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Outstanding Investor Digest

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

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ANNUAL MEETING ROUNDUP:
SEQUOIA FUND, GEMINI II FUND & WESCO FINANCIAL
"YOU SHOULD SEEK BUSINESSES
THAT JUST DROWN IN MONEY."

As always, we feel privileged to be allowed to sit in on the annual meetings of master investors and to share their lessons and insights with you. This edition's installment includes selected excerpts from comments by Sequoia Fund's Bill Ruane and Bob Goldfarb, Windsor Fund's John Neff and Wesco's Charlie Munger.

We never fail to learn from them and hope that you find their ideas and perspectives as valuable as we do.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
"WE NEVER HAVE AN OPINION ABOUT THE MARKET.
IT MIGHT INTERFERE WITH OUR GOOD OPINIONS..."

Amazingly, \$10,000 invested in Buffett Partnership, Ltd. in 1956 and reinvested in the stock of Berkshire Hathaway at the partnership's termination in 1969 would today be worth more than \$65 million — *after all taxes, fees and expenses*.

Yet even those figures understate Buffett's achievement. Believe it or not, before fees — but after all taxes — the \$10,000 would have grown to more than \$100 million.

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THIRD AVENUE VALUE FUND'S MARTY WHITMAN
"THESE ARE NOT ONLY COMPELLING BARGAINS,
BUT MOST OF THEM WILL PROBABLY GO INTO PLAY..."

Marty Whitman's returns in so-called control investing have been nothing short of spectacular. For example, his longest lived investment partnership earned 26.3% per year before fees and expenses since its inception on May 1, 1987 — nearly triple the returns of the Ibbotson Small Company Index which earned only 9.0% per year.

Whitman hasn't been a slouch in passive investing either. His oldest equity mutual fund has earned 18.7% per year after all fees and expenses (but before withholding for potential tax

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ACORN FUNDS' RALPH WANGER ET AL.
"HERE'S HOW YOU CAN READ NEXT YEAR'S NEWSPAPER:
A SIMPLE, POWERFUL WAY TO THINK ABOUT THE FUTURE..."

Since founding the Acorn Fund roughly 23 years ago (on May 31, 1970), senior portfolio manager Ralph Wanger has produced a compound annual return for shareholders of 16.4% after all fees and expenses vs. 12.1% for the S&P 500 and 15.1% for the Ibbotson Small Cap Index.

Wanger started a second fund — Acorn International — in September of 1992. That fund is off to an even better start having earned a compound return after all fees and expenses of 43.7% per year vs. 18.9% for the MSCI EAFE Index.

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from page 1)

liabilities) for the 9 years beginning January 1, 1985 and ending December 31, 1993. The comparable figure for the Ibbotson Small Company Index was 12.0%.

Here are the year-by-year performance figures for Whitman's partnerships and mutual funds *after* all fees and expenses alongside those of Ibbotson's Small Company Index. (All performance figures were provided by Marty Whitman and Ibbotson Associates.)

Year	Third Ave Value Fund	Equity Strategies Fund	WHR Workout Fund	Carl Marks Strategic Inv. L.P.	Small Cap Return
1985		+22.3%			+24.7%
1986		+31.6			+ 6.9
1987		-16.2		- 4.1% ²	- 9.3
1988		+37.2		+38.3	+22.9
1989		+15.8	- 6.2%	+34.0	+10.2
1990	+ 8.6% ¹	+22.5	+55.0	+12.5	-21.6
1991	+34.4	+12.4	+24.3	+23.4	+44.6
1992	+21.3	+ 2.7	- 4.0	+ 8.9	+23.4
1993	<u>+23.7</u>	<u>+18.2</u>	<u>+14.3</u>	<u>+27.6</u>	<u>+21.0</u>
1990-93		+13.7 ⁵	+20.6%	+17.8% ⁶	+14.1%
1990-93 ³	+27.9%				+29.9% ⁷
1989-93		+14.1 ⁵	+14.7%	+20.9% ⁶	+13.3%
1987-93 ⁴				+20.2% ⁶	+ 9.0% ⁸
1985-93		+15.2 ⁵			+12.0%

¹ For the period 11/1/90 through 12/31/90.

² For the period 5/1/87 through 12/31/87.

³ For the period 11/1/90 through 12/31/93.

⁴ For the period 5/1/87 through 12/31/93.

⁵ After deduction of withholding for potential tax liability. Before its deduction, the compounded annual return from 1/1/85-12/31/93 would be 18.7% per year.

⁶ Before all fees and expenses, the gross returns were 23.4% for 1990-93, 27.2% for 1989-93 and 26.3% for 5/1/87-12/31/93.

⁷ The Ibbotson Small Company Index return was +6.5% for the period 11/1/90 through 12/31/90.

⁸ The Ibbotson Small Company Index return was -22.6% for the period 5/1/87 through 12/31/87.

Whitman's letters to Third Avenue Fund shareholders are always interesting and meaty. With a foot in the world of control investing through his position as general partner of WHR Workout Fund and Carl Marks Strategic Investment, L.P. and chairman of Danielson Holding and that of passive investing in his capacity of portfolio manager of Third Avenue Value Fund, Whitman brings a unique perspective to bear on today's financial scene and the opportunities offered thereby.

However, after reading his latest few letters, we were particularly intrigued and thought that you might be, too. We're very pleased to bring you the following excerpts from a series of recent conversations with the always insightful Whitman and some investments he's particularly excited about today. We highly recommend it and hope that you find his perspectives as fascinating and valuable as we do:

WE'RE BUYING FINANCIAL STOCKS LIKE CRAZY
AT HUGE DISCOUNTS FROM NET ASSET VALUE....

OID: *I understand you're finding a thing or two to buy here and there.*

Whitman: I'm buying the stocks of depressed financial institutions like crazy. Hopefully, I'm right. But frankly, I think it's obvious once you look at it.

OID: *You suggest that many financial companies are being priced at once-in-a-generation giveaway prices — like many stocks were in the 1970s.*

Whitman: That's right.

OID: *How can that be? After all, most stocks are nowhere near mid-1970s prices.*

Whitman: I've pondered that same question myself. After all, the Dow Jones Industrials are now around 3700 versus 800 to 1200 in the mid-'70s. And most stocks are selling for relatively lofty multiples of earnings and book.

But as I said in my letter, amateur passivist investors — a category which includes most mutual fund managers — are *momentum* investors. They're trying to beat the market in the *short* run. And they've got no conception of value.

OID: *You don't have to mince words with us.*

Whitman: So if these managers don't think that certain securities are going to outperform the market in the short run — no matter *what* their values may be — they don't want to own them. And that kind of mindset is the dominant force in investing today.

OID: *Robertson Stephens' Paul Stephens, among others, says the same thing.*

Whitman: And the second thing is that for years, stock prices have always been leavened by competition from control buyers who are not short term at all. They're *very* value conscious. And by and large, those who would take over these companies have been out of the market for the last four years because they couldn't get financed.

OID: *And as a control buyer for your partnerships and Danielson Holdings, you should know.*

Whitman: I hope so. But that's mostly changed, I think. The banks are back in full force. There's no longer any problem with well capitalized banks doing HLT [Highly Leveraged Transaction] loans. It's going to be the '80s all over again.

THE "BIG PICTURE" IS A BUNCH OF CRAP.
IT'S THE BOTTOM-UP STUFF THAT COUNTS....

OID: *But how can you even be more long than short with the current crew in Washington? Isn't the proposed striker replacement bill alone likely to wreck our productivity and competitiveness — not to mention boost inflation — by increasing days lost to strikes by something like 1,300%.*

Whitman: It might. But let me tell you something about the "big picture". The "big picture" becomes important insofar as a country lacks political stability or if there's

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

violence in the streets. But all the other stuff people call the "big picture" — like interest rates, the Dow Jones Average and so forth — that's all a bunch of crap.

OID: Don't hold back. You can speak freely with us.

Whitman: You may quote me. That's top-down stuff done by people who don't understand anything and think they're wonderful if they beat the S&P 500 by 20 basis points. That's strictly amateur hour.

This is the real world. You have the same problems in finance that you have in the real world. And we'll function pretty well if we can have political stability and an absence of violence in the streets.

OID: You call this political stability?

Whitman: This stuff about politics and interest rates and the business cycle is just talked about by people who don't know anything...

OID: I strongly resemble that remark.

Whitman: You can sound very expert talking about that stuff. But it's very unimportant.

OID: What is important?

Whitman: Understanding the individual company and the individual security — bottom-up stuff. That's what's important.

OID: And what does it look like from the bottom up?

Whitman: I think that there are a tremendous number of great values out there today. Most things are overpriced, I suppose. But I'm not spending a lot of time *looking* at overpriced stuff.

OID: At least not intentionally.

Whitman: That's right.

EXTRAORDINARY RETURNS ARE AVAILABLE
TO CONTROL BUYERS OF FINANCIAL COMPANIES.

Whitman: But I've spent considerable time researching potential acquisitions for Danielson Holding Co. (DHC/AMEX) in the financial services area. We've looked in-depth at regional broker/dealers, bond insurers, title insurers and community banks. And it appears to me that the ones that we're buying are selling for prices akin to those at which high grade common stocks were available in the mid-'70s.

OID: In other words, very, very cheap.

Whitman: You've got it. Let me give you an idea of how cheap these things are being priced in the public market. In an actual deal that we tried to do recently, we calculated what our returns would be if we paid a 60% to 80% premium over the current stock price. And we calculated that even if pre-tax income dropped 35% from '93 levels, we'd still earn a 50% per year initial return on our equity before tax.

OID: That's 50% with a five and zero?!

Whitman: One and the same. And, of course, since Danielson essentially doesn't pay taxes, that would also be

after-tax.

OID: And that's assuming market prices for the acquisition, not some kind of sweetheart deal?

Whitman: That's right — just a typical broker/dealer transaction.

OID: To get to that kind of return, what assumptions did you make about your acquisition financing?

Whitman: I was going to go out and get 70% of the purchase price in senior secured loans, maybe 15% in mezzanine finance — in subordinates and/or preferred — and 15% by putting up equity, which would have been very conservative for an LBO.

OID: It's all relative, I suppose.

Whitman: And I would have paid 8% to 9% for the senior secured loans and 10% to 11% for the mezzanine.

OID: I had no idea rates were that low for LBO money.

Whitman: That's the market. And even those figures don't take into account the fact we could get still lower rates — dramatically lower — if we gave the people providing the senior or mezzanine financing a little bit of an equity kicker. In fact, if we did that we could probably get a *single-digit* rate on the mezzanine.

OID: Wow.

WANTED: WELL MANAGED FINANCIAL COMPANY.
SELLERS GET TO HAVE THEIR CAKE AND EAT IT TOO.

Whitman: One of the reasons we can do this kind of deal is because management can pay shareholders a 60% to 80% premium over the current market — mostly in cash, but perhaps a little bit of preferred stock and a new issue of Danielson common stock. And that would make the sellers the largest shareholders of Danielson.

Then they'd have to pay off the money they borrow to distribute to their stockholders. And the tax savings from Danielson would give them the money needed to pay off debt and be back where they were in a few years with significant equity ownership in Danielson.

OID: Through ownership of an interest in Danielson.

Whitman: The largest, single interest. It's a *hell* of a deal.

OID: We'll send you an advertising rate chart.

Whitman: And getting back to just how cheap we think these broker/dealers are, if Danielson is willing to do such a deal at 160% to 180% of the current stock price, why shouldn't Third Avenue Value Fund and/or anyone else go out and buy all the stock they could at today's price?

OID: Because they think you're being overly optimistic?

Whitman: That's hard to imagine. Remember, I'm assuming that average annual earnings over the next five years will be less than last year's earnings by 35%. And frankly, I think that with Danielson willing to pay 160% to 180% of today's stock price, if you wait 6-12 months, there are going to be a lot of commercial banks willing to pay — make that *anxious* to pay — 50% more still.

And maybe I'm missing something. But that's the

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

way the numbers look to me. And that's the way I think the industry's going.

DON'T ASK WHICH IS THE BEST VALUE.
ASK WHICH IS THE MOST DOABLE DEAL....

OID: Might we get you to tell us about some of the specific ideas that you find most compelling today?

Whitman: Sure. Among the broker/dealers: there's Alex Brown (AB/NYSE), Raymond James (RJF/NYSE) and Piper Jaffray (PJC/NYSE). Among the bond insurers: there's Capital Guaranty (CGY/NYSE) and MBIA (MBI/NYSE). Among the regional community banks: there's GP Financial (GNPT/OTC) and Security Capital (SECP/OTC). Among the life insurers: there's Security-Connecticut (SRC/NYSE). And among the title insurers: there's First American (FAF/NYSE) and Stewart Information Services (STC/NYSE). I guess that's a pretty good list.

OID: We'll be judge of that.

Whitman: And we're finding bargains elsewhere, too — for example, among computers, there's Digital Equipment (DEC/NYSE).

OID: And Apple, I noticed.

Whitman: Yes. However, Apple may just make it as a going concern. Digital Equipment, I think, is in play.

OID: You're telling me that all of the ones you mentioned may make money from being in play?!

Whitman: Wasn't that the question — who I thought might be in play?

OID: No, just which ones were compelling bargains.

Whitman: I think these are compelling bargains, too — because they're very cheap on an operating basis. But they very well may go into play.

So you're asking the wrong question — because which is the best value is one question and which is the most likely doable deal is another. They're all very attractively priced. Identifying the doable deal — a pre-arbitrage, if you will — is where you get the most appreciation.

OID: I've never thought that way...

Whitman: You ought to...

OID: It sounds like you've been talking to my broker...

Whitman: Conventional finance doesn't think of these things as pre-arbitrage, but it should. Most businesses, sooner or later — probably sooner — will engage in asset conversion activities such as mergers and acquisitions, leveraged buy-outs and the like where the pricing parameters

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are going to be very different from what they are in trades involving outside, passive, minority investors.

OID: In other words, from prices that tend to prevail in the stock market.

Whitman: That's right, exactly.

WE'RE BUYING BROKER/DEALERS
AND GETTING MONEY MANAGERS FOR FREE....

OID: In that case, since you rave about broker/dealers in your latest letter, let's start there.

Whitman: I think all three that I just mentioned are extraordinarily well managed, growing and well financed.

And all three have money management businesses that are growing — which, I think, gives them a consistency of profitability that they've never enjoyed historically. Their revenues are no longer simply transaction-oriented.

Most investors don't appreciate the fact that fundamental value is not static and that for a variety of reasons, these broker/dealers have undergone corporate transformations and are now far more valuable franchises than they were only a few years ago.

OID: In other words, they've gone from...

Whitman: They've gone from just being transaction-oriented to having a cash fee business with persistence.

OID: And it doesn't concern you that these companies are reporting what may be peak earnings?

Whitman: They may be. I don't disagree with that. But I do disagree that they're going back to square one.

And let's say that '93 was peak earnings. Does that mean I shouldn't buy 'em? I'm not a momentum investor. It only means I should price 'em.

There's blatant disregard on my part of timing and market risk. I just don't like to take investment risk. Maybe it all fits together.

OID: That sounds similar to something Warren Buffett said at this year's Berkshire annual meeting — that he and Charlie focus on what will happen, not when it will happen — because it's often possible to know what will happen. But it's never possible, in their opinion, to know when...

Whitman: I'm absolutely with 'em on that point. You can't control the timing.

Most of these companies probably did report peak earnings in '93. But so what? Although they're selling relatively close to book value, I think all of them are selling at huge discounts from their realistic net asset value — if for no other reason than because there's no capitalization of their funds under management.

And three of the four broker/dealers in our portfolio have multi-billion dollar money management operations which account for less than 15% of their revenues which could be sold for a substantial portion of the current stock market valuation of these essentially debt-free companies.

And we didn't talk about the most important thing — that these businesses are so financially strong that they aren't likely to get into trouble.

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

ALEX BROWN'S AT 50% OF INTRINSIC VALUE
AND LESS THAN 5 TIMES TRAILING EARNINGS.

OID: Let's take 'em one at a time. What makes Alex Brown compelling?

Whitman: Again, all three broker/dealers I mentioned have a lot of money under management. For example, Alex Brown has \$11 billion. They're well managed. And their stock is selling at a little under 5 times trailing earnings.

OID: Wow. Tell us more.

Whitman: Sure. It sells for about \$26. But I'll bet you that it has a realistic value of between \$40 and \$50 if it were to be sold in a private transaction.

If you assume that their \$11 billion money management business is worth 2% of assets under management, that's \$220 million — or about \$14 per share on its 15-1/2 million shares outstanding. So you're paying very little for the rest of the business.

OID: On the other hand, it's been suggested that these brokers have generally sold near book value.

Whitman: That's absolutely right. But I think there's been a fundamental change in many of these companies' business.

OID: Maybe. But haven't most broker/dealers' stocks been savaged recently?

Whitman: They have.

OID: And isn't one of the reasons why broker/dealer stocks have been savaged lately the expectation that these companies' earnings are going to plummet? And if they're right, wouldn't that also apply to money management firms?

Whitman: We shall see. If they do, I'd rather own Alex Brown at \$25 than at \$50. And over the long term, investment companies registered under the 1940 Act have exhibited tremendous persistency.

OID: That's strange. I thought it was the traditional, full-service brokers who cold-called at all hours.

Whitman: Not that kind of persistency. I mean that the mutual funds' businesses have held up very well.

OID: Even in bear markets?

Whitman: Oh, yeah — particularly for fund families. Shareholders switch from their stock funds to the money management funds. But there's been a long record of persistency. With my luck, however, maybe that won't be true this time.

OID: That's my line.

Whitman: Sorry. Like I say, I don't try to predict the future. I try to buy what is pretty cheap. And I assume as a base case that the persistency that's prevailed historically will persist to some extent. There may be a panic movement out of stock and junk funds. But where's it going to go?

OID: Into mattresses or CDs?

Whitman: Probably money funds and treasury funds.

OID: But aren't those much less profitable because of their lower fees?

Whitman: Yeah. I'm not saying that profits aren't going to go down. I'm just saying that the companies I've mentioned are bargains even if profits *do* go down.

BANKS WILL START BUYING BROKER/DEALERS.
AND THEY'LL PAY A REAL PRICE FOR THEM....

OID: May we ask your cost for Alex Brown?

Whitman: About \$27 — a little over where it is today.

OID: I see it has a book value of \$22.50 as of year end '93. Where would you say it's fairly valued?

Whitman: In terms of comparative value with other broker/dealers?

OID: No, in terms of intrinsic value.

Whitman: Probably close to \$50.

OID: How do you arrive at that number?

Whitman: I just take a five-year view. And do I know what's going to happen? Yeah. There's going to be a huge consolidation of financial institutions. And the largest institutions like money center banks and regional banks are increasingly going to find that they don't have the appropriate know-how to do the retail side and that they'd better go out and buy themselves a broad consumer presence. And they're going to start buying broker/dealers — the best of them. And they'll pay a real price for them.

OID: Very interesting.

Whitman: Yeah. I think that there's a *huge* market for commercial banks to be buying broker/dealers on a long-term basis — especially once they finally get rid of Glass-Steagall. And that's going to happen at some point.

Failing that, I'd still think that the long-term trends are going to be pretty good. They'll be very cyclical. I'm not saying that there won't be down years. But basically, these guys are going to increase their market penetration and do pretty well. Over the next five years or so — at the top of the next cycle — Alex Brown will be earning a hell of a lot more than it did at the top of this cycle.

They reported \$5.61 in '93. I don't know what they'll earn the next time around. But I don't see any reason why they couldn't earn \$10 next time. The folks at Alex Brown are very capable people.

OID: And yet after the top of the last cycle, you got a chance to buy them at a discount to book.

Whitman: Maybe they will again. Could be. But maybe they won't. They now have a higher value relative to their book than they ever did before — in part because they have so much money under management.

And some of these guys, like Raymond James, are starting to establish a presence overseas in Asia and Europe. And if those populations ever start following the U.S. investment experience, these guys might *really* have huge markets.

Meanwhile, you're not paying an awful lot to speculate about the future.

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
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OID: Is there such a thing as normalized earning power for these companies?

Whitman: I don't know. They did \$5.61 in '93. So let's say their normalized earnings are about \$4 a share.

OID: In which case, they're selling for 6-1/2 times normalized earnings.

Whitman: And they're essentially debt-free.

OID: Which would imply a return on equity of around 16-1/2%.

Whitman: That's right. I think that's fair, don't you?

OID: It's certainly well above the historical average of American industry.

Whitman: And well above the average of financial institutions with a big retail presence, although it's certainly well *below* the average for money managers.

WHAT SCARES ME MOST IN THIS BUSINESS?
POTENTIAL LITIGATION LIABILITY....

OID: What is Alex Brown's niche?

Whitman: They're very strong in the Baltimore market and in the equity underwritings of electronics, biotech and high tech. That's also a weakness because that's an excruciatingly volatile market — *excruciatingly* volatile.

OID: I imagine so.

Whitman: But they're very good at IPOs.

OID: How do they stack up competitively? Do they have a moat?

Whitman: I think so. I think they have a great niche. I don't think Merrill's going to eat their lunch. But you never know.

OID: Then what could make you wrong here?

Whitman: The thing that scares me more than anything in this business is potential litigation liability — 1933 Act liabilities for false and misleading information in new issue prospectuses.

OID: Generally speaking or in the case of Alex Brown specifically?

Whitman: Both. However, I do worry about it more in the case of Alex Brown simply because they do a lot of high tech IPOs. It could happen. But it probably won't.

OID: So you're willing to overlook it.

Whitman: Yeah, at this price. Sure. And from what we know from the public record, they don't seem to be having too many problems. They had a big lawsuit that just got settled. So it hasn't been a big problem. However, it *could* be.

But the next time I invest in something where there's nothing wrong, it'll be the *first* time. The only time I made an investment where nothing was wrong was Public Service of New Hampshire mortgages. And I didn't know nothing was wrong until it was all over.

All of these things have something wrong. The

broker/dealer business is a regulated industry. And I think that liability risks are huge — though not as big as they are for the tobacco companies.

But lawsuits could conceivably make their situations much worse than accountants' liability has been for the Big Six — and it's virtually put them out of business. Some of those accounting firms may be insolvent. Some of the bigger firms have already gone out of business — like Laventhal & Horvath. The RTC and the private bar have really devastated the accountants.

Maybe a lot worse will happen to broker/dealers — I don't know. So it does worry me.

OID: But not enough to keep you from buying them.

Whitman: I do things even though I worry about them — as I probably should. But that doesn't mean I shouldn't *do* them.

I always worry and think about the worst case outcome. And when I do that, I can find less of it realistically speaking in the case of the credit enhancers than in the case of almost any other investments I'm making. For example, I'm doing the depository institutions like crazy. And a lot could go wrong in those. The best capitalized bank in the world is too highly leveraged by most industrial standards.

OID: Other than liabilities, what else could turn these broker/dealers into a mistake?

Whitman: We talked about it — if their earning power were to absolutely deteriorate and/or the funds they have under management didn't show any persistence. And they could always mismanage the company in the future — borrow a lot of money and use the proceeds injudiciously.

HOWEVER, MERRILL LYNCH IS TERRIFIC.
AND MINE AREN'T A LOT CHEAPER....

OID: On that score, how do you view management at the three that you've told us about vs. management at the biggies — you know, Merrill, Salomon, etc.?

Whitman: One of the problems I have doing all of these regional brokers is that they're not great bargains compared to Merrill (MER/NYSE). Salomon (SB/NYSE), I think, is more of just a trading house. They don't have a lot of money under management. Basically, they're trading.

OID: Which is inherently a less desirable business.

Whitman: In my opinion. As I see it as an outsider, it looks less desirable and less persistent as an anchor to windward. Maybe they're pretty good at what they do. But that's the way I look at it.

I think Merrill is terrific though. In fact, I think Merrill, Fidelity and Charles Schwab are all very rough competition for all the ones I'm buying. But I think I priced them right. I hope I did anyhow. But I'm not sure that I'm buying them an awful lot cheaper than I could buy Merrill Lynch.

OID: Although Merrill is selling at a higher price-to-book...

Whitman: But what has Merrill got under management — something like \$280 billion? Don't hold me to the exact figure, but...

OID: It's a bunch.

(continued on next page)

THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

Whitman: That's right. And Merrill reported \$6.14 of earnings for '93. And its stock trades in the \$30s.

OID: *At less than 6-1/2 times trailing earnings.*

Whitman: Yeah. So the ones I'm buying aren't priced appreciably different than Merrill.

OID: *Then why aren't you buying Merrill Lynch?*

Whitman: Because Merrill Lynch isn't going into play very easily.

OID: *That's the second or third time you've mentioned takeover. And you focused on that subject in your letters, too. But have takeovers among broker/dealers really been that frequent?*

Whitman: BankAmerica bought Schwab. In my book, [*The Aggressive Conservative Investor*], I point out that the vast majority of broker/dealers went out of business.

OID: *That's certainly something to look forward to.*

Whitman: But I think that was a different era. Today, these guys are well financed, they have a public market and they have tremendous diversity of business owing to the fact that they have a lot of fee income they never had before that seems to be persisting.

OR YOU CAN BUY PIPER JAFFRAY
FOR LESS THAN NOTHING....

OID: *You also mentioned Piper Jaffray?*

Whitman: Piper Jaffray is also extraordinarily attractive. It's selling for well under 6 times earnings. As I recall, they manage over \$12 billion. And they're about 40% owned by their ESOP. So they might be particularly receptive to a premium over market offer.

I don't know though. I've never spoken to 'em.

OID: *Whether they are or not, you'd certainly imagine that their incentives would be in line with yours.*

Whitman: You'd certainly think so.

OID: *What's Piper Jaffray's book value?*

Whitman: Around \$10. And they're selling for about \$12-1/4. So there again, they're selling within a reasonable range of book.

And I think that their money management operations are worth almost as much as their current stock price. Assuming that their money management operation is worth about 2% of its \$12 billion in assets, that's \$240 million. Allocated over Piper Jaffray's 17.6 million shares outstanding, that's more than \$13.50 per share.

OID: *And how much debt is there?*

Whitman: No net debt.

OID: *Not bad. It sounds like you're essentially buying a money management operation at a discount and getting a brokerage firm for free.*

Whitman: A brokerage firm/investment bank, yeah.

That's one way of looking at it — assuming they're separable. And money management is only about 15% of their revenues.

OID: *Wow. And their distinctive competence?*

Whitman: They dominate the upper Midwest — retail, munis, underwriting for local and regional companies and localities — you name it.

OID: *Why is this thing apparently being given away?*

Whitman: Because they've had some problems in their money management operation this year. It's been in Barron's. They had some hotshot doing derivatives for them who came a' cropper in the first quarter. As a result, they were down something like 26% in the first quarter of calendar 1994.

OID: *What was the nature of the problem?*

Whitman: They guessed wrong. That was the nature of it.

PORTFOLIO REPORTS estimates the following were Third Avenue Value Fund's largest equity purchases during the quarter ended 4/30/94:

1. CAPITAL GUARANTY CORP
2. ALEX BROWN INC
3. GP FINANCIAL CORP
4. RAYMOND JAMES FINANCIAL CORP
5. PIPER JAFFRAY COS INC
6. FIRST AMERICAN FINANCIAL CORP
7. SECURITY-CONNECTICUT CORP
8. STEWART INFORMATION SVCS CORP
9. MBIA INC
10. AMERICAN PREMIER UNDERWRITERS

AND THEY'VE EARNED VERY HIGH RETURNS
AND ACCUMULATED ASSETS LIKE CRAZY....

OID: *What kind of returns has Piper Jaffray been earning?*

Whitman: In '93, they earned \$2.29 on an opening book of \$7.45. And they earned \$2.21 in '92 on an opening book of about \$5.21.

OID: *Wow — that's an average return on equity in excess of 30%.*

Whitman: That sounds about right.

OID: *How inflated are those returns in your opinion?*

Whitman: Things were extraordinarily good cyclically for them in '93. They'll be off quite a bit in '94. Their book will be up, but their earnings will be down. So maybe their ROE will go down into the high teens.

OID: *What can you tell me about Piper Jaffray's management?*

Whitman: I'd like very much to meet them, but I never have. Based on the record though, they're very good. I'd assume that what you see is what you get. And the numbers suggest that they've done a wonderful job to date.

OID: *It certainly looks like it. Besides the high returns, they're also growing very rapidly. According to S&P, they have 17 closed-end funds and 16 open-end*

(continued on next page)

THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

mutual funds. And they introduced six new funds and raised \$2 billion in assets in '92.

Whitman: That sounds about right.

OID: And they've grown all the way from \$5.7 billion under management to \$12 billion since '92.

Whitman: Yep.

OID: Wow. How'd they pull that off — aside from the fact that it's been a bull market?

Whitman: They're terrific people. They just dominate the market they're in. And the Midwest, which had been very depressed in the early '80s, came back pretty strong. Plus, they're probably just plain good.

And probably most important of all, like you said, there's been a roaring bull market for their services. *

OID: So they've had the wind to their backs.

Whitman: But suppose that it *was* just a bull market. Given all of this stuff that they put into the business, they're not going back to square one. Their basic earning power is permanently higher. And they haven't overleveraged and/or bet the company to achieve it. In fact, they've built a strong financial position at the same time.

RAYMOND JAMES IS SO WELL MANAGED.
PLUS THEY HAVE A GREAT TERRITORY.

OID: And Raymond James?

Whitman: I love them. Oohhh!

OID: If you can't control yourself, we can continue our discussion later...

Whitman: They're so well managed — and growing. Plus, Florida is a great territory with great demographics. And I think that Tom James has got to be some kind of a genius. They just run a first class business.

Of course, I may just be biased because they like Third Avenue Value Fund.

OID: So you have a conflict of interest.

Whitman: It's true. But I've met quite a few people. And everybody I've met there has been first class. It's a pleasure being with 'em. Of course, it's a lot easier to be so enthusiastic with the stock at \$15 than it would be if it were \$40.

OID: I know exactly what you mean.

Whitman: They're the kind of guys I'd go down the tubes with. I love to read the chairman's letter to his stockholders. I just think they're good people — first class all the way.

OID: A very underrated factor, I think.

Whitman: Agreed. I feel very much that way. But what's the difference what I think. Look at their record. It's first rate.

RAYMOND JAMES SEEMS TO DO EVERYTHING WELL
— INCLUDING EARNING VERY HIGH RETURNS....

Whitman: At the end of their last fiscal year which ended September 30, their book value was \$9.64. Since then, they've earned \$1.18. So make it \$10.50 to \$11 today.

OID: And what kind of returns has Raymond James been earning?

Whitman: For the last couple of years, they've earned something in the neighborhood of 24-25% on average equity.

OID: I could learn to live with returns like those.

Whitman: Who couldn't? But again, I'm not saying that they'll always be that high. The last year or two has been a great time for these companies. And their earnings and returns are likely to come down some from those levels.

OID: Probably. But it looks like they managed an average ROE of about 20% for the two years before that.

Whitman: That sounds right. And contributing to those returns is the fact that like Alex Brown and Piper Jaffray, Raymond James has quite a bit of assets under management. In fact, they have about \$8 billion overall under management, of which \$5.7 billion is in Eagle Asset Management — which they own 100%.

Assigning that operation a value of 2% of assets would indicate a value of \$160 million. And allocated over their 21-odd million shares outstanding, that's nearly \$8 per share of value for their money management operation alone.

OID: So once again, a very high percentage of their stock price is represented by the intrinsic value of their money management operation.

Whitman: Oh yeah. And their money management fees are only about 10% of their revenues.

OID: Wow. Incidentally, how rapidly have these guys been gathering assets in the money management area?

Whitman: The \$8 billion under management at the end of their fiscal year is up about \$1-1/2 billion from a year earlier.

OID: That's pretty fast, all right.

What's their niche in the broker/dealer area — other than being very strong in their region?

Whitman: They do underwriting well. They do money management and financial planning well. And they do a very good job in the broker/dealer area. In fact, they've got a first rate research department. For example, The Wall Street Journal always has these stories about which brokers outperform the market and so forth. And Raymond James is always #1 or #2. Most of the time, they're #1.

But maybe that means they play the market too much — I don't know.

HOWEVER, THERE MAY BE AN ACHILLES' HEEL
WHEN IT COMES TO PERSISTENCE....

OID: What are Raymond James' negatives?

Whitman: Other than those I've already mentioned for all broker/dealers, I can't think of any. Well, maybe there's one — although I'm talking like a rank outsider.

(continued on next page)

THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

As a general rule, it seems to me that mutual fund families have more persistence than investment management firms per se. Once people go join these mutual fund families, they tend to stay in them a lot more than they do in a straight investment management situation.

OID: Why do you think that is?

Whitman: I'm not sure. I haven't done a study on the subject. However, I suspect that it's because the families of funds tend not to lose clients. If their shareholders don't like the market, they take them out of equity funds and put them into money market funds or bond funds.

And Raymond James is relatively big in investment management and relatively light in mutual funds within their \$7 billion of assets under management.

OID: So that's a slight negative.

Whitman: I think so — at least compared with Piper Jaffray where it's the other way around. However, that may be an over-generalization on my part.

OID: Meanwhile, if your thesis is correct, each of these companies' earnings are likely to be much less cyclical in the future than they have been in the past.

Whitman: Yep.

OID: And investor perception is likely to change, too — eventually.

Whitman: Yep.

MERGERS, TAKEOVERS, ETC. ARE THE NORM
SO WHY NOT INVEST THAT WAY?

Whitman: And they're very likely to go into play, too. Don't forget that part.

OID: You keep coming back to that....

Whitman: I gave a speech last year that I called, "Escaping from the Efficient Market Straitjacket". It was one of my better papers. And afterwards, a professor came up to me and said, "What you say is very interesting. But it really doesn't refer to common stocks in general. All you're talking about is mergers and acquisitions, takeovers and going privates."

(continued in next column)

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And I said to him, "Professor, why don't you get one of your research associates to take any index you want — the Dow Jones Industrials, the S&P 500, you name it — go back over almost any five-year period and see how many of those stocks you talked about *didn't* engage in the types of activities I talked about. And I guarantee you that you'll find that the answer is very few."

And once I say it, you and I know that it's true. To make the assumptions of academic finance that all these businesses are strictly going concerns is a load of crap.

OID: I wish you'd feel more free to speak your mind with us instead of being so inhibited....

Whitman: I can't help it if I'm shy. All these guys are going to do mergers and acquisitions and restructurings — in other words, be in play. It's the norm.

These academics make all these assumptions about what "the market" and "the world" are like. But they don't know what the markets and the world are like. It's a case of the patients taking over the asylum. Instead of some professor telling me that all I'm talking about is mergers and acquisitions, he ought to sit down and see whether mergers and acquisitions or restructurings or going privates or takeovers — any of these asset conversion activities — are really the norm or whether they're the exception.

And again, if you take a five year period, I'd almost promise you...

OID: In certain industries, at least.

Whitman: No, *generally* speaking. In fact, I'd argue that until lately, the only place it *wasn't* true was in the electric utility industry. And it's even true *there* now. What would you *exclude* — the steel industry? Even drugs — just look at Merck and Medco and others.

So if you're a long-term investor, the prospects of going into play are a fair consideration to take into account.

OID: I've never heard that case made before. However, you make it well.

Whitman: As I say in my book, there are more *differences* between the price you pay for a business and the price you pay for a stock than there are *similarities*. The variables are very, very different.

OID: How so?

Whitman: At any given point in time, the best performing equities in a stock market will be those reporting improving GAAP earnings per share quarter to quarter, those that have the most popular industry identification, and those that are most heavily promoted by insiders and members of the financial community. And as far as I can tell, the typical fund manager emphasizes those same factors — again, especially those forecast for the quarter or year ahead. For whatever reason or reasons, the idea seems to be to try to forecast immediate price performance of the stock.

OID: It's hard to argue with you there.

Whitman: Thus, in the short run, stock prices are driven by outside passive minority investors who implicitly assume that most resources will continue to be employed by the same managements in the same ways that they have been historically.

OID: Good old rear-view-mirror investing.

(continued on next page)

THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

Whitman: Exactly. In contrast, in corporate finance, one evaluates the quality and quantity of resources in the business and examines the ways in which superior returns might be achieved by obtaining new finance and/or by changing the way those resources are employed or managed over a relatively indeterminate future.

So I think there are an awful lot of bargains out there right now — in effect, a great big arbitrage opportunity. And when prices are low to reasonable, you generally get the public taken out. That's part of the arbitrage.

Meanwhile, the managements of most companies in our portfolio couldn't care less about the market prices of their securities or what "Wall Street" thinks. Most of these companies are extremely well financed with no need for outside capital — particularly equity capital. And few of the controlling shareholders are looking to dispose of their holdings — at least in ordinary public market transactions which would reflect neither private business values nor control premiums.

So for all of those reasons, I think these stock prices are very low relative to their business values. And again, I think these broker/dealers will look mighty attractive to the money center banks, among others, within a few years, if not sooner.

IT'S HARD TO IMAGINE A BUSINESS
THAT'S INHERENTLY MORE ATTRACTIVE....

OID: You've been using 2% of assets as a rough value for these money management operations. How do you come up with that?

Whitman: It's at least that. At Danielson, as you know, we own a small trust company and manage money. And I've spent the better part of the last two years trying to buy a money management business.

OID: What's the problem?

Whitman: The problem is that all of these guys want crazy prices. I've met a lot of money managers who'd be willing to sell to Danielson. However, I have yet to meet the money manager who doesn't think his business is going to grow 20% compounded and who doesn't want me to pay for that growth today. We've been offered firms for 3-4% of assets managed — and we've declined. It's a very buoyant market.

By comparison, the companies that I've told you about — Alex Brown, Piper Jaffray and Raymond James — are ridiculously cheap. And there's a ready market for them. I didn't invent the wheel in the takeover business. It's not like I'm saying something new is going to happen. You can look at what GE's paying for Kemper or what Mellon's paying for Dreyfus.

OID: Can you save us the trouble?

Whitman: In the public market, these things sell for something like 15 to 20 times earnings.

Dreyfus' sale to Mellon may be a terrific bargain for Mellon because Dreyfus has \$700 million of surplus cash. However, I haven't worked out the exact number.

Another way of looking at it is to assume that you're

collecting a fee of 1/2 of 1% of assets, that there's a 60% expense ratio and that the market pays ten times operating earnings. That way, you also come up with a valuation of 2% of assets under management — or four times revenues. So however you do it, you come up with essentially the same number.

OID: But why is that good?

Whitman: First, it's a very simple business. It's a cash business with no receivables or collection problems, no inventories and very little property, plant and equipment.

And there are damned few fixed costs. In fact, employee compensation is 60-70% of your costs. And those are very variable. It's almost like having a toll booth on the George Washington Bridge if you do it right. It isn't like analyzing an automobile or biotech company.

And because it's so much easier to understand, the pricing is a little more efficient.

OID: No business is perfect....

Whitman: Then, if the money management operation is under the aegis of the Investment Company Act of 1940, they're under what I consider to be the most intelligent, productive government regulation out there.

OID: For whatever that might be worth. I've always thought intelligent, productive government regulation was an oxymoron.

Whitman: Generally speaking, it is. However, the genius of that regulation is that it gives passive investors in mutual funds extremely effective substantive protections while still permitting the promoters to get rich.

The mutual fund investor is protected against the stupidity, fraud, general misconduct and avarice of advisers to a much greater extent than has existed in any other investment vehicle.

Therefore, there's a strong case to be made that American investors are likely to stay with mutual funds long term. And if they do, our financial services companies should do just fine — because given persistence, it's hard to imagine a business that is inherently more attractive than money management.

DIVERSIFICATION'S A SURROGATE FOR KNOWLEDGE
AND USUALLY A VERY POOR ONE AT THAT.

OID: If you really like something and you can buy as much as you want, how much will you concentrate?

Whitman: In the case of the Third Avenue Value Fund, all the way up to the limits imposed by the Investment Company Act.

OID: Which is?

Whitman: First, we can't put more than 25% in any single issue. But also, anyone with a broker/dealer presence can't have more than 5% of their fund in any one issue. And I may be getting pretty close in a few cases.

You know, Markowitz was absolutely wrong.

OID: Absolutely.

Who was Markowitz?

Whitman: The inventor of modern portfolio theory who got a Nobel Prize for creating the modern portfolio hypothesis.

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

Markowitz made the theoretical case for diversification. However, as I see it, diversification is only a surrogate — and usually a very poor one — for knowledge and control.

OID: Clearly, a surrogate is necessary for most people — present company excepted, of course.

Whitman: For them, it's right. And clearly, being an investment company, we don't do control investing. So we require some of it. But it's much better to bring knowledge to a situation.

Markowitz was just dealing with a bunch of untrained academics — in effect, chartists and technicians with Ph.Ds. That was his constituency. And they need diversification because they don't have any knowledge of the issue or issuer. They just know securities prices.

I believe in diversification insofar as I lack knowledge. Diversification is essential for ignorant passivists.

OID: I beg your pardon.

Whitman: But insofar as you're a knowledgeable activist, it's something to be ignored. And at Third Avenue, that's what we try to be.

BANKS MAY NOT LOOK EXCITING,
BUT THEIR RETURNS WILL BE....

OID: I believe you mentioned four other categories of financial companies?

Whitman: That's right — bond insurers, regional commercial banks, life insurers and title insurers.

OID: Which category or categories are most compelling today?

Whitman: Probably well capitalized regional commercial depository institutions selling at a discount from book.

OID: We keep hearing that from more than a few of our contributors — including Charles Brandes, Michael Price and others. And of course, they're a perennial favorite of Peter Lynch.

Only they're so boring. I mean the banks, of course, not our contributors....

Whitman: I don't think you'll find the returns so boring if you own them. And I say that, first of all, because they're obviously in play. They're going to get taken over — probably at 2-1/2 to 3 times book. There's a huge shrinkage going on.

OID: That's what Charles Brandes told us last issue.

Whitman: Good. Then I agree with him.

OID: On the other hand, these banks' underlying returns aren't anything to write home about, are they?

Whitman: I think they are. I just think that they'll continue to employ their surplus resources and earn an increasing return on net worth.

OID: But isn't it likely to be a pretty puny return?

Whitman: It may be puny, but I don't think it's puny on the prices I'm paying. Even if they can only manage a measly 10% ROE, it isn't a puny return on my cost. In fact, we project that if they can manage a 10% return on equity for five years and then be taken over at two times book — and the average deal's taken place at 2-1/2 to 3 times book — then the average return to the fund would exceed 40% compounded.

OID: Which, as I recall, is similar to the kind of returns we calculated in our feature with Brandes.

Whitman: Then I think he's right.

AT A WHOPPING 30% DISCOUNT TO BOOK,
GP FINANCIAL'S A SLAM DUNK....

OID: You mentioned GP Financial and Security Capital. Tell us about GP Financial.

Whitman: It's over in Brooklyn someplace.

OID: Let's save the negatives for last. What makes it a bargain?

Whitman: It's selling at a big discount from book. GP Financial's book value is north of \$30, whereas its stock is currently around \$22.

OID: Why is it selling at nearly a 30% discount to book?

Whitman: No earnings — or very little earnings.

OID: I'm extremely sympathetic there.

Whitman: But it's overcapitalized. And management intends to earn a reasonable return on book in the future by employing its assets.

OID: Don't we all. But what makes you think that they'll successfully begin to earn decent returns — even 10%?

Whitman: Banks and other depository institutions that are conservatively run tend to be utility-like long term and have normalized earnings between a 10% and a 16% return on net worth. That's essentially a slam dunk.

All they have to do is attract these 4% deposits and buy 5-6% mortgages. They enjoy the 2% spread. And they're earning 10% on equity. It isn't that hard for conservatively run, community-oriented depository institutions — or at least it hasn't been historically.

OID: When did they de-mutualize?

Whitman: GP Financial is the holding company for Green Point Savings Bank. They were in that famous scandal last year when Republic New York wanted to buy them and its insiders were all enriching themselves.

OID: What was the ultimate outcome?

Whitman: Republic Bank wanted to buy Green Point at a big premium. But the banking commissioner ultimately sided with GP Financial's management and told Republic Bank to get lost.

So GP Financial wound up coming public in January of '94 at \$15 a share.

OID: Why is the discount still so large? Because of the bad press and concerns about management being

(continued on next page)

THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

shareholder-oriented?

Whitman: Yeah, I think so. But why are you asking me about why GP Financial's stock is cheap? If I knew that, I'd be playing tennis at this very minute.

I CAN'T KNOW WHICH STOCKS WILL BE TAKEN OVER,
BUT I DO THINK THAT MOST OF THEM WILL BE.

OID: And what about Security Capital?

Whitman: The same story. Book value is maybe \$50. Meanwhile, Security Capital's stock price is at about \$39. And it's extraordinarily well capitalized.

OID: You honestly think that these things will be taken over one day at 2-1/2 to 3 times book?

Whitman: No. I think that among our portfolio of 10 to 15 stocks, maybe 8 to 10 of them will get taken over during the next five years or thereabouts, but I can't know that GP Financial and Security Capital will be among them — especially since I know GP Financial's CEO, Tom Johnson, from when he was at Chemical. And I know he may resist.

It's like the quote you mentioned from Warren Buffett: "You can tell *what's* going to happen. But you can't tell *when* it's going to happen."

That's a great quote. I think it's really very true. You can smell out the long-term trends. That's not very hard. But to try to figure out *when* it's going to happen — you can't. I learned the hard way that great things usually happen about six months after I sell. So I don't sell anymore.

BOND INSURERS' GROWTH IS NOT ONLY
LIKELY TO PERSIST, BUT EVEN ACCELERATE....

OID: Would you expect roughly similar returns from the bond insurers, life insurers or title insurers?

Whitman: I don't think any of them will do as well as the broker/dealers. But I think bond insurance is a fantastic growth business.

OID: No, seriously.

Whitman: Bond insurers have *fantastic* prospects.

OID: Could you explain a bit about what it is they do and why they have such great growth prospects?

Whitman: They provide bond insurance — mostly for municipal issuers, but increasingly with the securitization of other assets like real estate mortgage loans, credit card receivables or automobile finance receivables.

OID: They bless it?

Whitman: They essentially insure it. They write an insurance policy which says: "This instrument will perform in accordance with its money terms — whether or not the issuer pays. And if the issuer doesn't pay, the insurer will pay all interest, principal and premium, if any, when due." In effect, they assume the money payments if there's a default by the issuer.

OID: In effect, they're like Freddie Mac and Fannie Mae?

Whitman: That's right — except that there's no government affiliation. They're private insurers of mostly municipal obligations.

OID: But how can they have fantastic growth prospects if they aren't going to earn high returns?

Whitman: They will.

OID: Why?

Whitman: First, it's a long-tail business. They don't pay out their claims right away. So they'll keep building up their net investment income. That's a real source of stability — especially in an environment of high interest rates.

OID: Couldn't you say the same thing about a passbook savings account?

Whitman: These companies' returns will be much higher than a passbook savings account. It's not a business that's easy to enter. To get into this business, you have to have a AAA credit rating of your claims-paying ability. As I recall, there are only seven primary writers in the business.

Furthermore, a number of things are going to happen. The muni business is going to grow a lot as people insist on buying insured bonds rather than uninsured bonds. Close to 40% of the new issues of munis are now insured.

And as U.S. infrastructure spending expands, there's going to be a big increase in municipal finance. Furthermore, more and more assets are getting securitized all the time. So it's a hell of a field for bond insurance. Finally, there'll probably be a large expansion of demand *outside* the U.S.

Therefore, I think that the growth record you see at somebody like MBIA is probably not only going to *persist*, but it may even *accelerate*.

YOU CAN BUY MBIA TODAY
AT A DISCOUNT TO ADJUSTED BOOK.

OID: Interesting. But what are you paying for all those rosy prospects?

Whitman: MBIA's book value is probably near \$40. Today, its stock price is \$58. Third Avenue Value Fund's average cost, as I recall, is around \$55.

OID: That's not so bad — about 1-1/2 times book.

Whitman: Actually, MBIA's probably selling at a discount to liquidation value because there's a huge equity in there for deferred premiums.

OID: For future business which is almost guaranteed to be profitable.

Whitman: Exactly.

OID: And if MBIA's net worth is understated, does that suggest that its earnings are understated as well?

Whitman: Yeah, probably. Their earnings weren't understated in '93 because they had the benefit of a lot of refinancings which, among other things, gives a big pop to reported earnings because deferred revenues get credited to the income account on an immediate basis when insured debt is retired. This immediate pop for prepayment contrasts with crediting income periodically over the scheduled life of an insured bond. Without those refinancings, their core earnings may have been \$5.00 instead of \$5.80 or whatever

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

it was they reported.

But I just think they'll have steady growth in earnings — with earnings going up this year, next year and the year after that. They just have great built-in stability.

OID: And based on their stable earnings, maybe their stock will get a premium P/E.

Whitman: Probably. I just think the market's going to keep expanding for their product. Meanwhile, they're not going to have a lot of new competition.

OID: Could you say the same thing about the brokers?

Whitman: No, it's not as hard to enter that business.

OR YOU CAN BUY CAPITAL GUARANTY
AT 75% OF STATED BOOK.

OID: What's the story with Capital Guaranty?

Whitman: I love it.

OID: Why?

Whitman: Its price. Its book is around \$20. And today the stock is around \$15. Third Avenue Value Fund's cost, as I recall, is just a little over \$15.

OID: Why do you love it — price aside?

Whitman: Isn't that enough? It's cheaper than MBIA.

OID: How well managed are they relative to MBIA?

Whitman: I don't know, but they do have a AAA rating for claims-paying ability. And like I said, you can't be in the business without it. But I've never met the management.

OID: Other than their size and their price, how do they differ?

Whitman: I believe that Capital Guaranty only guarantees munis, whereas MBIA is starting to build a presence in asset securitization and also in Europe. Capital Guaranty is a much smaller, one-line company.

THESE GUYS HAVE A VERY BRIGHT FUTURE.
AND THEY'RE AT DEEP DISCOUNTS TODAY.

OID: According to Value Line, MBIA's earnings have increased 18% a year for the past five years. Do you expect that to continue?

Whitman: Yeah. I think that they got a little extra fillip in '93 because of the great amount of refinancings — which really aided their earnings. So maybe there'll be a little downward hiccup in '94.

But the basic trends are terrific. Again, I'm expecting past trends to continue at least in a straight line and maybe accelerate a little. I'm utterly convinced that these guys have a very bright future. They could always screw up and have a lot of losses, but I doubt that they will.

OID: What's the order of magnitude of what they charge to guarantee these bonds?

Whitman: It's negotiated. I think it's something like 50

basis points. I don't know exactly. But that's not too far off.

OID: Where are these companies fairly priced?

Whitman: Where would MBIA be taken out if it went into play? I would think somebody else would easily pay \$100 for it today — easy.

OID: And Capital Guaranty?

Whitman: At least 2 times book. So that's about \$40.

OID: Which suggests that you can buy it today for less than 40¢ on the dollar.

Whitman: Of the in-play price — that's right.

OID: And how would you assess management at these two companies?

Whitman: I only know them from the documents. But on that basis, they're fantastic, particularly MBIA. Capital Guaranty competes more on the basis of price out in the San Francisco area. Based on their records, I'd assume that MBIA and Capital Guaranty have first rate managements. But again, I don't know 'em.

OID: Do they own a lot of stock themselves?

Whitman: I don't remember. I did know the answer when I did the basic research and made the decision to buy them. It's an important question.

Incidentally, MBIA is mostly owned by other institutions. They were originally started by four insurance companies — Aetna, Travelers and a couple of others.

OID: Nobody's perfect.

Whitman: And when Capital Guaranty was started, USF&G and some big German institution were big holders. And the German institution still owns it.

THERE WILL BE MUNICIPAL DEFAULTS,
BUT THERE'LL VERY RARELY BE LOSSES.

OID: Back in the '30s, when lots of people and entities were under tremendous financial stress, did municipalities default?

Whitman: I think they did.

OID: Is that the "earthquake"?

Whitman: Even if it didn't happen in the '30s, you're dealing with entities today that are basically inefficient and, probably, basically corrupt. Whatever you may say about the Federal government, there's a lot more sunshine there than there is in the case of these municipalities. And you tend to get higher types in elected office and in the Federal bureaucracy.

OID: That's a mighty frightening thought.

Whitman: The SEC, for example, in general is a terrific bureaucracy. They're very efficient, smart guys....

OID: A compliment a day keeps the regulators away?

Whitman: Hopefully. To try to get that on a state and local level — as a generalization, you can't. From my own experience in finance, you'd get less worse quality regulation in the insurance industry if it were basically a Federal matter rather than a state matter.

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

OID: I gather there's not a third choice....

Whitman: So that's what I'm dealing with. Plus, in the history of mankind, there's never been a long history of financial contracts between parties where one of the counterparties hasn't failed to perform.

OID: Any other cheery thoughts?

Whitman: I'm just trying to be a realist. Loans go bad. And if you're going to deal in the insurance of municipal bonds, to assume that the history of no defaults will continue just isn't realistic.

OID: Did I understand you to say that these companies haven't had a claim in many, many years?

Whitman: MBIA hasn't. Some have though. FSA was almost sunk by claims. FSA got hurt because of their real estate exposure to two or three real estate loans. But no one to my knowledge has experienced distress on municipal insurance.

OID: Why then isn't this like an earthquake insurer who hasn't suffered an earthquake recently?

Whitman: I think that there *will* be a lot of defaults. I don't think their record on money defaults will be anywhere near as good in the future as it's been in the past.

OID: So this is a short? Or are you in effect saying that they're overreserving?

Whitman: That's exactly right. I'm saying that their reserving is *more* than adequate. The average outside guy figures that if there's a money default, there's a wipeout. But if someone in the distress business has some knowledge of what they're insuring, I would have every confidence that the insurer isn't going to suffer much of a loss, *if any*, on loans that go into default.

OID: In other words, there'll be defaults. But the defaults will very, very rarely lead to losses.

Whitman: Exactly. They'll be worked out in a Chapter 9 reorganization. Chapter 9 is almost the same as Chapter 11 — except that you can't have an involuntary petition in Chapter 9. And in the vast, vast majority of cases, the claimant will receive the full value of all principal and interest.

They're like buying Public Service of New Hampshire mortgage debt. Whether there was a default or not, those things were worth par plus accrued interest. I would have

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every confidence that most of the debt they insure would be worth par and accrued — regardless of whether there's a money default or not.

OID: Because the municipalities don't want to impair credit. And rich or poor, it's good to have taxing power.

Whitman: Exactly.

OID: So absent a revolution...

Whitman: You've got it. And the properties that underlie the bonds that the bond insurers are insuring are not high risk deals for the most senior lender who has good rights of subrogation. When there's a default on the bond by the issuer and the bond insurer makes service payments to the holders of the bonds, the bond insurer takes over the old holders' bonds. And these are pretty good bonds — pretty senior in the capital structure, if you will.

OID: And these are for things like municipal projects, dams, public works...

Whitman: Yeah — and utilities, water works, hospitals and schools, etc. And the creditors are first in line. Of course, any municipality is going to pay its firemen and teachers before it pays its creditors. But the creditors who are first in line are going to do pretty well.

OID: Didn't people lose money in some of the WPPSS Bonds?

Whitman: Yeah. Those were a disaster. The project they were associated with never went into operation.

OID: Won't that kind of thing happen from time to time?

Whitman: I suppose so. But every bond they insure has a shadow rating.

OID: Shadow rating?

Whitman: They're all rated AAA once they're insured. But the shadow rating is what they'd have been rated had they not been insured. And both MBIA and Capital Guaranty only insure investment grade.

They'll occasionally slip up and insure a WPPSS-type bond. But the overall portfolios ought to be terrific. WPPSS was a single purpose project that never got built and, therefore, of course, never went into operation. That could happen. In fact, it's ordained to happen from time to time. But I don't think it's going to be significant in the overall financial picture of any bond insurer that has an entire portfolio of these things.

OID: Even in a 1930's style "earthquake".

Whitman: Yep.

I HAVE NO DOUBT WHATSOEVER THAT
THEY'RE VERY CONSERVATIVELY RESERVED.

OID: What kind of assumptions do they make in their reserving?

Whitman: That's a good question.

OID: Thanks.

Whitman: All of them *underwrite* on a "no loss" basis. They try to select their business on that basis. And I think

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

that they try to be ultraconservative about their reserves. If they took reserves on the same basis they underwrite, then they wouldn't take *any* reserves.

In other words, they take reserves for losses. But if they thought that there'd be a money default on an issue that they're examining, they wouldn't underwrite it. Their actuarial assumption is that their bonds aren't going to lose, but they don't price it that way and they don't reserve it that way.

I don't remember what assumptions they make exactly. However, I was satisfied when I looked at it. These are very conservatively reserved people. Again, Capital Guaranty and MBIA are probably very much overreserved.

OID: Which again suggests that book value and earnings are somewhat understated.

Whitman: Yeah, probably. But that will be proven correct or otherwise by future events.

OID: You're not counting on it.

Whitman: No. It's one of my anchors to windward. The business is going to expand. They're going to write more insurance. They're going to enjoy an exploding market. That's on the demand side. And again, on the supply side, it's a difficult business to enter.

If the worst happens, we'll do all right. I *always* think that the worst is going to happen. But maybe they'll be as good as their past record. However, even if they're not, it won't be a big deal.

AND THESE GUYS DON'T HAVE INTEREST RATE RISK.
THEY'RE JUST DOLLAR-COST-AVERAGING.

OID: What kind of risk do they have in their investment portfolios?

Whitman: They're probably all invested in "1"s and "2"s — which are investment grades as defined by the National Association of Insurance Commissioners, the NAIC. Both of them are very, very heavily invested in long-term tax-frees.

OID: So they do have some interest rate risk.

Whitman: I don't think so. What you call interest rate risk is strictly amateur hour. If you're not trying to earn a spread, you don't have interest rate risk. And they're not going to have any payouts. So how do they have interest rate risk if they continually have new funds to invest?

If interest rates go up, all that happens is that their new money gets invested at a higher rate than their old money. They're just dollar-cost-averaging.

Don't be like those academics who don't understand finance. They certainly don't understand portfolio theory.

OID: If I understood finance, do you really think that I'd be editing a newsletter?

Whitman: Sure. You do a great job.

OID: Maybe we will be able to use this feature....

UNDERWRITING PROFITS + INCREASING PREMIUMS
= AN ENGINE OF WEED-LIKE GROWTH.

OID: You mention in your letter that one of the best things you can invest in is insurance companies that consistently earn an underwriting profit.

Whitman: Absolutely. And incidentally, bond insurers all have combined ratios well below 100.

OID: Really?

Whitman: They're mostly well below the 80s and 90s.

OID: Why then hasn't their return on equity been much higher?

Whitman: I'm really looking at growth in earnings per share. And what did you say earlier — that *Value Line* showed MBIA's growth in earnings per share at 18% for the past five years?

OID: That's right.

Whitman: If you have a combined ratio below 100, you're increasing the amount of premium you're writing and you're investing the cash flow from increased premiums and insurance profits into performing loans, it's *got* to be an engine of compound growth. It's not rocket science — just simple arithmetic.

Furthermore, they collect the entire premium up front. And it only flows into the income account in conformity with the bond's maturity.

OID: In other words, although they collect the entire insurance premium up front, they amortize it over the life of the loan.

Whitman: That's right. For a 30-year bond, they take the entire premium up front in cash. But for accounting purposes, they only book 1/30 of the premium each year — except, of course, when there are prepayments. However, if they increase their writings, their investment income explodes.

OID: Gotcha.

Whitman: And if the increased writings also have a profit factor, these things will grow like weeds.

THE TITLE INSURERS ARE FAR MORE VALUABLE
THAN THEY WERE ONLY A FEW YEARS AGO....

Whitman: Incidentally, I mentioned earlier that most investors don't appreciate the fact that broker/dealers had undergone corporate transformations and are now far more valuable franchises than they were only a few years ago. Well, you could say the same thing about title insurers.

OID: Why do you say that?

Whitman: First, because the business is getting more complex and databases are getting more important, there's been substantial consolidation of market share among the largest companies — so that the seven largest title insurers now have about 90% of the market up from something substantially less only a handful of years ago.

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
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Second, as asset securitization continues to increase, people who never had to get title insurance before do now. You can't package a portfolio of single family mortgages and sell off pieces of it unless each mortgage loan in there has title insurance. That didn't use to be so nearly as much.

And third, not only are more loans being insured and big companies getting more of the market, but over every cycle, the market seems to be increasing.

OID: So primary demand is growing at the same time that the rich are getting richer.

Whitman: Exactly.

OID: But why does that make the franchises so much more valuable?

Whitman: It's a business where profitability is very much volume driven. If they can increase volume, they're bound to be profitable. It's a very volume-sensitive business — with a very high breakeven point. But once you pass breakeven, it's very profitable — especially when you consider that like bond insurers, title insurers generally have combined ratios well below 100.

Plus, if they do their job right, it's a no-loss business — because their losses are based on events that have already occurred, not on future events like other insurance.

TITLE INSURERS DO HAVE THEIR NEGATIVES:
CYCLICALITY AND RELATIVE EASE OF ENTRY....

OID: But what makes you think competition won't simply increase along with demand and drive their profitability and returns way down?

Whitman: Aside from the fact it's not happening today, nothing. As I mentioned, it's currently going the other way. However, other than that, there's nothing to prevent that. And that's one of the vulnerabilities.

But they seem to be doing well right now. They reported record earnings last year. And their profits seem to be holding up this year. And starting in 1995, there ought to be a meaningful increase in the refinancing of 10 to 12-year mortgages that were placed on commercial properties when that business was booming in the mid '80s.

OID: What accounts for their single-digit returns from 1988 through 1991?

Whitman: Title insurance is extraordinary cyclical. It always has been. It's very real estate-related.

OID: I gather these companies earned decent returns in the mid-'80s.

Whitman: That's right. And I obviously think it's a good business — not only because Third Avenue Value Fund is investing in it, but also because Danielson made an unsuccessful bid to buy one of the large title insurers.

OID: However, it looks to me like these title insurers tend to sell around book value even when they're earning relatively high returns.

Whitman: I think that's right.

OID: Why is that — their cyclical demand?

Whitman: I guess so. But that doesn't make any difference to me. I'm not looking to make money on valuation discounts narrowing.

OID: Really?

Whitman: No. That's too much like playing the market. I'm concerned with the net asset value increasing.

OID: But it sounds like the credit enhancement businesses have a great deal more wind to their backs than do the title insurers — especially given the apparent barriers to entry in that business and the relative ease of entry in this one.

Whitman: It looks that way to me. Maybe I'm wrong. But I think the credit enhancers have fewer warts than almost any business that I've looked at. And when I think about my downside as a long-term buyer at these prices — in other words, what can go wrong — I really think that the credit enhancers give me much less pause and concern. That's how it looks to me.

OID: So why should we buy these dogs — I mean these title insurers?

Whitman: First of all, I don't think they're dogs. Second, although they do have more warts, in my opinion, than the bond insurers, so does everything else. And third, I love their stock prices. For example, today, you can buy Stewart Information Services for about \$18 — or well below 5 times trailing earnings and about 70% of its \$26 book.

OID: It's certainly hard to argue with the price.

Whitman: That's the way I see it. And you can buy another title insurer, First American, at about \$25 — or well below 5 times trailing earnings.

OID: Why are these prices so low?

Whitman: It's not just title insurers that are so cheap. Security Connecticut, for example, is a life insurer with a book value of about \$30 that you can buy today for only \$21 — or roughly 70% of book.

OID: We'll take 'em already.

THE "DIGITAL REVOLUTION" IS A GIVEN.
I ONLY WISH I UNDERSTOOD IT BETTER....

OID: I understand that since our last conversation, you've continued to buy Apple (AAPL/OTC).

Whitman: What about it?

OID: There's no need to get defensive.

Whitman: From everything I read, it looks like they're doing very, very well as a going concern.

OID: Aside from sales and earnings, certainly.

Whitman: Even there. They probably might have a lot of earnings.

OID: Probably might?

Whitman: Just trying to cover my bases.

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

OID: *I thought that they were betting the entire company on that new PowerPC chip.*

Whitman: Yeah. And it looks to me like it's going pretty well based on everything I read about it.

OID: *Then why doesn't the stock price reflect it?*

Whitman: How should I know? You're asking the wrong guy about why stock prices do anything.

OID: *Who do you expect me to ask — Dan Dorfman?*

Whitman: Why not?

OID: *What's the range of what you've paid for Apple?*

Whitman: We've paid as little as \$20 and as much as \$45.

OID: *Have you bought any more lately?*

Whitman: Nope.

OID: *Why not?*

Whitman: I don't know. Maybe it's because I don't bring the same level of expertise to computer hardware manufacturing that I do say to a broker/dealer.

OID: *Feel free to call anytime.*

Whitman: I'll try not to abuse the privilege.

OID: *But if you didn't already own Apple, would you buy it today?*

Whitman: Yeah. I think they're going to do very well. Plus, I love their industry. You want to talk about regrets...

OID: *Let's leave my portfolio out of this...*

Whitman: I wish I had the know-how to be much heavier investors than we are in the digital revolution and in biotech. I think they'll be such fantastic things in the next ten years.

OID: *Why do you say that?*

Whitman: It's obvious. Somebody was in my office this morning telling me how they now have flight simulation software that runs on a Mac or a PC for only about \$10,000 that enables the Defense Department to do a better job training pilots than a \$30 million flight simulator.

OID: *Wow.*

Whitman: The so-called information superhighway, interactive, the digital revolution and all that jazz — it's clearly going to revolutionize our lives. And mapping the human genome will open up huge vistas in medicine.

I just don't want to be unrepresented in the industry. But it isn't an area that we or our advisors seem to bring a lot of know-how to.

OID: *In other words, to put it as delicately as possible, you're afraid that you don't know what the hell you're doing?*

Whitman: I wouldn't go that far. But we'll restrict ourselves to companies that are very, very well financed with staying power. That's Apple. That's St. Jude (STJM/OTC). That's Gish (GISH/OTC). That's PharmChem (PCHM/OTC). And we'll certainly diversify.

It's not an area where I'm going to have the same degree of confidence that I would on mono-line insurers writing bond insurance. But I would really love expanded representation in the industry.

WHAT COULD MAKE APPLE A MISTAKE?
EASY. THEY LOSE MONEY FOR A LONG TIME.

OID: *Aren't these companies going to have competition from every guy graduating from MIT and every inventor with a garage, a basement or a chemistry set?*

Whitman: Yep. That's why I want a big financial position, merchandising capability and low manufacturing cost. Rightly or wrongly, I bought Apple because they're worldwide, they have a huge financial position, they're wonderful merchants and they're strong in certain areas — especially education.

OID: *I see you've also bought DEC. Why, praytell!?*

Whitman: That's what my directors and shareholders say. And maybe they're right.

DEC in particular and IBM dominate the relatively noncompetitive service business. But I don't want to talk about them right now. We'll just have to wait and see how those things work out.

OID: *So don't count 'em out yet?*

Whitman: Not in my view. Count 'em in — especially at these prices.

OID: *Would you be so brave if I told you that we had a significant position in Apple?*

Whitman: No.

OID: *Never mind, then. But besides that, what else could turn Apple into a mistake?*

Whitman: Easy. DOS and other systems become just as easy to use as Apple's operating system and they just persist as a going concern that loses money.

OID: *And isn't Microsoft supposed to come out with something fitting that description very soon?*

Whitman: That's right. But I think that's going to be hard to do. But who knows? Maybe they will.

BUT IF APPLE CAN'T CUT THE MUSTARD,
SHAREHOLDERS WILL STILL MAKE OUT FINE....

Whitman: However, my sense is Apple has huge amounts of valuable resources dedicated to the so-called "digital revolution". Therefore, from current prices, I believe shareholders will either do pretty well owning Apple as a going concern or selling out in a "Paramount-style" takeover. Again, Apple has tremendous resources and no creditors.

OID: *At least on a net basis.*

Whitman: That's right. So they'll probably wind up doing something pretty good for shareholders.

OID: *Like buying back shares?*

Whitman: Exactly. And as you know, they've already been active on that front.

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

OID: What do you think of their new president — Michael Spindler?

Whitman: So far, so good. What I read is *terrific*. But instead of spending all my time thinking about what people think of Apple and what they think of Spindler, I read what's there and make up my own mind. And what I read independently and what the experts I trust say suggests to me that he's doing a pretty good job.

It seems to me that they're doing a lot of good products. They have a lot of consumer acceptance. They're building up to where they may make a lot of money in the year ended September '95.

OID: Might you define "a lot of money"?

Whitman: Maybe \$4 to \$6-ish.

OID: I can call back when you haven't been drinking.

Whitman: If they make it, they'll make it big. We'll see. In any case, we have a lot more to make than we have to lose.

OID: How do you think Spindler compares to Apple Ex-Chairman Sculley?

Whitman: I think he's a vast improvement — especially when you look at who he got taken in by...

OID: Let's leave politics out of this. Lots of people believed Clinton when he said he was a New Democrat.

Whitman: No, I mean how Sculley was conned by the guys at Spectrum Information Technologies.

OID: Oh, that con...

But it sounds like you think they have a future — that they aren't likely to be another Sony Betamax.

Whitman: That's what I think. The introduction of the Power Mac seems very good. They're doing some things better with Newton. And the Quadra seems to be going OK. But who knows? Maybe they *won't* survive.

OID: You're normally very familiar with litigation issues. Have you looked at the litigation between Apple and Microsoft?

Whitman: No. I've just read the public stuff. I'm not that well versed in it. I've never read a deposition, a complaint or a brief.

OID: But you're not worried about the prospects of Microsoft having unlimited use of Apple's features?

Whitman: Let me put it this way — I'd be more worried if the price were \$50 than I am at \$30. And I'd be less worried still if the price were \$20.

OID: Then, congratulations. It looks like you're having less and less to worry about every day.

Whitman: I don't worry about Apple. They're awfully well financed. They have an awful lot of staying power. But that doesn't guarantee that they'll make it.

OID: And yet even Spindler says that if Apple can't increase its market share to 25%, they won't have the economies they need for long-term survival.

Whitman: Fine. Then maybe they *ought* to sell out. If they don't make it, then I think they're very likely to go into play. And in that case, I think we'd make out just fine.

GIVEN A WELL FINANCED, WELL TRIED CASE,
THE TOBACCO COMPANIES ARE DEAD MEAT.

OID: The last time we spoke, you told us some fairly dramatic things about tobacco litigation that we'd never heard before. And they seem to be coming true. Could you give us an update there?

Whitman: I still think they're dead meat.

OID: There's no need to hedge your opinion. You can speak freely with us.

Whitman: Like I said, I'm just naturally shy.

OID: Any additional insights since then?

Whitman: Yeah — two excruciatingly important facts. First, the plaintiffs are now well funded. And these state actions by Florida and Mississippi could be devastating. Like I said before, I think tobacco liability is going to make asbestos liability look like an odd lot.

OID: You don't think that the state laws will be thrown out as being unconstitutional?

Whitman: They could be. But I wouldn't want to spend my money hoping that that's so. As you say, I've got a lot of litigation background...

OID: Nobody's perfect.

Whitman: But one of the things that impresses me about the American judiciary is that you mostly get judges — and, to some extent, juries — who are very intelligent laymen who in effect say, "Let me sit down and figure out what this is really all about."

At least that's so when you get a well tried, well financed case. You get very intelligent layman judges who sit down and try to figure out, "Gee, what's really going on here?"

OID: So?

Whitman: So any thoughtful judge who takes a look at the tobacco industry is going to conclude that these guys have been guilty of poisoning the population. That's what's been going on...

OID: And as you pointed out, obfuscating with clearly disingenuous and obviously circular legal defenses.

Whitman: Exactly. So given a well-financed, well tried case, these guys are going to be dead.

OID: Which many would consider only fitting given the millions of deaths that most believe they've caused.

Whitman: Amen.

BUT WHAT I SAY ISN'T *ORDAINED* TO HAPPEN.
I JUST WOULDN'T WANT TO RISK *MY* MONEY.

Whitman: As you know, what opened my eyes was reading the Cippolone decision that the U.S. Supreme Court promulgated in July of '92. Everybody went to the

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from preceding page)

OID: Especially with \$1+ billion of loss carryforwards and some expertise in the financial area.

Whitman: Agreed. But that doesn't get a deal done. We need an attractive deal.

OID: It's a good start.

Whitman: Based on the ingredients and the statistics, Danielson has what it takes to be an extremely cheap stock. But its management has to perform.

OID: Modesty becomes you.

Whitman: I'm just trying to be realistic. We haven't done a deal yet of any significance with the resources we've created. We've been very skillful in creating the resources — a debt-free vehicle with tremendous tax losses and a pretty good insurance subsidiary. But we really haven't done anything yet of real significance on the acquisition front.

DANIELSON'S SELLING AT ONLY 1.6 TIMES BOOK
AND ABOUT 12-1/2 TIMES PRE-TAX.

OID: Could you help us get a handle on Danielson's current fundamentals?

Whitman: Danielson has 15.1 million shares outstanding. Year end book was just under \$4 per share. And we have something over \$1 billion in loss carryforwards.

OID: Or around \$70 per share in loss carryforwards.

Whitman: That's right. They're huge. And for all practical purposes, we won't have any serial expiration — which in effect means that we'll never have to pay taxes. We'll be tax-sheltered forever.

OID: Sounds like the investment publishing business. What can you tell us about your existing businesses?

Whitman: Our workers' comp insurance company in California is doing very, very well. It'll probably have written premiums this year of about \$100 million. And maybe we'll get the combined ratio down to something slightly over 100 and trending down.

We also have a small trust company in San Diego where, I think, the verdict is still out on how profitable it's going to be. We've got to build up the business.

It's OK, but it's not like our insurance company — which I think is a proven quantity. They increase earnings every year and they're very conservatively run and well reserved as far as I can tell.

OID: Can you give us some idea of the earning power of your current operations?

Whitman: Yeah. I'd say \$6 to \$9 million — maybe \$6 to \$10 million. It's insignificant compared with the earnings potential inherent in having the parent company make one or more meaningful acquisitions of profitable businesses.

OID: Before and after tax.

Whitman: That's right. That's a very rough guesstimate. And it's not exactly a forecast, but rather earning power under present conditions.

OID: And would you say present conditions are average, below average or above average historically speaking?

Whitman: They're average. The trust company is slightly below what we ought to be able to do. And the workers compensation insurance business is average.

OID: I gather that most of Danielson's earning power is in the insurance company.

Whitman: Virtually all of it. I mentioned before that there are certain businesses that can fall off a cliff and give you a lot of unpleasant surprises. Well, I imagine that this is one of them. The best managed workers' compensation insurance company in the world can do that to you. It's just the nature of the business and its liabilities.

But our insurance subsidiary is all right. It's a well managed company.

OID: So what's \$6 to \$10 million of earnings power in those businesses worth?

Whitman: Danielson is like Berkshire Hathaway — it's a nonregistered investment trust masquerading as an operating company.

OID: Would I be wild-eyed to give it 10 times operating income?

Whitman: I don't think so.

OID: In that case, \$6 to \$10 million of earnings divided by Danielson's 15.1 million shares outstanding would imply operating earnings of 40¢ to 67¢ per share and a current value of \$4 to \$7 — before adding anything for loss carryforwards or future potential.

Whitman: That's probably not too far off — although, as we discussed, you can currently buy other companies in the same business today for a much lower P/E.

OID: And Danielson's current price?

Whitman: Around \$6-3/4.

OID: Or about 12-1/2 times normalized pre-tax.

Whitman: That's right. So give it whatever multiple you want. It's OK with me.

OID: If only the market were so accommodating.

Whitman: The thing that will make or break the common stock, in my opinion, is not the operation of the two subsidiaries, but what we do with the resources at the holding company — a little bit of cash, no liabilities and huge tax attributes.

It seems to me Danielson ain't worth a tinker's damn unless I can put \$20 to \$50 million of normal earning power in it — in other words, unless I can do an LBO.

OID: And this seems to be a terrific environment for it.

Whitman: Yeah, I think so — in the abstract, yes. That's true. But we haven't done a deal yet.

OID: Is there anything else tremendously compelling that we didn't talk about?

Whitman: You've got my favorites.

OID: Bless you.

Whitman: My pleasure.

—OID