more than your share of energy stocks over time. What accounts for that?

Sams: I've always felt comfortable with it. I'm located in the Southwest. And I think energy a lot more.

OID: That's funny. I'm located in Manhattan. And I'd just as soon stay as under-invested here as possible.

Sams: Probably because you've got good sense.

HIGH LEVERAGE PLUS STUPIDITY
EQUALS A PRESCRIPTION FOR DISASTER.

OID: What's been your biggest mistake lately?

Sams: The disaster was Forest. It was a total disaster. It's a bankruptcy.

I very seldom lose on something like that. And darn it if I didn't just flat lose on Forest.

OID: What lesson can we take away?

Sams: That's like the football team that's pretty good, but gets beat 52 to nothing. And the coach says, "I'm not going to make them look at this."

Mentally, it might bring on a need for psychiatric help if we go through it.

OID: Isn't it a matter of probabilities though? If you buy companies that are cheap and under distress, aren't a certain number of them just going to fail?

Sams: I guess so — although thankfully it's one of the

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few I've had. In fact, I owned Forest personally. I started buying it at around $14 and averaged down in it. I wound up selling it at about $2-1/2. And I lost a lot of money in it personally. In fact, it was my biggest loss ever — *by far.*

But this business keeps you humble. I've had some wonderful years. And this happened last year to me. I kept asking myself, "I've never taken a loss like this before. I really missed this one. Am I losing it?"

OID: And the answer?

Sams: It just had too much debt — and stupid, stupid management. They were very, very late cutting expenses.

It was oriented toward natural gas. And they always went elephant hunting. They weren't happy unless they owned 50% or more of a well. Can you imagine that they were drilling a 14,000 or 16,000 foot well last year with gas prices where they were?

OID: They bet the ranch and lost.

Sams: That's right. And they finally realized how bad it was. But the bankers just came in and made them start laying off family members. I believe they had three or four family members making $250,000 to $350,000 per year.

They've run this company a long time. It was a very wealthy family. And it looks to me like they've lost it. The last time I looked — let me hold my pulse here — I think it was selling at $1 or so. That's the story.

I think if they'd been smart enough to realize the problem and if they hadn't been fighting among themselves, they could have kept the situation from becoming fatal.

EXCELLENT MGM'T & OPPORTUNITIES GALORE
AT THREE TIMES DEPRESSED CASH FLOW....

OID: Last year, you said: "Coda's a tremendous value. It's at $2. And I believe that it will sell for between $3 and $4 within 18 months."

Sams: It wasn't a total disaster. It's at $3. So it's up 50%.

OID: We could live with that.

Sams: But if you try to sell 100,000 shares, you'll get $2-1/2 — in which case you're only up 25%.

OID: Coda is quite a contrast to Forest.

Sams: Exactly the opposite. Let's face it. I was wrong so far — although it hasn't been 18 months yet. Gas prices have gone down and oil prices have gone nowhere. Therefore, Coda's fundamentals haven't improved a great deal at all. In fact, they should have declined.

And yet the stock's gone from $2 to $3. The reason is that they've shown good judgement. They showed discipline and didn't get too leveraged up. I congratulate them. They're just the opposite of Forest Oil.

For example, management keeps costs very, very low, a very modest headquarters, no deer leases and no airplane. They don't pay themselves much money. And they own the stock themselves.

OID: A powerful combination. How do you see their prospects going forward?

Sams: Coda is still doing the same thing as always. If you recall, most of the big oil companies are exiting the lower 48 and going elephant hunting internationally in what they perceive to be a better political environment. And they're putting their reserves up for sale in the lower 48.

Companies like Coda are trying to evaluate these properties and buy them at advantageous prices. If they can do that and prices of these commodities a few years from now rise some, you can get very good returns. If you can buy good quality oil in the ground at $3.50 per barrel, you're going to do OK.

And most companies that drill and do exploration in the lower 48 have an average finding cost of $6 per barrel — including the dry holes.

OID: So that Coda buying it for $3.50 or so is saving almost 50%.

Sams: The only disadvantage is that they're not getting good exploration potential. In other words, they're buying proven properties. The best they can hope for is some infield drilling. And the people selling know what the infield drilling potential is. No big finds are going to happen here. Still, they're getting oil for $3.50 per barrel — which is very, very good.

OID: Sounds like it. But how do you value Coda?

Sams: These small exploration companies usually sell for 3 to 7 times cash flow. The ones selling for 7 times cash flow are usually the ones who either have excellent exploration potential or very long life reserves. For example, they may have 18- to 20-year life reserves. Therefore, their cash flow will continue for a long time. And you can make a strong case that they'll get much better prices on their gas in say 8 years — especially relative to what it's costing them to buy those reserves today.

On the other hand, short life reserves — say 6 years — gives you the cash back quicker. But what will you do with the cash? You're going to drill again. And suppose you hit dry holes. Then you've lost it.

So when oil stocks are popular, those companies with long life reserves and exploration potential sell at 6 to 7 times cash flow.

OID: And Coda?

Sams: During pretty good times, Coda could certainly sell for 4 times cash flow. It won't sell at 6 or 7 times cash flow because they don't have a lot of exploration potential. They're 60% oil and 40% gas right now.

I think their cash flow last year was 75¢. We're looking for Coda's cash flow this year to be $1.00 to $1.10. So it's selling for a little less than 3 times cash flow based on current energy prices.

If oil and gas prices go up, you could have a quick pop in cash flow and an expansion in its cash flow multiple. And you know that it happens real quick when it happens. But you can't depend on the commodity price going up. However, you can count on them making another acquisition at good prices.

I think it's a comfortable place to be. I don't think there's much downside. And if things turn positive and

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they make a nice acquisition or two of some good properties, it's not very hard at all to imagine Coda at $5 — especially with only 9 million shares outstanding.

The bottom line is that the jury's still out. I was wrong for the first year. But I made money despite being wrong.

OID: Good management and the right price.

Sams: Good point. The entry point was correct. After all, they had an equity offering at $3. You just happened to make the call at the right time when it was $2.

THE ECSTASY AND THE AGONY —
PARKER & PARSLEY PETROLEUM & MESA.

OID: What about Parker & Parsley?

Sams: It was $7-3/8 when we last spoke. And in a year that oil stocks went down, Parker & Parsley went up about 60%. My entry point again was correct there. And I made back my Forest losses there. So I'm back even again.

OID: One final bad memory. What happened to Mesa?

Sams: That's my other Forest. I was completely wrong on Mesa Petroleum for the same reasons that I was wrong on Forest: too much leverage and poor management.

OID: What was management's mistake?

Sams: Boone Pickens continued to pay the dividend when he shouldn't have — when the cash flow wouldn't support it. He borrowed money to pay the dividend. And they were leveraged up. He made a bet on the price of gas going up and gas prices, of course, got worse and worse. And there's the problem.

His timing was completely wrong. He should have stood up, looked in the mirror and taken his medicine. But he kept hoping for it to turn. Meanwhile, he kept paying out that big dividend and got the company into trouble.

And now I'm out of the stock. It's the biggest loss that I've ever taken in the Fund. I lost about two-thirds of my cost on that one.

OID: If you came across those same situations today, how would you act differently — if at all?

Sams: I might avoid them if the debt was quite that high. However, I'm not sure that I'd change much. Value guys always talk about risk/reward and all like that. And when they talk about that, they usually mean that there's not a lot of downside. Maybe there's 10% downside risk and 40% upside potential. And most value guys like situations like that.

I accepted bankruptcy-type risk in those cases. It's probably best to stay away from bankruptcy candidates. But most of the time, you wind up winning on these deals. In the cases of Forest and Mesa, I didn't. In both cases, I think if management had been more aggressive they could have worked out very well.

But I still like looking at my losers.

OID: In that case...

Sams: In that case, you can go to hell....

Obviously I'm not a salesman. If I had to make my living selling, I'd have starved years ago. But I try to kind of tell it like it is. And I like to concentrate on the negatives first and the positives second. If you can solve the negatives, the positives take care of themselves.

Therefore, I talk a lot about the negatives. The last thing I want to do is be a marketer or a manipulator. There are enough managers who only tell you about their winners and hide their losers.

OID: Whereas Templeton and Lynch acknowledge that a certain percentage of their ideas will be mistakes — and Buffett even devotes a part of his annual report to the things he should have done — that no one would otherwise know about.

Sams: That's the way to do it. I'd rather come away, not be popular and be able to live with myself.

CHAMPION'S AT A DEEP DISCOUNT TO BOOK
AND IT'S NO SECRET WHY....

OID: You also said you still liked Champion. What's the story there?

Sams: Champion's done absolutely nothing. It's unbelievable. But I feel real comfortable with it now.

The S&P was up 30% in 1991. The OTC was up 50%. Champion International was down about 15% for the year — during a year that the paper group was up big.

OID: So?

Sams: I look at that as a positive. Anybody with any common sense would say, "God! Something is wrong with Champion International." And there is — the management. Siegler, the guy who runs it, is not a good manager.

The paper industry is out of phase. Newsprint is over capacity. Market pulp prices aren't going good. And the parts that *are* in phase — wood products and linerboard — are areas that Champion isn't heavy in.

They also don't have the consistency of Kimberly Clark in the tissue market. And they have a demonstrated ability to be in the wrong place at the wrong time.

OID: And this is a stock you're buying?

Sams: Believe it or not. They have world class assets. Champion International has made capital expenditures of around $3-1/2 billion over the last decade.

OID: Has the $3-1/2 billion been well spent?

Sams: Almost any analyst will tell you that Champion has world class assets. There's no question about that. The problem is just that the industry's in a down cycle.

Incidentally, I own something like 70 companies. And I can't remember the exact figures for each of them. I know a little bit about each of them, but I'm not an expert in any of them. So I can't tell you if it's $3-1/2 billion or $4 billion, for example.

OID: But you're satisfied with how they've spent it?

Sams: Yes, I am. I'm sure some of it's been wasted. Some analysts, in fact, will tell you that they've wasted quite a bit.

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But those are the analysts who hit something when it's down. And they tend to be the same ones who jump on the bandwagon when earnings momentum is intact. To me, the right analysts are saying that they have good assets, but that it's going to be quite awhile before they can get their earnings back.

This guy, Siegler, needs to step out of the way. And you can be assured that Tisch has some kind of plan down the road. He has about 15% of the company — close to 15 million shares.

OID: And doesn't Berkshire Hathaway own some preferred stock in Champion?

Sams: Yeah, but he's got a great convertible preferred. It pays something like 8-3/4% — which is 85% tax free to Berkshire. So he gets a wonderful effective yield there. And it's convertible at around $38. So he can sit there and draw a nice income for a long time, effectively getting paid while he's waiting — while Tisch and I are common shareholders.

And Champion cut its dividend from $1.10 to 20¢. That's when I went in. I liked the fact that Tisch was in there and the fact that other paper stocks were going up and this one wasn't.

What I'm looking at is the risk/reward trade-off — with emphasis on the *risk* part.

OID: How do you see the upside and downside here?

Sams: The stock's selling at $26 today. The upside might be $33 to $36 a share. Shoot, it was $30 last year.

Lots of people might say, "Bill, that's only 30%. I want a double."

OID: I strongly resemble that remark.

Sams: But as I see it, it could go to $22 — or less in a panic. But I'd just buy more — because there's a hard book of $40. And any analyst would tell you that they could liquidate this company in a normal market for paper at between $45 and $50 a share.

OID: Of course, this isn't a normal market....

Sams: Bulls say that the paper cycle will be at a more favorable point in a few years — that it could be worth $55.

That's how these things get going. Once things start getting positive, it gets overdone. Ditto on the downside.

OID: And it's overdone on the downside right now.

Sams: Let's just say I'm happy holding a $26 stock with a hard book of $40 — especially considering that this stock has reached 90% of book in every past bull market. That would give me a target of $36.

And, of course, we had a super cycle in paper stocks during the late '80s. Now some parts of the industry seem to be trying to bottom. Some have gotten better and others are still declining. I suspect that we will not have another super cycle for a long time. And therefore, I think that we're going to see consolidations.

The paper industry tends to screw up — when they have a lot of money coming in, they overexpand. They borrow money to build the plant. And just when it's almost complete, the cycle turns down.

I'm not sure if it's a bad business or if the people who manage this business just aren't real smart. It's probably a combination of both. In any case, return on equity never seems to be very good for Champion.

Yet International Paper has done a beautiful job. And their stock price reflects it. Some of these paper companies sell for 2-1/2 times book. And here's a company selling at a little over 60% of book.

OID: With its largest shareholder being a pretty astute operator and investor.

Sams: That's right. Having said all that, I understand why very few analysts are recommending Champion — because its earnings are going to be very low again.

OID: How low?

Sams: I'm estimating earnings of about $1. But I've seen estimates as low as 80¢ and as high as $1.60. And people wait and say, "Oh, I'll buy Champion later when its $4 to $5 of earnings power comes through."

Of course, if they do, you can be pretty sure that they won't be paying 65% of hard book. Again, I think there'll be a general consolidation in the industry at some point. And that's the time to sell a plant.

If I were running this business, I'd try to sell some of these wonderful assets to my competitors who just *had* to be in the business — and lower my debt or keep the cash, as the case may be. Then, when the cycle turned bad — like last year — I'd buy my stock in.

Why in the world when you have something selling at $25 with a hard book of $40 and a liquidation value of $45 wouldn't you be buying your stock in?

OID: Because you like running a bigger company or you can justify higher compensation by managing a larger company?

Sams: Or you have too much debt or you're stupid. That's not considering the shareholder and it galls me. But that's one of the problems here. And it calls for new leadership.

I understand he pays himself $3-1/2 million at the same time the company is known for being poorly managed. In fact, he's gotten some bad publicity in that regard lately.

You can go back 20 years and find the stock at today's price. That's what I call a horrible management job.

OID: But you haven't owned it for the entire 20 years?

Sams: No, just for a little over a year. My cost in Champion is around $27 — $26.85 to be exact.

Champion's board of directors doesn't appear to be too astute. I guess they must be yes-people or something. They don't own any stock to speak of. It's typical.

OID: Unfortunately.

Sams: Yeah, very unfortunately. In fact, I'll go a little further here. Since I own so many of these companies, I've decided — and I think that Fidelity has made a public statement, too, on this — to start being a little more active this year in my negative voting for the boards.

And Champion is one. I'll look at the prospectus. But I'll probably use my votes to send a message. If other holders did that, we'd get some action, I think.

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OID: Any other negatives?

Sams: One negative is that Tisch hasn't bought any stock since the end of October. And that's despite the fact that it got down to $22-1/4. He could easily have bought a lot of stock between $23 and $25, but he didn't. And I don't know why not. His cost is $27-ish.

He's cleared to buy up to 25%. So he's stopped buying it for some reason.

OID: Maybe he likes what he sees elsewhere better — for example, in the energy area.

Sams: He did make a move over there. He bought some drilling rigs. But I'm still a little concerned why he's not buying stock.

Rumors are that he's still interested and would like to buy more, but I don't see any action there. Of course, the minute that you see another filing, the stock would go up a couple of points.

OID: Would you be any less happy to be an owner without Tisch as a significant shareholder? Would it change your decision?

Sams: It's a good question. If he wasn't there, I'd be very much more concerned. I wouldn't sell the stock now — because it's so cheap. But I'd sell earlier than I would with Tisch in it. I feel like I need a catalyst here.

OID: Would you have bought it in the first place without Tisch?

Sams: Probably. But I wouldn't have taken nearly as large a position. This is by far my largest position. It represents about 9% of my total assets under management. And that's pretty big because I own 70 companies.

In my private accounts, it represents 15% of assets. And I have nothing else over 8%. So it's my largest position by far.

OID: Why do you own so much less of Champion in FPA Paramount Fund?

Sams: That's because we're limited in the Fund to 5% of the Fund at acquisition cost. Once it gets over 5% of assets, I can't buy any more. If it goes down in price more than the Fund's other assets, I'll buy a little more to bring it back up to 5%. But until it does, I can't.

BOISE CASCADE: MORE POTENTIAL REWARD,
BUT MORE RISK, TOO....

OID: According to Portfolio Reports, you've also been buying Boise Cascade. What's the story there?

Sams: I have a large position in Boise Cascade. But it's more risky than the other stocks I've given you. I expect them to lose about $2.50 this year.

OID: And the reason you own it?

Sams: They have the leverage to make $4 or $5 at some point — 1994 or so — if the cycle works like we hope it does. But it's not as conservative as Champion. The potential reward is more in Boise, but there's more risk, too. Boise is much more leveraged. In 1991, Champion broke even or made a little money — 25¢ or so. Boise, on the other hand, lost almost $3.

OID: But again, you're picking it up at a deep discount to book.

Sams: To a shrinking book. In 1991, they lost $3.87. And most analysts think they'll lose $3 this year — and then they'll turn the corner.

I think I'm OK there. It's only $3 from its low. Boise's currently around $22. And I feel good about the paper cycle. But it could take longer than I think.

OID: And what's their book value?

Sams: The book keeps coming down of course — since they're losing money. Their stated book is around $36. And in a normal paper market, their liquidating book would be something between $40 and $50.

They won't liquidate. But that should keep the stock from going to $15 or anything like that.

OID: How would you assess management quality?

Sams: Only fair. Not tops, but not real bad either. Obviously, they've leveraged the company up far too much.

What I'm a little worried about right now is the talk about Germany, Japan and a worldwide recession. That means we could all be in recession at the same time. And it means that we could all turn around at the same time, too. So this horrible outlook could get good — maybe too good. But it may take longer.

I've bought more Boise recently because of the price. And I would buy more if it went lower. But again, it's riskier than the others I mentioned.

A VERY WELL MANAGED CYCLICAL
AT NINE TIMES EARNINGS....

OID: What about Hanson?

Sams: Hanson is interesting. It's sort of a new position for me. It's a perfect stock for this stock market because it's a cyclical-type company. They have quarries over here in this country and several subsidiaries that are in cyclical industries — like a crane company. And they just bought the large English homebuilding company — Beazer.

And they have a great balance sheet. If they didn't have a great balance sheet, I'd be scared to death.

OID: Could you tell us about the fundamentals?

Sams: I'm carrying earnings here for the year ended September '92 of about $2 — up from $1.84 in '91 and $1.93 in '90.

OID: So you're talking all of 9 times earnings.

Sams: Right. And the people running the company have a long record of up earnings.

OID: One of the best.

Sams: One negative: it's so huge with so many shares outstanding — 961 million shares. So it's a big company.

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It's cyclically oriented. And it hasn't done a thing.

But the way I see it, it has a good balance sheet and a great yield — about 7-1/2% at its current price of $18. And they're going to start paying dividends on a quarterly basis.

Goldman Sachs and Legg Mason are recommending it. Here again, I'm looking at my downside first. The negative could be that the upside disappoints you and it doesn't do a whole lot.

But I'm willing to live with that given what the stock market's done over the last few years.

THE SECRET OF SUCCESSFUL SELLING: SELL WHEN THERE'S NO REASON TO DO SO....

Sams: It's pitiful to say, but people don't get excited anymore about a stock going from $20 to $30. I get the feeling that people say, "Oh, I guess that'll be all right if we can't do any better." We're so spoiled.

I'll buy a stock that goes up 50% in the next two years all day. Give me that and I'll sign a contract and walk away.

OID: That sounds good, but isn't significant upside almost a form of downside protection?

Sams: That's right. Good smart money managers have their eye on Coastal. And they're holding off where good ol' dumb Bill is plodding ahead. You wait and see. They'll be there right before these stocks make nice moves and they'll do very well.

But that's because they have a better sense of timing than I do.

OID: I feel bad for you. However, as I understand it, you've directed two mutual funds to returns of over 18% per year after fees for the last 21 years.

Sams: That's right.

OID: And that's despite holding how much cash on average during that time?

Sams: About 30%.

OID: How do you reconcile that with bad timing?

Sams: Every once in a while, you'll catch me lying.

OID: Our thoughts exactly.

Sams: I'm *not* a good market timer. People who really know me accuse me of being a pretty good seller. I've not, however, been a very good seller in the last few years because the market only seems to move in one direction.... Everything I sell keeps going up.

In the old days when we had shorter cycles, I'd shock people by selling things well. I'd sell something and it would go down. And people would ask me, "How did you know to sell it?"

OID: And the answer was inside information?

Sams: Not exactly. I'd sell because there was no reason to sell. They'd say, "What do you mean by that?" And I said, "Everyone likes the stocks hitting new highs. You just start letting them have a little."

If there's a reason to sell, the stock's not going to be there. And sooner or later, either the stock market or an industry or a company will screw up. If you just sell into strength, you're going to end up winning if you just have the patience and don't go back in at a higher price.

OID: The exact reverse of most bank trust departments where they pay dearly for a clear sky and sell cheap at the first sign of rain.

Sams: Exactly. Again, selling when nothing's wrong hasn't worked for the most part in recent years — since we've been in a super-cycle for earnings momentum, growth and so forth.

But I see what's going on. And I know where we are. We're in a very speculative bubble. It can go on for months and months. No one knows when it's going to stop. But I've been through it before — as we all have. It usually stops when you least expect it.

So I've exited the earnings momentum and growth stocks already. And what I'm doing right now is exiting the Over-the-Counter stocks — because I know what happens. When something goes wrong, the bids just disappear. Those bank trust departments will want to sell.

When something goes wrong, no one wants to stand up for anything any more. And it's just devastating — especially with the NASDAQ being up 50% last year and up a little this year.

I'm moving away from smaller companies because everyone else is moving towards them. They had a tremendous year last year. And they could have a good run for three to six more months.

But it's always that trade-off between risk and reward. They have tremendous sponsorship. So I'm moving out.

OID: There's no reason to sell — so you're selling.

Sams: You've got it. My favorite stock is Coastal. I'm buying some today. Enserch will be OK long term. And I think that Champion will be OK long term as well. Nothing else gets me very excited today.

But I've been so successful. I guess I've got to increase my losses somehow.

OID: You've quietly built one of the best long-term records among all mutual funds. However, you're not very well known. How do you account for that?

Sams: It's too bad, I guess, that I haven't been with a single fund for 21 years. It'd be a different life now. The lights would be brighter. There's no question about it.

OID: But I somehow don't think you'd like that.

Sams: No, I don't think I would.

OID: Thank you, Mr. Sams.

—OID

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GARDNER INVESTMENTS'
TOM RUSSO
(cont'd from page 1)

year for the S&P 500.

Here are Semper Vic's annual performance figures before fees alongside those of the S&P 500. (Performance figures provided by Gardner Investments.)

Year	Gross Annual Return	S&P 500 Total Return
1984	+13.6%	+6.3%
1985	+44.0%	+32.2%
1986	+26.7%	+18.5%
1987	+37.1%	+5.2%
1988	+20.2%	+16.8%
1989	+25.0%	+31.5%
1990	+5.3%	-3.2%
1991	+27.3%	+30.5%
1984-91	+24.4%	+16.5%

As you requested, we gave Russo a call — actually several calls. The following excerpts were selected from those conversations. We learned a thing or two more about Guinness and why it may be — in Buffett's words — a franchise. We hope you find Russo's comments as enlightening as we did:

YOU READ IT HERE FIRST —
DESPITE A CERTAIN EDITOR....

OID: After Buffett confirmed his Guinness purchase in this year's letter to Berkshire shareholders, several of our subscribers remembered that you mentioned it as one of your favorites last year in OID and asked us to follow up with you for an update.

Russo: I'm a little disappointed.

OID: Disappointed? You were hoping for Alan Abelson, maybe?

Russo: Probably every investor in New York will call over to London and say, "Send me a file on Guinness. We better start investing abroad."

In some ways, it's too bad.

OID: More competition?

Russo: You bet.

OID: I'm sure he agrees. As you know, there are only two types of competition that he doesn't like — foreign and domestic.

Russo: I love that.

OID: How has the market reacted to the news?

Russo: It's like the age old adage of "Buy the rumor and sell the news." When Mr. Buffett was rumored to be buying Guinness, it ran from £5.50 to £6.30. And then when he announced, it was back to £5.50 again. It closed today at £5.60.

OID: Can you tell when he bought it?

Russo: No, I can't. But my sense is it wasn't until after September. As late as June 1991, it was still at about $8. By late November, the stock was at $8.70. Given his purchase price, it appears he likely bought it between then.

OID: So it looks like he bought it after our interview?

Russo: It looks like it.

OID: Buffett's said he had more money than ideas. But I didn't realize he was that desperate....

Russo: Mr. Buffett only needed to meet Guinness' management to know they speak his language. He only needed to look at their paper trail to see they bought back stock in '87 at £1.60 vs. today's price of £5.60. He knows that when the stock market gets myopic, Guinness' management has the very unusual profile for a British company of being willing to buy back stock.

OID: What was Buffett's cost?

Russo: The real measure of his skill is that he paid so little for it. I'm not sure how he executed his trades so cleanly given that he bought so much. But I think he only paid $8.40 per share.

OID: How much of Guinness did he buy?

Russo: There are 1.9 billion or so shares outstanding. With Guinness at £5.60 per share, that's about £11 billion in equity capitalization. At approximately $1.70 to the Pound, that's equivalent to about $19 billion.

I think Mr. Buffett's initial investment was about $290 million. So he owns something like 1.5%.

OID: But that's nowhere near a full position.

Russo: No, it's not.

OID: What do you think happened? Do you think Guinness' price just ran away from him?

Russo: He bought very, very well. And don't forget — that's as of year end. He may have bought more since.

OID: Good point. But where has Guinness' stock price been since then?

Russo: You had an opportunity to buy it below $9 since then — but not at $8.40 again. And that's despite the fact that the Dollar went from $1.878 to the Pound at year end to $1.70.

OID: Incidentally, when we spoke, Guinness' stock was $16.50. It looks like that was before a 2 for 1 split. So split-adjusted, it was $8.25.

Russo: That's about right. So it's been an OK stock, but it hasn't been a great stock since then.

As you recall, your real thrust going over Guinness previously was, "It just doesn't seem cheap."

OID: Must you embarrass me in front of my subscribers?

Russo: If the shoe fits.... And I said, "I'm probably stretching a little bit on this one, but I'm paying up for the quality of management and the strength of the franchise."

OID: I wonder who was right — me or you and Buffett?

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GARDNER INVESTMENTS'
TOM RUSSO
(cont'd from preceding page)

Sams: It wasn't cheap — which has shown up in the performance. It was valued at $8 a share. Now it's valued at $10 a share. About half the gain came from the dollar's decline since July and about half from the rise in Guinness' share price in local currency.

COKE & GUINNESS: NO RESPECT AT HOME, BUT POWERHOUSES ABROAD....

OID: It's interesting that Buffett apparently paid up for Guinness very much like he did for Coke.

Russo: Guinness is intrinsically interesting as a business. It's the world's second most profitable beverage company. Its pre-tax profits in '91 approached £1 billion. Guinness focuses on two core businesses —- distilled spirits and beer. With distilled spirits' earnings of £750 million in '91, Guinness is the most profitable liquor company in the world dominating its markets with brands like Black Label, Dewars and Tanqueray.

Guinness' other core business, brewing, has long concentrated on its hugely profitable stout product niche expanding sharply over the last few years. Guiness brewing earned nearly £250 million in '91.

The reason why I've swapped out of most of my other beverage companies into Guinness is that they have focused on their core businesses so well. The others are hung up with food or restaurants or any number of other ancilary businesses which over time will detract from their returns.

OID: Makes sense.

Russo: Guinness has very high returns on capital. They have highly branded products. They have good pricing power. They have high barriers to entry caused by the brands. And there's very little likelihood of new brands coming into the market because it's perceived to be a declining market.

Guinness' spirits profits have more than doubled since '88. Its brewing profits have tripled over the last five years. There are also prospects for enormous profitable margin growth in new markets such as the Far East and Europe — although the price of the company's shares has been set in the old and declining host country's market.

It's ironic. You have British institutions by and large underweighting Guinness because of worries about rising domestic excise taxes and because of declining pub traffic as a result of the recession and people in England drinking less scotch whiskey — which is a fairly myopic view.

OID: In much the same way that Coke looked less attractive to its host country's investors because it's dog eat dog between Coke and Pepsi here in the U.S., despite the fact that Coke is dominant throughout most of the world.

Russo: That's true. And with Coke, Mr. Buffett came in and helped redirect the flow of capital so that capital allocation is more intelligent now. It's all directed offshore where the business is so dynamic.

U.S. investors have embraced that concept and realized that the local market be damned. Coke's prospects in foreign markets are terrific. And they're going to buy it *despite* the U.S. market.

OID: But they weren't saying that when Buffett bought it. And neither was yours truly.

Russo: That's right. That's why Mr. Buffett could buy it cheap — and why he could buy Guinness cheap.

Also, Guinness may be suffering from the Philip Morris effect — you know, "It's done so well for the last few years. How can it do well going forward? After all, it's the sixth largest company in the U.K. by market capitalization. It's going to slow down at some point. And, by the way, all of my friends are laid off and are drinking less." So you have that mentality sort of running through England.

There's also some residual effect of the Saunders affair in the stock price.

OID: The Saunders' affair?

Russo: In 1986, they made the acquisition that put Guinness together in its current shape. And stock manipulation took place with investors somehow involved with parking stock to complete the deal. It was really ugly.

What appears to have happened is that consultants to Guinness — which was in the process of a major restructuring in 1985 and 1986 — told the company, "You should really make a run at United Distillers Group in Scotland. It's Scotland's leading producer of scotch whiskey with 24% of the market. But they're production-focused and not marketing-focused. They really ought to be bought."

So they started the deal. But in the process, they triggered a counter-bid by a U.K. grocery store company called Argyll — who bid higher than Guinness. And some of the deals that were floated for United Distillers Group were based on the price of a share in the stock market. And in order for Guinness to win, some people were paid off to stabilize share prices. And there was a payback arrangement set in place with one of the alleged manipulators. This support of the price in London allowed Guinness to prevail.

So Guinness won United Distillers. And it's one of the primary reasons why they did so well the past five years. But one effect of that is that the former chairman of Guinness — the guy who ran it before Anthony Tennant — was indicted along with five well placed investment bankers in England. And there's still a bad taste in investors' mouths because they're not sure if there isn't some residual liability.

OID: What do you think?

Russo: I think there's none. But nevertheless, that may be one reason why U.K. institutions still don't quite embrace Guinness as an idea.

OID: Whereas they view Coke as the real thing.

Russo: That's right. And the fundamentals for Coke and Guinness are quite akin. The dynamics for excitement are all foreign in both cases. And in the case of Coke, even though the domestic market is troubled, U.S. investors have been educated to understand that the greatest opportunity for volume growth and local currency profits occur abroad. So they're willing to embrace it — and have — to the tune of

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GARDNER INVESTMENTS'
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(cont'd from preceding page)

paying about 28 times earnings.

With Guinness, the greatest volume and profit growth is also in foreign markets. But the British haven't fully embraced the stock. It's still underowned in England.

I suspect that this move into Guinness by Mr. Buffett will both wake up the British institutions and, unfortunately, the American institutions.

OID: Meaning a higher stock price for Guinness.

Russo: That's right. And another thing going for Coke is that it tends to trade spectacularly well when U.S. investors begin to fear a declining dollar. At those times, they tend to move into companies that are called "the internationals" — the drug stocks, Colgate Palmolive and Coke — all of which earn 80% of their profits abroad. The reason why they buy them is that as the dollar declines, their profits get translated into more dollars. And you clearly get that effect.

In England, that happens almost daily. When there's fear of a declining pound and a rising dollar, you can see investors switching into Glaxo, ICI and Smithkline Beecham — which are considered in the local jargon to be "the internationals".

But you really haven't seen it with Guinness which is seen by locals as either a local brew producer or a local distilled spirits house. They don't really give it the multiple it should be afforded given the fact that more than 85% of its profits are earned abroad. And I think that aspect of Guinness will also lead it towards a higher multiple if the British continue to fear a decline of their own currency.

OID: Not so far fetched an occurrence.

IF IT'S NOT THE REAL THING,
IT'S CERTAINLY CLOSE....

OID: It's been suggested to us that Guinness' business is similar to Coke's — that they even both sell syrup.

Russo: That's right, but Coke's business is much better. To begin with, the beverage business overall is a superior business. But if you were to place beverage companies along a continuum, you would put concentrate for soft drinks all the way at one end with Coke being the best of all businesses.

At the other end of the continuum, Coca Cola bottling is the capital intensive side of Coke's business with the lowest return on assets.

OID: In other words, Coke's primary business of selling concentrate is a high margin business with very little in the way of capital requirements, whereas Coca Cola Enterprises' bottling business involves packaging and moving around huge quantities of product and requires relatively high amounts of capital.

Russo: That's right. And close to Coke syrup as a wonderful business is Bacardi Rum. And the reason is that they produce syrup — grain alcohol. And there's no aging. That's the big difference.

OID: Because aging means that you have inventory and, therefore, that it's more capital intensive.

Russo: Exactly. The key difference is that Bacardi doesn't have precious perfume-like pricing. It's pretty cheap stuff. And they sell massive numbers of bottles of the stuff. So it has characteristics more akin to Coca Cola Enterprises because of the volumes that they actually bottle. But their syrup side of the business is more like Guinness.

In contrast, cognac has to age a long time. But you get marvelous pricing. So you have to sell very few units.

Again, the quality of the business deteriorates as you move from a Coke to a Coca Cola bottling because of the nature of selling huge volumes for low values. That's what mainstream beer's all about and that's what Coca Cola Enterprises is all about — selling hundreds and hundreds of millions of cases of bottles. And it's that whole process of trying to distribute, bottle and recycle heavy things for low value that makes it less of a good business.

But Guinness would be pretty close to Coke's concentrate business because its best business — Johnny Walker Black — sells only 2-1/2 million cases a year. So it's very few bottles at a very high price. It's aged, so it does require some working capital to finance its inventory. But liquor, unlike beer, requires very little production capital because you may only produce 2-1/2 million cases a year.

In beer, you're producing 50 or 100 million barrels a year. And that just makes it a higher capital and a lower return on asset business.

OID: In your interview, we asked you, "Why is 15% growth a bargain at 13 times this year's earnings and 11-1/2 times next year's estimate?"

Russo: Incidentally, that's exactly where it is today.

OID: The answer may be in Buffett's latest letter to Berkshire shareholders.

Russo: He says very little about it in his letter. He says, "I like it. It's like Coke. As you know, the Chairman has an abiding passion for the product of Coke. I have an equal passion for the company of Guinness. But lest you worry, I have no confusion as to what products are made by which company."

OID: But as was pointed out to us by Steve Wallman, Buffett explains in this year's letter to Berkshire shareholders how a relatively certain income stream that's growing at 6% per year without incremental capital requirements may be worth 25 times earnings.

And Wallman suggests that such a valuation would have applied to See's when Berkshire bought it and to Coke today.

[Editor's note: See pages 17-19.]

Russo: If any product in the world is worth 25 times earnings, it's Coke.

OID: Does the same rationale then apply to Guinness?

Russo: Pricing power is good. And it's only been under the management of Guinness that they've been able to really effectively pursue that policy because the old management of United Distillers Group had a production mentality. It consisted of Dewars and seven other brands. And each of their brands was a separate company that

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GARDNER INVESTMENTS'
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maximized production. They didn't really care how it was distributed. They would ship it to the docks and it would go around the world. And it was priced however the local distributors wanted to do it.

Guinness completely changed that post-'86. They bought up all of their local distributors. They took total control over the product from production to the most final point at which the laws allowed them to. In the U.S., there's a split system. So they can't actually get involved in wholesale distribution like they can in other markets because of the law.

But they've taken control of their products in such a way that they can now control prices. They've driven their pricing up 8% to 12% a year for the last five years. And they take the incremental profit and try to encourage customers via advertising to trade up to the most profitable lines — to switch, for example, from a Johnny Walker Red to a Johnny Walker Black, which can incrementally boost profits by as much as four or five times per bottle. There's enormous marginal profitability because the variable production costs are so low.

OID: One reason why Guinness may, in fact, be a bargain at 13 times earnings.

Russo: Yes, I think that is key. And the other thing that's crucial is that in the liquor side of the business, no reinvestment is required.

OID: How much untapped pricing power do you think they have?

Russo: The standard scotch whiskey was probably £10.50 in London in November. They cut the price to £9.99 around Christmas as sort of a one-off seasonal promotion aimed to match the holiday spirit. I've been told that they've since raised the price to £11.40 — part of which reflects increased local excise tax.

So it looks like they basically raised prices another 8%. I can't confirm whether the increase has stuck or what kind of discounts are being given, but according to what Guinness' representatives told me earlier this week, it sounds like they're still raising prices.

And don't forget too that when you're talking about a price increase from £10.50 to £11.40, it's really not just an 8% increase. Something like £6 of the price consists of excise taxes. That portion doesn't go up with the increased price.

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So an 8% price increase increases the bottom line a lot more than 8%.

OID: Could you quantify that?

Russo: It's not exact. There are all sorts of pieces of the increase that get carved out to excise taxes, distributors and retailers, etc. So Guinness doesn't capture it all. But there's substantial leverage to the bottom line.

For example, Gunness' operating margin on stated revenues is approximately 27%. If you deduct that assumed amount of excise taxes, you wind up with an operating margin approaching 40%.

Therefore, a 3% gross price increase results in operating profit margins going up to 30% from 27% — or over 10%.

OID: A very important point.

Russo: Practically, some of that increase will go to marketing and trade promotions. They're reinvesting those profits into the business.

OID: Is there much debate in the industry about pricing power?

Russo: How much more the consumer will bear?

OID: Exactly.

Russo: I think that different companies are willing to go different paths on that issue. American Brands, for example, seems to think that the future lies in lower cost products. They seem to be inclined toward the cheap stuff.

Guinness has promoted this concept of the full price. So they're trying to raise prices — recognizing that people are drinking less anyway and that they'd like to drink better as they drink less. So they just offer ever higher image and higher priced product.

OID: It's been pointed out to us that the supply of aged scotch is quite finite at any point in time. You can't double your volume of 10-year old scotch next week — unless you're looking out 10 years from now.

Russo: That's true. You can change the mix. You can use less of your old scotch and more of your newer scotch. But by and large, that's right.

Guinness, for example, is extending the line by creating 15-year old Johnny Walker. As you might expect, age is a pretty important criteria. So they're able to raise prices pretty dramatically when they do that.

OID: It's also clear that aggressive pricing in alcohol or tobacco is much more readily tolerated than it would be in something like auto insurance.

Russo: That's right. But look at the pace of liquor tax increases at the local level.

OID: But as you pointed out the last time we spoke, there's almost an increase in your pricing power generated by those tax increases.

Russo: That's right — because it really does ultimately squelch demand for the cheap stuff. For example, let's say the cheapest stuff was $6 a bottle and Johnny Walker Black was $12 a bottle 5 years ago. If higher excise taxes drive the prices to $12 and $18, people tend to lose interest in

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that $12 bottle and migrate up to the more expensive stuff. They're paying a lot already anyway.

OID: And, as you described, gross price increases raise your net receipts far more.

Russo: Right — because so much is lost in the middle to the government. And the government has realized that consumers will pay more to indulge their sins. So the government is racing along trying to capture its share.

Intelligent manufacturers of these products — like Phillip Morris and Guinness — realize that if they don't act, the government will. And so they're moving forward with great vigor raising prices.

As these manufacturers move the consumer forward to the point of price elasticity, when the government next tries to come in and get more revenues from them, they'll find that the consumer will start to resist, volumes will go down and the government's take won't be much more.

So they're trying to get a larger share of the consumer's dollar before the government comes in and sort of stops the business.

OID: Which means that they'll very likely aggressively raise prices — because they have to.

Russo: That's exactly right. I mentioned the example of Canada where the tobacco industry leader, Imasco, failed to increase prices for nearly two decades. The price at retail went from $1.50 to $6.00. And the manufacturer's price only went from 60¢ to 90¢. Meanwhile, the government's take went from 80¢ to $4.00.

Those managers were really quite culpable in not taking their share of consumers' willingness to pay more. The government didn't stop them from raising prices. But tobacco industry leader, Imasco, was locked in a perceived market share war. So they refused to raise prices.

Finally, after 10 years, Imasco developed pricing religion. So the Canadian prices are starting to go up 12% a year. But Philip Morris' Hamish Maxwell, by contrast, had been raising prices every year in the U.S., where his company is the market leader.

And I think it's partly recognition that the government ultimately tends to come in and tax this stuff. Maxwell wanted to get their share of the consumer dollar up high enough so that when the government comes in, they have to factor in price elasticity.

OID: Before it happened the other way around.

Russo: That's right. Otherwise, the government will take all of the pricing out of the business.

But Guinness may be pushing the envelope a bit on the pricing of their standard products. For example, they recently bought Glenmore Distillers. And the reason, I think, that they bought Glenmore quite frankly is that Glenmore has a product called Scoresby Scotch.

If you go to a liquor store in the U.S., you'll see that Scoresby is a very price competitive brand. It was actually a scotch whiskey bottled in America. Glenmore imported the raw scotch from Scotland and bottled it in America.

They did a terrific job advertising using cartoons from Roy Lichenstein. And it was taking a tremendous amount of share on the west coast. It was becoming a popular brand at a very low price.

So Guinness came in about eight months ago and bought the company. I imagine that one of their agendas was to make sure that there wasn't such a thing as a popular low-priced scotch. So they're trying to keep the bottom from falling out of the business. And that's just by way of saying that I'm not sure that the basic scotch business has untapped pricing power.

But what Guinness does have is the ability to migrate customers to pay more to drink better, but less — which seems to be a growing consumer preference anyway. And Guinness is terrifically enhanced by that because a bottle of Johnny Walker Black is ten times more profitable than a bottle of Scoresby because of the economics of the business.

GUINNESS' EARNINGS PROSPECTS:
NEAR TERM CLOUDY, LONG TERM BRIGHT.

OID: What can you tell us about Guiness' earnings?

Russo: I'm projecting earnings of £760 million this year. There are just under 2 billion shares outstanding. So that's approximately 38pence per share. It should earn 44 pence next year. And it reported 33.4 pence for 1991 — which was about 1-1/2 pence below our expectation.

There were basically three reasons for that. First, there was the Iraq effect which kept people from traveling which hurt duty-free sales. Then, during '91, several major markets substantially increased federal excise taxes and that affected sales. Third, there was a worldwide recession.

Despite those factors, they were able to come through with darned good numbers. It shows their strength. Earnings were still up close to 12%.

OID: Which was well below their historical earnings growth rate.

Russo: Exactly. Since 1987, their earnings per share have compounded at 23% per year.

OID: But you don't think they can replicate that over the next five years?

Russo: I think that's pushing the envelope. I'm just not prepared to get much more aggressive than a 12% to 15% rate of growth in earnings per share this year and next. And I don't think they need to do much more than that to be an attractive investment. If they get it, it's terrific.

OID: But don't they get a certain amount of growth with little or no capital required?

Russo: That's right — from pricing, product mix and volume in new markets. But they do have old markets declining on them. And there is some question about whether or not they can raise prices like they have been doing over the past six years.

OID: But as you pointed out, they basically have to. If they don't, taxes will.

Russo: They are sort of forced to raise prices.

But ultimately, you face the Scoresby problem. How do you keep American Brands from taking a different tact

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and pricing product at a ridiculously cheap price and keeping pricing restraint on — like what's going on in the cigarette business?

OID: Bribes, threats, collusion or, if all else fails, buying them?

I don't see how anyone ultimately stops someone like Wal-Mart or Kroger from carving out big share with their brands — like Sam's American Choice Cola.

Russo: You've got to be aware, however, that when Coke says it's seeing competition from Sam's at Wal-Mart, it really doesn't matter. The U.S. is a mature market. Coke's growth will be abroad.

In Thailand, the reason people buy Coke is because they want to flash that label wherever they go. They don't want the knockoff. They want the real thing — because of what it says about where they've come in the world.

I still think that Guinness' prospects for global growth are undiminished. South Korea still hasn't opened up to foreign imports. Taiwan has yet to open up. All of China is as yet untapped.

OID: We keep hearing that there's an incredible desire for all things Western in newly emerging economies in Asia — especially in China. And don't they tend to be far more brand conscious than we are?

Russo: Absolutely. However, the Chinese tend to be more cognac drinkers than whiskey drinkers. But Guinness captures that with its LVMH affiliation anyway. The cognac side of Guinness is the H in LVMH — which stands for Hennessey. Guinness owns a quarter of LVMH. And in the really deep Asian markets, Guinness is a joint venture distributor of cognac *and* an owner of LVMH.

OID: Can you imagine the potential Chinese demand down the road?

Russo: It's going to be enormous. It's really exciting. But it won't necessarily be whiskey. It may be cognac. And LVMH is actually a purer play on cognac in Asia and on cognac in general.

In markets like Japan, Thailand and South Korea, consumers tend to favor whiskey. And of those markets, Thailand's now open. It's the second largest market in terms of profit for Johnny Walker Black in the world. And Taiwan and Korea are about to open up.

Japan has opened up and is immensely profitable. But one of the uncertainties is how things settle out with Japan. The Japanese are very, very cliquish. You've seen it with the beer trends. There are massive swings in consumer taste in Japan. If you get to the point where there's a new sobriety or a sense of shame for the problems that have recently come up, then all bets would be off.

Someone at Guinness recently told me that there are bars in Tokyo near the financial center that have closed. And it's no longer politically acceptable for the people associated with Japanese banks and brokers to go out and socialize after work because they have such shame. Is it conceivable that the Japanese engine of growth will stall for a while as they all retrench and have the catharsis caused by the shame of their mistakes?

But I don't think Asian prospects are purely Japanese. As we discussed, Taiwan is opening, Korea will open up and Guangdong will open up. And Thailand, Malaysia and Indonesia are growing markets.

OID: We're told that Guangdong's population is around 65 million people. And what's that — less than 5% of China's population?

Russo: China's huge. But if Asia currently represents 25% of Guinness' profits, Japan might represent fully 18% of that 25%. So I'm a little loathe to upgrade my estimate of earnings growth knowing that Japan's going through the wringer as we speak.

And that not only affects Guinness directly, but it affects the earnings that they get as a shareholder of LVMH. The contributions from LVMH were £123 million in 1991 and had historically been growing in excess of 20% per year. But a large portion of LVMH's business has been the sale of perfume and Louis Vuitton luggage to the Japanese both of which slowed down in 1991. On the other hand, LVMH's cognac and champagne segments continued to show strong growth in 1991.

OID: And how does LVMH's stock price compare to Guinness'?

Russo: LVMH is selling at roughly 16 times this year's earnings and 14 times next year's.

OID: So only slightly more expensive than Guinness. And how does management compare?

Russo: It's hard to say. It's French after all. And it's got a holding company structure that's quite complicated. LVMH is controlled by a man named Bernard Arnaud. And it's not as clear that his interests are as akin to shareholders as are those of Guinness' Anthony Tennant.

Incidentally, LVMH owns 24% of Guinness as well.

NET OF GOODWILL & LVMH,
GUINNESS' ROE IS WELL OVER 40%.

OID: What are Guinness' revenues?

Russo: Sales of Guinness last year were £4.1 billion. And sales should be about £4.5 billion this year. Its market value is £11 billion.

OID: Or about 2-1/2 times sales. And what about ROE?

Russo: Its equity is £3.6 billion. And its earnings were £628 million.

OID: That doesn't sound like such a high ROE.

Russo: That's including £1.4 billion of acquired brands at cost. Without the acquired brands or their earnings, equity is only about £2.2 billion.

OID: In other words, if you deduct the purchase price in excess of the assets acquired — so-called goodwill — Guinness' adjusted ROE would be £628 million divided by £2.2 billion or approximately 28-1/2%.

Russo: That's right. Guinness' LVMH investment was £1.1 billion. The contribution from LVMH was about £123 million before taxes or roughly £90 million after taxes.

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So deducting £90 million from Guinness' earnings, you get earnings of £538 million. And if you deduct £1.4 billion of goodwill and £1.1 billion of LVMH from its book value, Guinness' adjusted book is £1.1 billion. And £538 million divided by £1.1 billion gives you a pretty high return.

OID: If you call 48% high. But is their book distorted by share buybacks or anything else — or is that 48% a meaningful figure?

Russo: They only bought back about 5% of their shares and they probably bought them back below book. So I don't think their book is all that distorted. And they are a very profitable business.

OID: That's one helluva ROE.

Russo: Yes. However, it may not be fair to evaluate ROE in this fashion.

OID: To the extent that acquisitions will be a normal and recurring usage of their capital?

Russo: That's right. Instead of buying production equipment, they bought brands. And they capitalized the value of those brands and put them on the balance sheet. So the stated book value would be roughly £1.8 per share. If Guinness earns 38 pence this year as we expect, that's about a 21% ROE.

The £628 million was the stated net profit. If you divide that by £3.624 billion of book value, you get a 17% ROE. If you then back out LVMH's earnings and equity, you get £538 million divided by £2.498 billion — or 21.5%.

I just don't know if it's meaningful or not to back out their brand values. It's not in any way in the business. It's not in plant, equipment or inventory. It's gone.

OID: But those labels and distributors give them the right to earn very high returns and, probably, to invest their money at higher returns.

Russo: That's right.

OID: Which is probably one of the things Buffett likes.

Russo: No doubt. And Guinness has shown its ability over the last year through the acquisition of all of those liquor distributors on the spirits side and Cruzcampo in Spain on the beer side to absorb capital and earn staggering returns. And I think they'll do a good job with it.

So even though the numbers were a little soft last year, I still think their business is being built in a sensible way. Guinness managed to go through last year in a very tough environment and manage quite successfully.

The problem with Guinness to some degree is that they don't have enough reinvestment opportunities in their existing businesses. They can't reinvest capital in the liquor business. And they can't advertise in most countries. Of course, that's good and bad. U.S. laws, for instance, don't allow you to have advertising on television.

OID: But doesn't that mean higher profit margins, too? And don't Western goods largely sell themselves — at least to some degree — in these countries?

Russo: That's right. And not only that, the fact that you can't advertise means that the most attractive brands will probably remain so.

One of the things that Coke has is the ability to absorb capital in companies like Coca Cola Amatil and other ways that increase the opportunities for people to consume Coca Cola and leverage the returns that come from selling more concentrate.

Through the concentrate business, Coke throws off an enormous amount of free cash. And they can direct that through their investment in bottling directly into assets like vending machines, post-mix machines, bottling capacity and so forth — which will allow them to sell far more units.

With its 60% ownership position, Coke has the power to encourage Amatil to put out countless vending machines each year and do other installations with very fast paybacks. For example, vending machines may have a payback of 15 to 18 months.

They can get *enormous* volume growth through incremental capital spending. And that has a very leveraged effect on Coke's bottom line because concentrate is so profitable.

That still leaves them with unspent money. Even if they wanted to, they couldn't spend all of the free cash that they generate.

OID: We all have our problems....

Russo: Guinness doesn't have those opportunities to reinvest. But they continue to do the right thing. What they can do is continue to buy control of the local markets.

I think the past year was extraordinarily productive for the company. And a major piece of it was that they bought and put to work £500 million in Spain's most profitable beer company — Cruzcampo — which I think will allow them to invest a major amount of capital without facing diminishing returns. And that happened after our conversation.

And they have the confidence that they can do that given their experience in Ireland with their main production capacity for Guinness Stout. During the past five years, they've probably invested in excess of £150 million in the beer business in Dublin. And the profitability that's come from that investment has been staggering. It's taken the local beer profits from roughly £90 million to over £150 million. So the return on that investment has been staggering.

OID: I think a £60 million return on a £150 million investment qualifies as staggering.

Russo: I'm glad you agree. And having seen that and having seen what they've been able to do with their own product production and distribution economies via capital allocations in the U.K., they are now encouraged that they'll be able to get the same kind of returns on incremental capital that they'll spend in Spain where they made that huge investment.

Once they're done, I expect them to earn better than a 20% current return on their entire Spanish investment.

OID: With Guinness' return increasing each year from incremental sales, price increases and so forth — with little or no incremental capital aside from inventory.

Russo: That's right.

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OID: And didn't they only pay 13 times '89 earnings when they bought Cruzcampo in '90?

Russo: Less than 13 times earnings. Also, it came with net cash, so its effective cost was even lower.

Even better, Guinness can effect powerful economies and has a very low cost of capital. Furthermore, Spain is a very under-penetrated market. Cruzcampo only has a 29% share of the market. They'll grow from here — regionally and nationally. I'm pretty excited by their prospects.

Also since we spoke, they bought Ansbach which is a brandy producer in Germany. Through that, they bought a local brand which they often like to have to go along with their international portfolio. And they, thereby, bought enormous distribution power in Germany.

They bought Venezuela's leading rum producer. It's a local brand. It's the world's leading dark rum. And they bought another local brand in Venezuela — which they'll wrap around Johnny Walker Red — which does terrifically well there. They also bought Venezuela's largest distributor.

In Australia, they bought Bundenburg Rum. And they also bought distribution in Australia.

So Guinness weathered a tough year and took several steps that make it a better business. They were able to put over £1 billion to work into extensions of their core businesses. And they're doing it with very, very high returns on capital.

OID: What are you projecting for Guinness' capital spending this year?

Russo: Capital spending will be around £300 million this year.

OID: And you're convinced that they'll earn very attractive returns on those expenditures.

Russo: Certainly over time they will.

OID: And even if they don't invest another dime, aren't they likely to increase market share?

Russo: Sure. Their investments in distribution have less quantifiable payoffs, but they're all about market share and how they become more powerful in those markets.

I'm encouraged by what's happened within the company over the last year and their demonstrated ability to redeploy capital. But I don't think they'll be able to do that going forward at the same reinvestment rate. So I think they'll have more free cash two years from now than they did over the past 18 months — because they committed so much of that cash to new businesses. And I think their payback will be very, very good.

OID: Of course, it's hard to imagine that they won't have future investment opportunities in places like Brazil and China and so forth.

Russo: But there are fewer brands. They've really gone through them. There's no more major product line in Venezuela available. They bought the one in Australia. They bought the one in Germany.

In China, it's more a matter of pioneering their products. And that will take some capital as well. But I think they've done a lot of work this year in getting themselves straightened out.

So as a company, they can't invest in anything that directly grows volume the way that Coke can by investing in bottling capacity, vending machines, restaurant dispensers and those sorts of things. And they really can't invest in advertising like Coke can.

OID: But they can do these indirect things. Plus, they benefit from rising living standards around the world.

Russo: Exactly. And there's a migration throughout Europe away from the classic, traditional drinks of those countries towards the global brands. In Spain, the youth are emulating other Western Europeans — and consumption has gone from 1 million to 5 million cases in about six years. And there's real volume growth throughout Europe.

However, that doesn't mean that Guinness will need to spend another penny on fixed capital to serve their spirits growth — because they really never should have to build more distillery capacity. They will, however, invest more working capital to meet growing spirits demand.

They can also continue to acquire local brands — the acquisition of which gives them enormous distribution capacity in local markets. In some ways, the business that they're involved with is image and prestige and raising the consumer from low quality brands to the premium brands so they can enjoy the leveraged returns that that generates.

What Guinness has done over the past year to maximize its business prospects is to buy distribution power — because the business at the trade level is driven by who has distribution clout. And Guinness is reinvesting to make sure that it's they who have it.

OID: Why is distribution clout so important?

Russo: When you enter foreign markets, you must have relationships with the trade. Those trade relationships differ from country to country based on the legal structure and other factors. As I said, they're different in the U.S. than they are in other markets. You need a certain number of people on the street selling your product to the trade.

And to be truly effective in distribution, you also need a portfolio of four major products. You have to have a preeminent cognac, champagne, whiskey and vodka.

OID: And together, those elements spell one big moat.

Russo: That's right. And it spells raw business clout. It lets you come in and say, "You want my scotch whiskey? Well, don't you think you could give me a bigger order for Tanqueray and do less business with our competitors?"

You just move your products in under your powerful umbrella. And they've deployed a lot of capital to ensure that they have that market clout.

OID: For what it's worth, I suspect your earnings estimates are low.

Russo: For what it's worth, I hope so. But I really don't need a lot more given what I believe to be fairly certain numbers that I'm forecasting. And it's that certainty that makes me think it's attractive at these prices — and the fact that unlike most companies, they don't have to reinvest the money they earn to stay in place.

(continued on next page)

GARDNER INVESTMENTS'
TOM RUSSO
(cont'd from preceding page)

OID: Or even to move forward.

Russo: That's right. And they make the intriguing point that they put £1.1 billion back into their business last year and yet net debt went up by less than £400 million. It's a formula for making good money.

OID: And its characteristics sound very much like those which Buffett describes as having made media companies so desirable for so long.

Russo: I think so.

A DOMINANT NATIONAL NEWSPAPER
AT 7-1/2 (OR LESS) TIMES EARNINGS.

OID: Aside from Guinness, how many stocks have you bought in the last month?

Russo: Few — mostly small intelligence positions. Since I spoke with you, I sold out of Wells Fargo. I've also added to my positions in foreign stocks as the dollar strengthened. I'm looking at a couple of things right now, but it's tough.

I remember when we discussed Guinness, you were much more excited about Weetabix — which was at £5.50 and is now at £10. So your journalistic sense also turned out to have some kind of financial appropriateness.

OID: I guess there's a first time for everything.

Russo: Anyway, then we talked about Telegraaf which you correctly thought was terrifically cheap. And yet it's absolutely unmoved.

What did Telegraaf's earnings do?

Russo: They were flat. Look at Washington Post's earnings last year.

OID: Did they buy back stock?

Russo: No. All they did was build up cash. They'll probably have close to 8 guilders more in cash at the end of this year than they did last year when we talked. Instead of 30 guilders, they'll probably have 38 guilders.

OID: And Telegraaf's stock price?

Russo: It's 88 guilders today. It was 85 guilders when we spoke last year. And it has 11-1/2 guilders of earnings. So it's still selling at 7.5 times earnings.

OID: Before allowing for its cash — and slightly less than 5 times earnings net of its cash.

Russo: That's right. That's a pretty attractive price for the dominant national newspaper in the Netherlands.

OID: Hard to argue with you there.

Russo: So of the stocks we discussed last year, it's the one I continue to buy most heavily today.

OID: We certainly understand why.

Russo: And I've been adding to Guinness all along. I still think it's attractive here. It represents a big position in my partnership and most of our separately managed accounts.

I think that Guinness has continued to reinvest capital in an impressive way — in distribution and in brands that they've bought, particularly in beer.

I think that they weathered a terrible year last year where there were three strikes against them — the federal excise tax increases throughout the world, the recession and the war-induced slowdown in travel. And they endured all of those events and came out all right.

And I think that the dynamics of the foreign markets are unimpaired. Guinness is better placed to distribute in those foreign markets now than they were before as a result of their acquisitions in the liquor business.

I also think that the valuations are not more expensive now than they were a year ago — and clearly no more so relative to Coke, which might be your standard of what would be paid for a great business. Coke has gone from \$60 a share to \$82 — Guinness from \$8.30 to \$10. So Guinness is more attractive relative to Coke than it was a year ago.

The bottom line is that I've been buying it ever since July right up through recent days.

OID: Up to the current price.

Russo: Yes. And I think Mr. Buffett's purchase of a foreign company — the first time that he's ever done so — is pretty seminal. A lot of money will likely be invested overseas because of his recent move.

And increasingly, other money managers have begun to invest overseas. In fact, I've recently heard that one respected manager is saying that he believes the opportunity of the future is abroad — especially in foreign small cap stocks. And he points, as an example, to Weetabix.

OID: Which you told us about last year.

Russo: Others, I am certain, will be pointing to Guinness. So much the better, I guess. All told, it points to the fact that the world of foreign investing will soon become more competitive.

It's frustrating. But the world is definitely getting smaller. It makes me stay up later and get up earlier.

OID: I can relate. Thanks for the update.

—OID

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CHARLES BRANDES & GLENN CARLSON, BRANDES INVESTMENT COUNSEL

"I'm the highest percentage overseas that I've ever been. And it's easy to see why. Overseas markets are generally a lot cheaper than the U.S. market.... For example, European markets are generally selling for half the valuations cash flow-wise of the U.S. Other areas of the world are undergoing such dramatic changes — moving toward free enterprise, free trade and privatization. And these dramatic things are happening in markets that are already very reasonably priced."

"Instead of selling at a 50% discount to the world's markets, Hong Kong probably deserves a premium given its tremendous potential. Hong Kong is very exciting. Even more exciting — you can buy terrific businesses at terrific prices."

Conversation with OID — April 1992

WARREN E. BUFFETT, BERKSHIRE HATHAWAY

"Our Guinness holding represents Berkshire's first significant investment in a company domiciled outside the U.S. Guinness, however, earns its money much the same fashion as Coca-Cola and Gillette — U.S.-based companies that garner most of their profits from international operations. Indeed, in terms of where they earn their profits, continent-by-continent, Coca-Cola and Guinness display strong similarities."

Letter to Berkshire Hathaway shareholders — February 28, 1992

JULIAN ROBERTSON & JOHN GRIFFIN, TIGER MANAGEMENT

"The investment potential in emerging markets is tremendous. China's economic potential is nothing short of awesome. Despite all the economic press, economic reform is not a new concept in China. Over the last thirteen years, they've been experimenting with capitalism and have achieved results nothing short of incredible. In the Special Economic Zones, output has risen over 30% a year, exports are up over 300%, per capita income has soared 400% and profits have risen ten-fold. Almost 50% of China's industrial output comes from non-state owned enterprises and is increasing daily. The populace is absolutely driven to raise its standard of living."

"So far, Beijing seems quite pleased with the 'experiment' and has hinted at further economic reforms, stating that 'developing the capitalistic economy is a beneficial supplement to socialism...' 'To be rich is glorious,' says Deng Xiaopeng."

"How do we plan to invest in China? ... In Hong Kong, we have found large capitalization companies with high China exposure trading at around 12 times earnings with reasonably sure prospects of over 20% a year for the next 3-5 years. China could be *the* major investment story for the next decade or more...."

Letter to limited partners — April 1, 1992

Dear Subscriber,

Last issue, we said, "It's no coincidence that all three of our stockpickers ... have an international perspective. It might have been a lot longer than three months between issues had we not resorted to the international option."

It would seem we were not alone in that sentiment. Warren Buffett purchased Berkshire's first significant non-U.S.-domiciled investment. Brandes reported being more heavily invested outside the U.S. than ever before. And Julian Robertson seems to be increasingly oriented towards foreign activities.

It's a small world, after all, when we've not only featured some of the same countries as these managers, but even — in more than a few cases — the same securities.

Incidentally, we're no longer looking for hedges — although our knees are shaking more or less as much. However, rather than describe why we're less concerned about a severe correction in the near future than we were, we'll simply invite you to stay tuned for one of the more unusual interviews we've ever had — hopefully next issue.

Rather than list our favorite bargains this issue, we'll simply refer you to page 1. We're pleased to say we believe this issue contains even more good ideas than usual.

Some of you have expressed your preference for more frequent, shorter issues instead of the magnum cum opus-style double issues we've produced so far this year.

Frankly, we'd love to do so, as well. However, when we have an overabundance of material in any interview/issue, we have only three choices:

[1] Throw it away. [2] Deliver it to you in two parts in successive issues. [3] Produce double issues.

Alternative [1] is out of the question. Alternative [2] would create added delays in your receiving the material. Neither is consistent with bringing you maximum value. Of course, we always welcome your thoughts.

Until next issue,

Henry J. Emerson

Your Editor

P.S. Thank you for your support.

Outstanding Investor Digest is published monthly (more or less) by Outstanding Investor Publications, Inc.
Subscription rate: 12 issues — $375
Outstanding Investor Digest, 14 East 4th Street, Suite 501, New York, New York 10012 Telephone: (212) 777-3330