Outstanding Investor Digest

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

Volume XI Numbers 5 & 6 December 31, 1996

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ROBERTSON STEPHENS CONTRARIAN FUND'S PAUL STEPHENS
"THE NEXT SECULAR BULL MARKET WILL BE IN NATURAL RESOURCES & COMMODITY-BASED SECURITIES."

According to *Morningstar*, Paul Stephens has maintained 20%± of Robertson Stephens Contrarian Fund's assets in short positions and 2% or so of its portfolio in puts. And even the vast majority of his *long* positions have been in the securities of natural resource and commodity companies. So you can understand why he might not have done so well.

However, despite those seeming handicaps, Stephens somehow managed to earn a 19.8% per year return and

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FRANKLIN MUTUAL SERIES FUNDS' MICHAEL PRICE, RAY GAREA, LARRY SONDIKE, DAVID WINTERS, ET AL.
"THE PRESS HAS GIVEN ME *MUCH* TOO MUCH CREDIT. WE TRULY USE A TEAM APPROACH."

Franklin Mutual Series Fund — formerly Mutual Shares — has been the model of consistent excellence under the leadership of Michael Price. For the last 21 years, the fund has earned a compound annual return of 20.2% after all fees and expenses versus 15.6% per year for the S&P 500 — with far less volatility along the way.

Part of the formula — investing in bankruptcies and special situations — has been a page straight out of the book

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BARON ASSET FUND'S RON BARON
"WORRY ABOUT THE BUSINESS, NOT THE STOCK MARKET."

Ron Baron founded Baron Capital Management in 1983 — the year small-cap stocks began a stint in the doghouse. Despite that unfortunate timing, however, and what Baron terms "the worst year of his career" in 1990, he still managed a compound annual return of a rock-solid 22.2% vs. 16.8% for the Russell 2000 for the five years ending 11/30/96.

We're pleased to bring you some of his perspectives on investing generally along with some of his favorite ideas today from the Baron Funds' Fifth Annual Investment Conference.

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CENTURY MANAGEMENT'S ARNOLD VAN DEN BERG
"THE STOCK MARKET MAY BE STRETCHING IT, BUT THESE IDEAS CERTAINLY AREN'T."

As a 13-year-old in an East Los Angeles neighborhood, Arnold Van Den Berg was still physically underdeveloped from three years in an orphanage in Nazi-occupied Holland. To overcome his lack of strength, he took up rope climbing with such commitment that he set a record in the event — climbing 20 feet in 3.5 seconds — at his school that lasted until the event was discontinued about 15 years later.

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ROBERTSON STEPHENS'
PAUL STEPHENS
(cont'd from page 1)

Morningstar's coveted Five Star rating.

No one who knows Stephens should be surprised. After all, as we pointed out in our April 16, 1993 edition, he's a walking bundle of contradictions — a venture capitalist who buys growth stocks at value prices and an out-of-favor value investor who buys broken IPOs, biotechs and gold stocks (in emerging markets) in the same portfolio, to name just two.

We know we can always count on Stephens for a candid, no-holds-barred perspective and two or three ideas which are well off the beaten path (to say the least). Therefore, we're pleased to bring you the following excerpts from his comments at the *Grant's Interest Rate Observer* Fall Conference held October 30th, 1996 in New York.

PREDICTING THE MARKET IS A WASTE, BUT BEING HEDGED IS A MUST.

Predicting the market is a waste. Being hedged is a must.

Paul Stephens: At Robertson Stephens, I work closely with a team of ten analysts and subportfolio managers in managing a unique public mutual fund called the Contrarian Fund. It's about three-and-a-half years old.... [T]his group manages four other public mutual funds that own a lot of the same stocks.... We have a lot of cross-fertilization of research ideas and it's a real team effort that's working quite well.

We don't try to time the market, but we feel it's imperative and prudent to always be hedged in the classic hedge fund model.... Predicting... the stock market is a game the media has to play. I think it's a waste of energy and I don't think anybody knows what's going to happen with the stock market or where it's going to go tomorrow.

So we don't really focus on that at all. We spend all our time researching stocks and looking for things out of the mainstream where there isn't much competition. My favorite Warren Buffett quote, out of Roger Lowenstein's fabulous new book, *Buffett: The Making of an American Capitalist*, is "forecasting the stock market tells you a lot about the forecaster — it tells you nothing about the market." It couldn't be better said.

We try to do the opposite of what Wall Street's doing today.

As contrarian investors, we strive to reduce risk by buying out of favor stocks, or low expectation stocks — which is the opposite of what momentum investors are doing so prevalently on Wall Street today. We try to be

(continued in next column)

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visionary on new themes. We try to be aware of change in really "doggie" industries — in areas that are boring to most people — and be highly focused on the discovery of new ideas that haven't yet been picked up on Wall Street.

Timing is always difficult when you're a contrarian. And if you're four to five years early, that's also called being wrong. We'll get to a couple of our specific ideas that hopefully are timely in a few minutes....

What we want: Unrecognized, cheap growth with a catalyst.

One of our new mutual funds — called the Robertson Stephens Global Low-Priced Stock Fund and managed by Hannah Sullivan (who's worked with me for five years) — is a subset of this contrarian philosophy. What we look for, in our new Global Low-Priced Stock Fund and in our Contrarian Fund, are three things:

(1) First, we look for a very cheap stock price. But we're really trying to buy growth stocks at value prices. My Robertson Stephens heritage is to invest in growing businesses. I just don't want to pay the multiples being asked for today in most of the companies Wall Street's all excited about. This first criteria — low valuation — hopefully, is buying at one times revenues or less.

(2) Our second criteria is minimal institutional ownership and minimal research coverage by Wall Street.

(3) And third, and most importantly, is the presence of a catalyst for change. The catalyst is usually a change in management or the development of a new product. Sometimes it's a re-rating of an industry that was trashed for some reason.

Don't *leave* the party early just because you *came* early.

The HMOs are a perfect example. We got very involved in buying the HMOs in 1988 and 1989. Every single HMO at that point in time traded under $2 per share — US Healthcare, United Healthcare, Sierra Healthcare. Every one of them that was public was under $1 or $2 per share — and you could buy as much as you wanted. MaxiCare had gone bankrupt and all the analysts had given up on the industry. It was just a classic example of an industry that people thought was too cyclical or was going away.

And guess what — these stocks are all up 30 to 50 times in the last six or seven years. We bought a lot of them, but unfortunately sold them after they tripled and left a lot on the table.

That was an example of doing research where everybody else had stopped looking. But the lesson learned is not to *leave* the party early just because you *came* early.

Energy in the third year of a ten-year bull market.

Energy stocks were contrarian in the early 1990s. We spent a lot of time looking at oil and gas stocks starting in the spring of 1992 when the price of natural gas fell under $1 per mcf. And, today, we're still invested in energy.

But the energy area is no longer really contrarian — and I think they're beginning to become momentum stocks. Currently, the party is in full swing. So we still have full positions of around 13-15% in energy. And we think we're now in the third year of a ten-year bull market in energy.

(continued on next page)

ROBERTSON STEPHENS'
PAUL STEPHENS
(cont'd from preceding page)

THE BEST WAY TO PLAY EMERGING MARKETS —
GROWTH GOLDS AND BASE METAL COMPANIES....

The best way to play emerging markets....

Other contrarian ideas we're currently excited about are investing in China, Indonesia, Vietnam and Myanmar — areas that very few investors are especially interested in. And the best way to play these newly emerging markets is through natural resource companies.

So we're heavily invested in the natural resource sector and overweighted in the newly emerging markets of the world that have economic growth of 7-10% a year — three to four times what we see here in North America.

If you don't seek, you won't find.

Most of the countries that we're spending our time looking at you wouldn't have *wanted* to visit over the last 30 to 50 years. Or, in many cases, you weren't *allowed* to visit the country.

Hence, no exploration activity occurred. And you don't find major discoveries of oil and gas, nickel or gold unless you're putting *holes* in the ground.

We're currently buying growth golds & trashed base metals.

Besides investing in growth golds (that I'll get to in detail in a few minutes,] we're also currently buying base metal companies. Most of those have really been trashed — [companies in] aluminum, nickel and copper.

Many international investors are closet indexers.

As an aside, in doing emerging market investing, I've done an awful lot of traveling in the last five years — a lot of time in airplanes and helicopters. One thing I've noticed is that a large number of the emerging market investors manage their portfolios in a closet index fashion, though most of them won't admit it. They spend all their time on macro factors. What's the central bank doing in Indonesia? What are the cash flows in or out of Malaysia?

Then, once they decide they like the country, they buy the five or ten largest market caps in that country. Or often, if they like Mexico, they just buy Telmex, or if they like Brazil, they just buy Telebras. Most of them do very little in-depth stock picking or digging beyond the obvious top ten names in each country.

WE BELIEVE THAT THE NEXT SECULAR BULL MARKET
WILL BE NATURAL RESOURCES & COMMODITY-BASED.

More and more, you're going to see a global perspective....

Once we decide on a theme — like natural resources today or, maybe, semiconductors three or four years from now — we invest in that theme on a global basis. I think that's a trend that you're going to see more and more. The Morgan Stanleys, Morgan Banks, Goldman Sachs and a few of the international firms are now following industries on a global basis.

I think that makes a lot of sense. I don't know how investors can own a U.S. semiconductor business and not know what's going on in South Korea, Taiwan or Singapore. Or if you're going to be in the nickel business or the aluminum business and you're not aware of what's happening globally, you're going to get hurt or blindsided.

Next secular bull market will be in natural resources....

We believe that the next major secular bull market move over the next three to four years is going to be in natural resources and commodity-based securities. And, so, we're doing something about it. We're very aggressive in the way we've tried to exploit this opportunity.

New consumers will create demand for many commodities.

This is not a bet on increasing inflation. At the core, it's really the 2-1/2+ billion new consumers who are in the process of coming into the world marketplace from Indochina, mainland China and India and another billion consumers from the former Soviet Union who are starting to buy things. These 3+ billion new consumers are going to be buying air conditioners, washing machines, motorbikes, pots and pans, telephones and beer and Coke cans made of aluminum. All of these products use or are made of stainless steel (which is 60% nickel and 40% ferrachrome), copper or aluminum, and oil and gas. So these are some of our major investment themes.

WE *EXPECT* HIGHER COMMODITY PRICES.
WE'RE JUST NOT *RELYING* ON 'EM.

We do expect higher commodity prices....

Within the natural resource arena, I'd like to explain for a minute how we approach this group differently than most traditional commodity investors. Most natural resource players want the most leveraged plays to a price increase in the commodity. Price increases will eventually happen. We think it will occur with gold, with nickel and to a lot of these other commodities. And it's already occurring with oil and gas.

We're buying growth stocks in the natural resource sector.

Our focus is different though — probably because of the Robertson Stephens heritage of being in the Silicon Valley and focusing on growth stocks for the last 27 years. All of the efforts of our investment management team — and we have geologists on staff — are focused on companies that are growing their reserves.

We're not gold bugs wishing for the price of gold to go up like many people have been for the last 15 years. We're trying to buy growth stocks in the natural resource sector. We only buy growth gold companies — companies that are growing their reserves. If proven reserves go from 2 million ounces to 10 million ounces to 40 million ounces, you own a growth stock.

The best growth golds are focused on exploration properties, almost exclusively outside of North America....

We have growth golds in Asia, Africa and Latin America....

Our growth golds are operating in Southeast Asia in a major way — primarily in Indonesia. In West Africa, it's in countries like Ghana and Mali. Throughout Latin America, it's primarily in Chile, Brazil, Argentina and Peru. And, most importantly, in Latin America, its the Guiana Shield — those

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ROBERTSON STEPHENS'
PAUL STEPHENS
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three little countries, Guyana, Surinam, and French Guiana, along with Venezuela — where there's been much exploration success. And it's been going on for about five years.

Even in the former Soviet Union....

Lastly is Kazakstan, in the former Soviet Union, where huge deposits are now coming on stream and being developed by Canada's First Dynasty Mines and Teck Corporation and by a company traded on the London Stock Exchange — Bakyrchik Gold. These three companies are developing two of the largest proven gold deposits in the world. One is 9 million ounces of gold at Vasilkovskoye — and the other is 13 million ounces at the Bakyrchik mine. We have positions in all three of these companies.

WE'VE HAD A LOT OF SUCCESS IN MINING SO FAR — FOR EXAMPLE, DIAMOND FIELDS & GOLDEN STAR.

Diamond Fields Resources was up 35 times in 2-1/2 years.

We've had a lot of success in the mining area in the last five years, most recently with a company called Diamond Fields Resources that was acquired by Inco for C$4.3 billion. Our investors made about 35 times [their money] in 2-1/2 years.

And Golden Star Resources was up a bunch this year.

Most investors who buy gold companies own Homestake, Echo Bay, Battle Mountain, Placer Dome — and we don't own any of those. Golden Star Resources has been our favorite growth gold for the last four years, but it's up [a ton] this year. It's easy to like it. We still own 100% of the 9.9% of the company we bought four years ago.

We expect them to triple reserves in the next 18 months.

It's still not that well known, but it's aggressively growing its gold reserves. They're up to about 2-1/2 million ounces right now. We think they'll be at 7-8 million ounces in the next 18 months. And they've joint ventured with an excellent gold company that most investors haven't heard of called Cambior [CBJ/AMEX].

INDOCHINA GOLDFIELDS HAS THE RIGHT STUFF — IN TERMS OF MANAGEMENT, CAPITAL & PROPERTIES.

One that's down, cheap, unknown, well capitalized & more.

But I'd much rather tell you about a new stock that's down and cheap and that might go up a substantial amount in the next few years — and that's Indochina Goldfields.

I doubt if anyone in the room knows the company. The symbol is ING on the Toronto Stock Exchange and the Australia Stock Exchange. It did its IPO at C$15 per share in July of this year. It's now C$9-1/2 per share — and it's got U.S.$200 million in cash. Cash represents about a third of the current stock price, it has no debt and has excellent management.

It has an outstanding COO and an outstanding geologist....

One of the best mining companies in the world in terms of management is RTZ in London. And their number three executive — Gordon Toll — left to become Indochina Goldfield's chief operating officer about a year ago. And he has had a major impact on the company.

ING's president is Ed Flood who worked with me for three years as our in-house geologist at Robertson Stephens & Company. Ed's an outstanding international geologist.

They've tied up key ground & some interesting properties.

The company currently owns 50% of a world class low-cost copper mine in Myanmar. No one likes copper right now, but I think that will change in the next year or two. And they begin production in 1998.

Indochina Goldfields was one of the first companies to tie up very key ground in Indonesia — primarily on the islands of Java and Kalimantan which used to be called Borneo. Java and Kalimantan are the prime places in the world to be finding elephant type discoveries — which are 10 to 20 million ounce gold discoveries. It used to be a big deal if you had a 1 million ounce discovery.

The company also owns the control blocks of two other interesting gold companies. The first is 18% of Emperor Mines, an Australian company whose gold properties are on the island of Fiji where they have 2-1/2 million ounces of proven gold reserves which should grow to about 5 million in the next few years. They currently produce 150,000 ounces per year of gold, And that should grow to 250,000 ounces per year in a few years.

They also bought 27% of Bakyrchik Gold which has proven reserves of 4 million ounces and a gold resource of an additional 9 million ounces.

PORTFOLIO REPORTS estimates the following were Robertson Stephens Contrarian Fund's largest equity purchases during the quarter ended 9/30/96:

1. INDOCHINA GOLDFIELDS LTD
2. METROMEDIA INTL GROUP
3. TECK CORP CL B
4. GRACE W R & CO
5. NORMANDY MINING LTD
6. NGC CORP
7. WILLIAMS COS
8. TARRAGON OIL & GAS LTD
9. HARMONY GOLD MINING CO LTD ADR
10. KN ENERGY INC

A classic contrarian bet & our largest growth gold holding.

Indochina Goldfields is currently hated by anybody who bought it on the IPO at C$15 in July. The drop occurred at the time of the Sumitomo copper scandal this summer. And then both the IPO market and gold stocks got crushed in July. So it's a classic contrarian bet on a broken IPO.

With $200 million in cash and outstanding properties, it's our largest growth gold position. We've bought it almost every day since the IPO — at C$11, C$10, and now at C$9-1/2 per share.

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ROBERTSON STEPHENS'
PAUL STEPHENS
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IN CALGARY, ENERGY'S SELLING AT HALF THE PRICE FOR FASTER GROWTH AND LOWER FINDING COSTS.

Calgary-based oil & gas is half the price & otherwise better.
We are 13% weighted in energy — with most of the emphasis on natural gas companies. We've been invested here for a while, with a lot of exploration and production companies and energy service companies.

I guess the most interesting thought is that 80% of our holdings are headquartered in Calgary. You can buy businesses — both oil and gas in the ground, and energy service companies — at half the multiples of their U.S. energy counterparts. What trades for 7-8 times cash flow here sells for only 3 to 4 times cash flow in Canada.

Plus, these companies are growing dramatically and the Canadian oil and gas companies have lower finding costs. My partner, Andy Pilara, spends a lot of time in Calgary.

EVERYONE HATES ALUMINUM STOCKS TODAY — LIKE MAXXAM AT 20-30% OF BREAKUP VALUE.

What may be the most contrarian idea right now — cash....
In terms of other contrarian ideas — I guess cash must be the most contrarian investment you can make right now. However, we don't get paid to hold cash.

Everybody hates aluminum stocks right now....
We have a 6% commitment to aluminum — that's contrarian. Everyone hates aluminum stocks right now. Andy Pilara has done a lot of work in aluminum and feels very strongly that 1997 and 1998 will see a major reversal from today's depressed aluminum environment.

It's hard to buy growth aluminum companies. So here we've focused on supply and demand and on the price of aluminum going back to the 90¢ to $1 a pound range, or higher. We've invested in companies with the best operating leverage — namely, Kaiser Aluminum [KLU/NYSE] and Alumax [AMX/NYSE].

Kaiser is dirt cheap. But the best way to buy it is MAXXAM.
Kaiser's dirt cheap at $10.50 per share. The best way to buy it is to buy the holding company that controls it. And that's a company some of you know called MAXXAM [MXM/AMEX] that owns 50 million shares of Kaiser....

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And there's no debt at all at the MAXXAM level. All of the debt is nonrecourse and at the subsidiary level.

MAXXAM's selling at 20-30% of breakup value....
So Maxxam is a very cheap natural resource holding company that's doing some very creative things. We come up with somewhere between $150 and $250 per share for its true breakup value. And you're paying very little for it at $40 per share [today].

And some of that breakup value may be realized soon....
MAXXAM also owns 100% of Pacific Lumber. There's lots of negative news about redwood trees and the Headwaters Forest. But that will likely get settled over the next 12 months. And, then, 25% of Pacific Lumber may be offered as an IPO.

WOULD YOU BELIEVE HOUSING AT $15/SF AND VINYL DOORS FOR COCA-COLA TRUCKS?

One of the most innovative, new growth companies I've seen.
For the last year, I've been very vocal about what I think is one of the most innovative new growth companies I've discovered — called the Royal Plastics Group [RYG/NYSE] — which listed on the New York Stock Exchange a few months ago. It's a Toronto-based company most people haven't heard of.

Its stock is up about 100% from it's IPO a year ago. But I think it can grow substantially for the next 10 years.

PORTFOLIO REPORTS estimates the following were Robertson Stephens Contrarian Fund's top ten holdings as of 12/24/96:

1. ROYAL PLASTICS GROUP LTD
2. INCO INC
3. VOISEY BAY NICKEL
4. INDOCHINA GOLDFIELDS LTD
5. DUNDEE BANCORP
6. MAXXAM
7. GOLDEN STAR RESOURCES
8. KAISER ALUMINUM
9. ALUMAX
10. METROMEDIA INTL GROUP

They come up with one new product after another....
Royal Plastics extrudes vinyl (PVC) to make innovative building products. It's really a building components technology company. It has C$700 million in revenue and has earned 10% net after tax. But the few people that know it in Canada think it's expensive because an 18 P/E multiple is high in the building industry.

What I see is a creative management team that comes up with one new product after another. Last week, they announced that Coca-Cola has signed them up to build vinyl truck doors for their Coke truck fleet. They already make normal garage doors for houses in a joint venture with Overhead Door — and now Coke has asked them to manufacture lightweight doors for their trucks. There's 160,000 Coke trucks out there and it's $1,000 per truck. So they potentially have a new $160 million business —

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ROBERTSON STEPHENS'
PAUL STEPHENS
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because the Coke truck drivers are having back problems from lifting those heavy metal doors.

Most exciting to me is their housing solutions.

The creativity that comes out of Royal Plastics can be seen in a series of different products. The one that got me the most excited is the low income housing system they developed with its widest application being for the emerging markets.

I happened to be traveling in China for two weeks with several companies and met Royal Plastics in Beijing. And I stayed with management for a couple of days as they were signing a deal to manufacture houses for the city of Shanghai. In China, the biggest problem isn't food, but housing. People are leaving the farms and coming into the cities — and there's no place for them to live.

Their plastic has withstood 200 m.p.h. winds.

Royal Plastics has come up with a system of extruding 8 inch hollow ten-foot beams, that you slide together like Lego's, to form the permanent walls of the house. Then, the hollow beams are filled with cement. You're basically building cement structures of 1, 2, or 6 stories that have withstood 200 m.p.h. winds and hurricanes.

Homebuilding w/semiskilled labor at $15 per square foot.

If this technology had been around 40 years ago, there probably wouldn't have been a mobile home industry.

Vinyl is the same hard plastic that goes into the grill of your car — and the vinyl forms the permanent indoor and outdoor walls of the house. It's a great product. And you can build a 660 square foot house in three days with three semiskilled workers at a cost of $15 per square foot.

Royal Plastics now has housing plants in about four countries. And 60 countries either have model homes or are starting to build houses in the hundreds. I think it's a company you'll hear a lot about in the next 5 or 10 years.

THE OPPORTUNITY IN RUSSIA IS MASSIVE. UNFORTUNATELY, SO ARE THE RISKS.

Published figures for Russian stocks are "fantasyland".

I went to Russia about 3 months ago after people kept telling me I ought to buy Lukoil or Mosenergo — and Russia was suddenly very popular with all the New York hedge funds. So I spent a week in the Czech Republic and Russia with a bunch of macro investors. We saw the Central Bank, the finance minister and the IMF. And I learned a lot about macro investing. We visited GUM Department Stores in Red Square and a couple of the other oil companies.

One of the most interesting meetings was going to Arthur Andersen's Moscow office and talking to them about the "audits" they're doing on these companies. I said, "how do you really know if the numbers are real?" And they said, "we don't — they're guesses." They really don't. The numbers published for Russian ... stocks are fantasyland. So I see extra risk in direct ownership of Russian shares.

It's a massive opportunity, but indirectly is the way to go.

I think a better way to participate in the growth of the former Soviet Union is to own U.S., British, or Canadian companies operating in Russia with joint venture partners.

But I came away from the former Soviet Union thinking that here is a massive opportunity with a new market of a billion people that are just beginning to consume.

Business practices in Russia leave much to be desired....

But in terms of capitalism, I think the Russians went to the wrong movie. Managements all have their hands in the till trying to steal as much as they can as fast as they can. I don't think they understand capitalism in the way we'd like them to....

They don't understand that investors and shareholders are partners.... No one pays their bills. No one pays taxes. They often set up related party companies where they can take the profits into a separate company which they own [outright] — rather than the one you're invested in.

What they're doing isn't unheard of. It's just the degree....

The rumors are that the politicians and managements of privatized companies have illegally transferred hundreds of billions of dollars from corporate balance sheets to their private Swiss bank accounts. This is called "capital flight". And Russians now own the Rolls Royces and the fancy flats in London and the villas in the south of France.

This will eventually all change. And it's supposedly not all that uncommon in the emerging markets. I just think the Russians have taken it to a very high level.

One way to participate — Metromedia International Group.

Nonetheless, I'd still like to find ways to participate in the future growth of the former Soviet Union. We own a company that may be one way. And I'm going to try to find others. It's called Metromedia International Group [MMG/AMEX]. This is John Kluge's new vehicle. He's doing it again with his old Metromedia partner, Stuart Subotnik.

With Metromedia International Group, you own a U.S. company, traded here, with people who understand what shareholders are all about. The future of MMG is based on the wireless licenses that they're getting throughout the former Soviet Union — and also over into Beijing and other parts of China. It's paging, it's cellular, it's radio and it's wireless cable. And then they also own a movie library of 2,000 films which is estimated to be worth the current stock price of $11 per share.

I think it's a lower risk, open-ended call on the former Soviet Union without having to give your money to the Russians and hope that they give it back to you some day....

—OID

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FRANKLIN MUTUAL SERIES FUNDS'
MICHAEL PRICE ET AL.
(cont'd from page 1)

of his late mentor and teacher, Mutual Shares' founder, Max Heine. Another part of the formula, acting as catalyst to shake up companies that are mismanaged, undermanaged or that own underutilized assets has more recently come to the fore.

Since selling his firm to Franklin Resources and joining the Forbes 400, Price has probably adorned the cover of more financial publications than any money manager in recent memory — with *Fortune* even going so far as to suggest that his name was being used in some quarters as a verb to mean shaking up managements of public companies who had become too comfy at shareholder expense.

Here are Franklin Mutual Shares Fund's annual returns alongside those of the S&P 500. (All figures were provided by Mutual Series Fund, Inc. and *Ibbotson Associates*.)

Year	Mutual Shares Annual Return	S&P 500 Total Return
1975	+34.1%	+37.2%
1976	+55.2	+23.8
1977	+15.6	- 7.2
1978	+18.1	+ 6.6
1979	+42.7	+18.4
1980	+19.4	+32.4
1981	+ 8.9	- 4.9
1982	+12.9	+21.4
1983	+36.6	+22.5
1984	+14.5	+ 6.3
1985	+26.7	+32.2
1986	+17.0	+18.5
1987	+ 6.3	+ 5.2
1988	+30.7	+16.8
1989	+14.9	+31.5
1990	- 9.8	- 3.2
1991	+21.0	+30.5
1992	+21.3	+ 7.7
1993	+21.0	+10.0
1994	+ 4.5	+ 1.3
1995	+29.1	+37.4
1975-95	+20.2%	+15.6%
1986-95	+15.0%	+14.8%
1991-95	+19.1%	+16.6%
1993-95	+17.8%	+15.3%

We're particularly pleased to bring you excerpts from comments by Price and associates Rob Friedman, Larry Sondike, Ray Garea, Jeff Altman and David Winters — at the latest annual meeting of Franklin Mutual Series Fund which was held on October 25th plus conversations with Ray Garea, Rob Friedman, Larry Sondike and David Winters from December 2nd right up to press time. We hope that you find their perspectives on a variety of industries and companies plus their insights on some current bargains (believe it or not) as intriguing as we do.

WE CONTINUE TO BE BIG BELIEVERS — BOTH IN MUTUAL AND OUR APPROACH.

We're *highly* incentivized for our funds to perform well....

Michael Price: The structure of the merger was designed to ensure continuity of management — because you don't fix what isn't broken. We're all staying five years or more. We're all very happy doing what we're doing.

And we're *highly* incentivized for the funds to do well, both in terms of money invested in the funds and performance incentives for the funds to do well — not just in growth in assets, but [investment] performance — because we know that if you don't perform well, you're not going to grow your assets whether you're a load group or a no-load group.

We believe in this place and this approach going forward.

Price: So we are all absolutely big believers. I think I'm the *biggest* believer in this place going forward. And that's why I was willing to structure the merger with a very large investment in the ongoing company. My family already has a lot of money in [the funds at] Mutual — and we're going to have a lot more in Mutual — because we're believers in this approach to investing.

Some of the people here have been shareholders for 10, 20, 30 and 40 years. Ernie Low is here. He's been a shareholder since the early 1950s. He's an old friend of Max [Heine]'s.

He knows that this approach works. And these fellows who have been working in this approach for 8-10 years are huge believers.

So I don't see any changes because of the merger — any difference in what we do for a living — [which is] to put the money to work well. The whole goal is to compound at 15% with less risk than the market in general.

We spend our time appraising companies and waiting.

Price: As many of you know, we get here with a three-pronged approach. First, we invest in stocks based on their asset values.... So we spend our time trying to figure out what companies are worth. And then we just wait for the market to hand them to us 30-40% cheaper than that. That's roughly half or two-thirds of your money depending on the market.

Second, securities of distressed/bankrupt companies.

Price: The other third of the money is in cash, which is ammunition, and in claims against bankrupt companies — which is a very fertile way to create cheap common stocks. And in this country, the bankruptcy process works very, very well. It's efficient. Companies go in — and they come out. They don't get liquidated too often.

And through buying bank loans and trade claims and publicly traded bonds at large discounts from their par value, we're able to create the new company's equity — like we did in Sunbeam — very, very cheaply.

Third, mergers, takeovers and liquidations....

Price: Third, we invest in companies involved in mergers, takeovers and liquidations. We've done that for a very long time. And that's been a very busy area this year.

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The result: our historical performance with less risk.

Price: That three-pronged approach has given us the performance and the lower volatility we've had. And, I think, if we keep doing it right, it entails less risk than the market in general....

I'LL BE DOING SOMEWHAT LESS, BUT I'M GOING TO BE WATCHING.

I have contractual and monetary incentives to stay here.

Shareholder: There's been a lot of speculation ... that you would be leaving in one or two years. But you're sort of indicating that you intend to remain in charge of the fund for five years. Is that correct?

Price: Well, I have a five-year contract. And I'm also required to be there investment-wise with a lot of money in the funds. So I'm certainly going to pay attention. And, third, there's an earnings incentive to stay. So I have three reasons involving my contract and money to stay. Plus, ... you just don't walk away from a place you've been [at for] 21 or 22 years.

Shareholder: Can you opt out of your contract with Franklin? And can Franklin terminate your contract?

Price: No. It's a no-cut contract.

Shareholder: And can you sell your shares?

Price. No. I've committed to invest a huge amount of money in ... all the Mutual Series funds for a 5-year period.

My associates will do more and more. I'll do less and less.

Price: And standing at this desk are the people who really run Mutual day-to-day — Larry Sondike, Jeff Altman, Ray Garea, Peter Langerman and Rob Friedman. Rob's stationed in London this year. He'll come back in the next year and maybe someone else will go over. These are the people — with another 11 who are the analysts — who work on the situations, call and visit the companies, talk to the traders and do all of the day-in and day-out work. And we all sit and talk and have a good time doing it.

Peter and Jeff have been here since '86, Larry probably from '84, and the others from '88 or '89. So everybody's been here 6, 8, 10 years — 12 years. And they're all staying. I'm staying. It'll be this team in the future the way it's been in the past....

And these guys are chomping at the bit to do more and more. And over this five-year period, they'll do more and I'll do somewhat less. And I'll watch how well they do. I have all of the confidence in the world in them. So that's the transition.

(continued in next column)

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I've gotten *much* too much credit for this place.

Price: We're truly a team approach. The press has given me *much* too much credit for this whole place.

I think we will be more than ever incentivized to perform well — because the mutual fund industry, I think, is just about the most competitive industry in the country. Our report card — our [share] price — is in the paper every day.... We don't report earnings quarterly. We report 'em *daily*.... And it's real competitive. We have to perform for you. If we don't, we don't get any of the money in the earn out.

Five years is an arbitrary figure. I love what I do.

Price: [But] I happen to love what I do. It's an option on my part to just stay. I don't think you sign contracts for longer than five years. Lawyers tend to put a number down in a contract and it happened to be five years. So we'll see how it goes.

NOTHING AROUND HERE WILL CHANGE — EXCEPT EVERYTHING WILL BE ENHANCED.

We'll have total autonomy....

Shareholder: Will you have complete autonomy?

Price: On the investment side, we will have total autonomy. Our office is down the road in Short Hills — and we'll stay in that office. We'll stay in the same trading room and trading desk with the same people. In fact, we'll be able to expand our group to add junior analysts.

Franklin isn't going to interfere in what we're doing.

Price: Franklin won't ever call — we've talked about this — and say, "Michael, you should look at this situation or that situation." That's just not going to happen. They appreciate our style.

Remember Franklin was largely a fixed income firm. Templeton was largely an international investing firm. We're largely a U.S. domestic equity manager. They didn't have that. Bill Lippman does run some terrific funds at Franklin — Balance Sheet Investors, a micro-fund. He's dealing in some areas that overlap with us, but not to a great degree. We have our own style. And they're not going to interfere in what we're doing....

And I'm not working part-time. This isn't a part-time job.

Shareholder: Is your contract term full-time?

Price: Oh, *yeah*. *Everybody*'s full-time. It's not a part-time position. No one's coming in part-time.... And then there are additional people — another 11 — with three-year situations.

And that all depends on performance. If they do well, they're going to be paid very well to stay. If they don't, then we'll find *other* people.

Nothing will change — except everything will be enhanced.

Shareholder: You're saying Mutual Shares will be the same as Mutual Shares is today.

Price: Right.... Your stock will remain a no-load stock. It'll continue to be listed under Mutual Series in the paper. It will be run by the same group of people who have run it in the last 10 years. And I'm going to be involved — and I've been here for 21 or 22 years. The approach, the style

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FRANKLIN MUTUAL SERIES FUNDS'
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— everything about it — will not change. And everything about it will be enhanced by this deal. It will get smarter....

WE'VE HAD ONE OF THE BEST TRACK RECORDS *AND* ONE OF THE LOWEST EXPENSE RATIOS....

We're going to learn a lot from Franklin. We'll get smarter.

Shareholder: I want to quote something from *Morningstar* dated August 30th, 1996:

"The drafters of the Investment Company Act of 1940 saw fit to give independent trustees a distinct role.... The fund's advisor has the duty to interpret the fund's investment mandate faithfully, but also to seek to maximize the total profits of managing the fund's assets. Only independent trustees — those with no direct ties to the advisor — are paid specifically to safeguard shareholders' interests."

It goes on to say:

"One of the simplest ways for fund trustees to serve investors is to exert pressure on the advisor to keep expenses modest."

Back in the 1970s, if I recall correctly, Mutual Shares had $5, $10, $20 or $25 million — certainly it was less than $100 million — under management. So you're entitled to get more money because the fund has grown. But I believe that the shareholders are entitled to see the benefits of the reduced expenses of the growth of the firm. It's obviously not 10 times as expensive to manage a firm with $10 billion under management as it is to manage a firm with $1 billion.

Price: I agree with a lot of where you're coming from. And I'm one of the directors, too. I'll be the largest shareholder in Mutual. So keep that in mind....

[As for your comments on independent directors,] our board will be made up of 12 directors. And I believe that the interested directors will only be Mr. Lippman, Mr. Price and Mr. Langerman. So that's three interested and nine disinterested. Some of the directors will be on other Franklin/Templeton boards. And the thought there is that over time — because Franklin/Templeton is running 110 funds and is very skilled at the best ways to get printing jobs done, organize annual reports and service shareholders — we'll have a cross-fertilization from all of the experience in the Franklin/Templeton group to the Mutual group.

We've been basically a small fund company for years. We've evolved into a big fund. And in this partnership, we're going to learn a *lot* from them. Adding Mr. Milsap and Mr. Heinz and one or two others who are [already] on the boards of Franklin and Templeton funds will, I think, be a terrific benefit for Mutual shareholders. We'll get smarter.

Mutual's been both unique and a bargain for years.

Price: The board negotiates the advisory contract annually — the fee and the terms — with the advisor. And since 1949, that negotiation has resulted in Mutual Shares having one of the best track records in the industry and one of the lowest expense ratios in the industry.

One of the things the board does when they look at the contract, the actual expense ratio and the advisory fee is to compare it to what else is out there. And it's always been in the middle or below the fund industry [average].

The two foreign funds — where our expenses are *much* higher — are at 80 basis points. And Mutual Shares at 60 [basis points] is below the industry average. You can't get the kind of investing that we do, I don't think, anywhere else in the [mutual fund] industry — the mix of bankruptcies, deals and cheap stocks — in any other mutual fund group. If you [do] want to duplicate it, you have to buy partnerships. And their fees are 1% plus 20% of the profits in many cases.

So I've thought that Mutual's been a bargain for *years*....

We get terrific, cheap execution. It's our money, too.

Price: On the trading side, we do a lot of business. We do it with everyone on Wall Street. Typically, we do it at 4-5¢ per share. And we get terrific executions. On the telephones on our trading desk, each turret has 15 pages of 40 lines [each]. That's 600 different lines. We're using 300-400 of 'em now — to domestic and foreign brokers. We have nine floor brokers on the New York Stock Exchange, three on the American, wires to Over-the-Counter firms — wires *everywhere*. And we trade as cheaply as we can. Once again, remember it's *our* money, too....

BIG ISN'T NECESSARILY BAD.
E.G., SEARS, ITT AND CHASE.

Big isn't necessarily bad — for example, Sears....

Shareholder: Some worry that if Mutual Series funds get a lot more money, they'll have to go to larger cap stocks and, therefore, be a lot less nimble. Do you feel very confident that the Mutual Series funds will do as well in the future as they have in the past?

Price: Some of our best situations have been the largest cap stocks. A perfect comparison is Sears Roebuck — which Rob Friedman got us involved in — versus Wal-Mart five years ago. Wal-Mart stock was $25 — and Sears was $33. In the past five years, Sears went from $33 to today's price in the high $40s. But, meanwhile, it's given us stock in Allstate and stock in Dean Witter and cash distributions. So adjusting for all of those distributions, Sears's stock is probably $120 — and Wal-Mart is still $25.

That's the difference between a growth stock that doesn't grow or whose growth slows and a value stock where the value's unlocked. And Sears had 350 million shares outstanding. So it was a huge market cap.

[Editor's note: Actually, we estimate that Wal-Mart had a larger market cap than Sears, but who's counting....]

We've owned ITT (profitably) several times in years past.

Price: And we find other ... [big cap investments]. For years, Larry Sondike has worked on ITT. And we've probably owned it three or four times in the last 12 years. We've made money *every* time. As you know, ITT split into three parts. We traded out of all three parts.

Now we're starting to buy back the three parts — two

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of the three parts anyway. Big cap stocks, remember, are more liquid. So it's easier for us to move around.

And Chase isn't exactly micro-cap, either.

Price: And maybe some of you are aware we bought a few shares in Chase a year and a half ago. Ray Garea said, "Chase is too cheap at $35. It's worth $65. So it fits Mutual."

So Ray bought 11 million shares of Chase. The stock today is at $84. We still own a lot of stock. And *that's* a big cap stock. So there's nothing wrong with big cap or little cap. If we're walking down the street and there's a $20 bill lying on the street, we're going to bend over and pick it up — big cap, little cap, we don't care. We want to make money for the shareholders.

EVEN IN EXPENSIVE MARKETS (LIKE TODAY'S),
WE FIND POCKETS OF OPPORTUNITY....

Despite a Dow near 6,000, we're finding things every day.

Shareholder: I understand that you basically look at one investment at a time.... But would you give us your comment on the general market, the huge flows of new money going in and what you foresee over the next few years?

Price: We find pockets of opportunity in groups that haven't performed well. So the overall market might be making new highs at 6,000. But inside that market, you've got HMOs that got destroyed in July.

You've got companies here and there with weak earnings in a quarter that surprise the Street — and the stock drops ... from $45 to $15. That's the shift from the *growth* stock guys to the *asset* guys — the *value* guys. When a stock goes from $45 to $15 on weak earnings, what you're seeing is the growth guys getting out and the value guys buying it — because the value is probably $20.

So we find things every day.

Ray Garea: HMOs continue to be very cheap. We continue to believe that within the health care sector they are probably best positioned to grow. But they're not for the faint of heart. They're very volatile. And you have to pay attention. But we continue to find the area attractive.

We think Horizon Healthcare is cheap.

Shareholder: Do you still consider Horizon Healthcare to be a plus?

Price: Yeah. We own the stock. We think it's cheap. In fact, I'm going to see 'em Monday in Albuquerque. And we're trying to make it *not* cheap. We're trying to get it up.

It's getting late in the day for financial stocks. But Chase....

Garea: ...In terms of [other] things [we've done] lately, we've made a lot of money in the financial sector in a variety of ways. But I think it's getting late in the day. The risk/reward is changing a bit in that arena.

We still own a very large position in Chase. It continues to be one of the cheapest banks out there, and one whose prospects are certainly above average. We've also done a lot of other companies....

TODAY, U.S. WEST MEDIA GROUP IS *CHEAP*.
BUT WHEN THE CLOUD LIFTS, IT'LL DO VERY WELL.

A good example of what we do....

Larry Sondike: U.S. West Media Group is a good example of what we do. We initially bought U.S. West, Inc., — [which is] a Bell regional holding company — as a value stock because it was cheap [based] on the value of the assets. And we acted as a catalyst. The company did a restructuring to separate higher growth cable [and] wireless assets from the slower growth local telephone core.

Ultimately we traded out very profitably of the local telephone piece and we've continued to hold and buy more of the higher growth cable, wireless and directory publishing U.S. West Media Group company.

We own a ton of U.S. West Media Group. And it's *cheap*.

Shareholder: So you still feel optimistic about U.S. West Media Group?

Price: Yeah, it's OK. U.S. West Media Group is basically a very, very large cable company today. And cable stocks have been under huge pressure because of competition and capital expenditures in the industry. And the results haven't been that good.

So the stock's $16 — but that's *cheap*. We think the asset value is $30+. That's why we own it. And we own a *ton* of it. But it hasn't worked well. That's why we don't own one stock. We own *lots* of stocks.

When the cloud lifts over cable & wireless, it'll do very well.

Sondike: The stock's recently been weaker, I think, for primarily two reasons. First, cable and wireless entities are distinctly out of favor. And, second, the company made a large acquisition which was dilutive.

[But] we think that the market's grossly overreacted to the businesses it's in. At $16, it trades at perhaps 50% of the asset dollar. Plus, we think there are several catalysts to unlock value. The company's indicated publicly that they expect to realize the value of their wireless assets and distribute it to owners as soon as possible.

So this is a good example of a stock we bought as a value stock. We act as a catalyst for change and the realization of value. Unfortunately, it later became another value stock — though we think the company's going to surface those values. And when the cloud lifts somewhat over cable and wireless, the stock will perform very well.

SUNBEAM STOCK MAY BE AHEAD OF ITSELF TODAY,
BUT IT COULD BE UP 50% IN THE NEXT 12 MONTHS.

This guy's been around. And he knows how to do the job.

Shareholder: There's been a radical change in Sunbeam management. Would you care to comment on the company's position and such?

Price: Mutual owns about 17 million shares of Sunbeam — which is more or less 20% of the company. It's trading around $24. The new management is going to sell assets. They're going to close plants and bring production facilities together. They're probably going to reduce the number of SKU's [Stock Keeping Units] the company produces. They're going to bring out new products.

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And they're probably going to grow somewhat through acquisition and grow their international business. They'll also start advertising much more effectively.

Dunlap's been very successful — very effective. He's worked for some of the toughest guys in the world — like Kerry Packer and Rupert Murdoch and Jimmy Goldsmith. The guy's been around. And he knows how to do the job.

Under Dunlap, Sunbeam's EPS (and stock price) will rise.

Price: And that's why the stock went from $14 when it was announced to $19 and has climbed to $24 [since]. I think it's maybe a little ahead of itself, but not that much. It never should have been $12 or $14 before. It was probably a $16 or $17 stock. But — and this is the key — the right management is very important.

[Therefore], I think the way to look at Sunbeam is not to look back at the price that its stock was trading at right before Al Dunlap came on, $12 or $14, but [rather to] look back to what it was earning a year prior to that — which was $1.05 — and figure Al Dunlap should get that $1.05 to $2.00 and that the P/E multiple for these things are 19. So we think that stock could be a mid-$30s or upper $30s stock a year from now once his plans have been implemented.

ITT IS A GOOD VALUE TODAY — AS ARE TOBACCOS, WE THINK.

ITT is a good value — whether it's realized soon or not.

Shareholder: You indicated that you were buying two of the three pieces of ITT. Do you have any further comments?

Price: Well, ITT split up into three companies: (1) Hartford Insurance; (2) ITT Industries — which is largely, I think, some defense, electronics and auto businesses, and (3) ITT Corp., which Rand Araskog runs, which owns gambling, Caesar's World, Madison Square Garden, the Knicks and the Rangers (which might be reasons to buy it or not buy it), and Sheraton, the St. Regis, the CIGA chain and MSG Network.

The stock started trading in the upper-$40s, moved up to $63 — and today it's $42. I think the values within ITT are higher than where the stock's trading. But I also think that not much is gonna happen to bring them out any time soon. It's a good value. But I don't think it's the best way that company should be structured....

A universal settlement would push tobaccos much higher.

Shareholder: At June 30th, we owned quite a bit of RJR and a big chunk of Philip Morris. The tobacco industry has gone through such turmoil over the last 4 or 5 months. Have we lowered our position somewhat?

Price: Yeah. The RJR position's been cut in half. And the Philip Morris is gone. They're real tough stocks to trade. But they are cheap. They're cheap *any* way that you look at 'em.

But it's very hard to quantify what their liabilities could be. There is pressure on the managements to settle for 15 or 20 years of future suits. And if there were ever a universal settlement, these stocks would both be substantially higher.

We still own 6 million shares of Reynolds.

WE'RE NOT (HIGH) TECH INVESTORS — EXCEPT FOR BUSTED TECH STOCKS.

We like tech stocks — or at least *busted* tech stocks....

Shareholder: Do you have any interest in the new technologies like wireless — like CAI Wireless?

Price: No, we're not tech stock investors until they stumble. Some of you may recall that we were involved in the Storage Technology bankruptcy in the mid-'80s. And we were involved three years ago in Wang — which used to be a tech stock bankruptcy. And, in both cases, we did extremely well. Even though we were creating and buying technology, we were paying less than the net cash per share.

And there are busted tech stocks that we're looking at. There are some things that are *way* down. But we really want to buy things cheaply.

Shareholder: May I have your opinion on IBM?

Price: We don't follow IBM, but they're doing well....

Would we buy AT&T today? Yeah.

Shareholder: Do you consider AT&T a value play today?

Price: We could talk about AT&T for hours. And it also goes to our comments before about large cap stocks. Maybe they're tough to figure out. The stock's down a lot. So it's probably getting pretty cheap. That's why we own it.

There are other things coming out. You know they're going to unwind NCR. And other pieces are coming out. Their balance sheet's in pretty good shape. [And there's] new management. But Wall Street ... was disappointed in who they picked. So we don't yet really understand it.

I think it's OK. If I owned AT&T, I wouldn't sell it here.

Shareholder: Would you buy it?

Price: Would I *buy* it? Yeah.

[Editor's note: *Portfolio Reports* estimates that AT&T was the largest purchase of Mutual Beacon, Mutual Qualified and Mutual Shares funds during the six month period ending 6/30/96.]

WE HAVE VERY GOOD EXPECTATIONS FOR DIAL — PLUS THE CHEAPEST STEEL COMPANY IN THE WORLD.

We have very good expectations for Dial.

Shareholder: I read that you didn't approve of the way Dial was restructuring. What's happening over there?

Price: It's moving along. Dial is two companies now — Dial Soap's business, Dial, and Viad. And we have very good expectations there.

Algoma's *awfully* cheap — one of the cheapest in the world.

Shareholder: What's your current opinion on Algoma?

Price: Algoma Steel is a Canadian steel company. They reorganized because they had too much debt in '91 and '92. They largely supply auto companies in Detroit. And I think it's one of the cheapest stocks in the world. So, that's my opinion. Jeff, we own what percent of Algoma?

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Jeff Altman: About 8%.

Price: And we kind of like the management. It's related to steel prices and all sorts of things. But it's an *awfully* cheap stock.

FUNDS' PERFORMANCE HAVE BEEN VERY SIMILAR. BUT GOING FORWARD, SHARES WILL BE MORE U.S.

Fund portfolios impacted by their size and their charters....

Shareholder: What's the difference between the funds?

Price: Mutual Shares, Mutual Qualified and Mutual Beacon have been very similar as they've grown over the years. Discovery is half in Europe. So it does perform a bit differently. And Mutual European is 85% in Europe.

The performance characteristics will change a little bit — because I think Mutual Shares will evolve into a fund that's largely invested in the U.S. It might still do special situations around the world — but [will remain] largely U.S. equities. And Beacon will have some Europe and Discovery more Europe and European — *mostly* Europe.

When they began plays a part, too.

Price: But [as to the differences in] the cash balances in the funds and the relative weightings in certain things... We have Sunbeam in [Mutual] Shares, Qualified and Beacon, but not in Discovery, for instance, because we didn't have Discovery when we bought Sunbeam. So over time, that's how these portfolios evolved. And that's why they behave differently.

But the approach is the same. And it shows....

Price: But the *approach* is the same. And, by and large, for a long ... time, the *performance* has been, [too] — within 300 basis points....

Are we competing with our sister funds? It's a big world....

Shareholder: Isn't Mutual European in some way in competition with the new owners?

Price: No. They have ... funds that invest in Europe. [But] I looked over the list of securities that all of the Franklin funds own and I know what we own. And [there are] *very* few overlaps. There are a *lot* of stocks out there....

They own Volvo. And we own some Volvo. They own St. Joe Paper. And we own some St. Joe Paper — and a couple of other little ones. But they own 500 stocks we *don't* and we own 500 stocks *they* don't.

WE'RE SHAKING THE TREES IN EUROPE AND FINDING *ENORMOUS* OPPORTUNITIES.

We've increased our European exposure by 800%.

Rob Friedman: I'm the sole London representative here in the room today.

[Editor's note: Friedman informs us that this was his "feeble attempt" at dry, British humor. He's actually their *only* London representative — *anywhere.*]

Friedman: I moved to London in February. About three years ago, we had just over $500 million invested in Europe. Today, we have about $4-1/2 billion concentrated in three or four different nations.

The first thing we do in a new country — shake the trees.

Friedman: ...When you go to a country, you visit the brokers, visit the companies, [and] shake the trees. First, you're going to see the *big* companies — to kind of get a sense of the lay of the land. You shake the tree a little bit — and suddenly you find three *smaller* companies. You shake that tree a little more and find two *other* companies.

We're shaking the trees & finding *enormous* opportunities.

Friedman: Sweden is relatively small population-wise, but has an inordinately high [stock] market capitalization because they have huge industries that they've developed over 100 years.

You go visit someone and say, "Who do you admire?" And he can literally lean over, point out his window and say, "You oughta go talk to *that* guy." So you go talk to that guy and he gives you three more people.

And that's basically why I'm there.... We're out there shaking the trees of these different countries and finding *enormous* opportunities....

Our U.S investment techniques are working in Europe....

Altman: ...One of the things that we recently did was to focus on some good bank/bad bank situations in Europe — in Sweden primarily — where banks were stuck with a bunch of real estate that was not properly valued on their books. So they separated into public real estate companies.

We bought both the banks *before* they separated and then the real estate companies afterwards. That situation has worked out very well — with returns somewhere in the 30-40% range within 2-3 months of them separating. So that's kind of an example of how we've found value and how we've taken some of our bankruptcy and distressed real estate investing and used it and extrapolated on it in Europe and in other areas.

We're finding *amazing* situations in France.

Friedman: Europe is 350 million people — [which is] larger than the United States — with margins in their corporations [that are] maybe half of ours. It is an entire continent begging to be restructured....

It's *going* to happen. It *is* happening. We put money into France now. And we're finding *amazing* situations of undervalued assets there....

WALLENBERGS ARE *INCREDIBLY* SMART. AND WE'RE BUYING THEM AT A DISCOUNT.

Incredibly smart (and proven) people at a large discount.

Shareholder: How are we involved with the Investor people and the Wallenberg family?

Friedman: There are a number of Swedish holding companies. They have a *zero* capital gains tax rate —

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FRANKLIN MUTUAL SERIES FUNDS' MICHAEL PRICE ET AL.
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which was done by the Swedish government to encourage them to invest for the long term.

These companies are trading at *enormous* discounts. The Wallenbergs are a slightly well-known family in the Swedish home market. (Actually they are *the* family in Sweden.) Investor, their holding company, has compounded 20% a year, for five years, 10 years, 15 years and 20 years. And yet it trades at a 45% discount.

They're *incredibly* smart.... They're well represented in pharmaceuticals, in telecoms and in forestry.... And we can buy their assets and brains at an enormous discount.... Again, it's the largest tree in Sweden. We're shaking it very vigorously and finding many ... opportunities as a result.

EUROTUNNEL MAKES SENSE BUSINESS-WISE.
AT 60-70% OFF, IT MAKES INVESTMENT SENSE, TOO.

We knew that the Eurotunnel made sense business-wise.

Shareholder: What about Eurotunnel?

Price: Eurotunnel cost £10 billion to build. It's probably worth £5 or £6 billion. And we basically paid about £4 billion for it by buying the defaulted bank debt. We bought it knowing that the Eurotunnel does make sense, that people like to use the train or the trucks to get their goods and people across the Channel and that it's going to stay in business.

And at 30¢ on the dollar, it made sense investment-wise.

Price: [Therefore], it's just a matter of restructuring the balance sheet. By buying the debt at 30¢ — and it's now trading at 40¢ — we create the restructured company cheaply (equity and debt). So we own a lot of Eurotunnel.

WE HEDGE OUT CURRENCY RISK TODAY.
AND *IF* EUROPE UNIFIES IT, WE'LL HEDGE IT, TOO.

We hedge out currency risk via forward contracts.

Shareholder: How do we protect ourselves against currency swings?

Price: We made the decision that we're stock pickers, not currency experts. But when you buy a foreign stock, first you have to buy the local currency to pay for the stock. So, every night, you have to see where your stock closed. But you also have to see where the *currency* closed versus the dollar because we have to translate the position back into dollars because our funds are quoted in dollars.

So we hedge currency movements out of the performance of the fund using forward contracts. We buy a contract for the same amount of that local currency that moves and it counteracts all of that currency move.

The cost runs about 1% annually. In some countries, we actually *earn* a little money on the contracts. It depends on the interest rate differential and the liquidity of the currency markets [in each country].

If Europe unifies it's currency, we'll just hedge it, too.

Shareholder: Could you or Rob [Friedman] comment on the aspect of the European Community and the prospect of dealing with one common currency and what impact that will have on European firms?

Price: Rob, you can speak to this. I don't think they'll ever come up with one currency for all of Europe.

Friedman: It depends on the industry. Some businesses will love it and some will hate it. If you're in the forestry industry, [for example,] you're ruing the day they unify into one currency. So *if* and when it happens, we'll consider how to proceed.

Price: Just think about Coca-Cola. We don't own Coke. But so many companies do much of their business in other currencies and translate it back into U.S. dollars. Oil companies are largely a U.S. dollar receiver and they pay a lot of expenses in local currencies.

Sometimes we talk about it, but we usually don't hedge those companies currency exposures differently. It gets too complicated. So we just hedge the whole position.

WE BOUGHT CANARY WHARF AT 33¢ ON THE $1.
WE THINK IT'LL WORK OUT TREMENDOUSLY WELL.

We bought our stake in Canary Wharf at 33¢ on the $1.

Shareholder: I read in *The Wall Street Journal* where you had invested millions of dollars in Canary Wharf.... Was that done personally?

Price: No, no, no. *All* the funds own Canary Wharf. Canary Wharf was an office project built in the Docklands to the east of London during the late '80s. It's much like Battery Park City in Manhattan. They filled in land and put in big retaining walls and built big buildings to allow the city — the financial district of London — to move east and get big wharf spaces for trading rooms and other kinds of offices.

Canary Wharf cost over £2 billion to build. We — and another three or four investors — bought out the banks for £800 million. So we paid about a third of what it cost....

We think it's going to work out tremendously well.

Price: When we bought it, it was [only] 60% occupied. It's now *82%* occupied. In fact, they recently announced that Citicorp is moving their European headquarters to Canary Wharf. And I think it's going to work out tremendously well over 4 or 5 years. It's carried at cost. And it's about a 1% position in Shares, Qualified, Beacon and Discovery.

Shareholder: Does Paul Reichman have an active role?

Price: Yeah. Paul Reichman's involved in the management of it....

FIRST RATE MANAGEMENT AND A VERY GOOD PRICE
MADE RAILTRACK A CLASSIC OPPORTUNITY.

Railtrack was priced to go....

Price: David Winters is a railroad buff. And the U.K. government privatized Railtrack. And David can tell [you] that story....

David Winters: I love railroads. I'm a fanatic.

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Mutual historically has always been interested in railroads and bankruptcies. It's the history of the company. And I've sort of followed in that vein.

The first railroad in the world was in the U.K. And the U.K. railroads went bankrupt during the Depression — and the government nationalized them. About a year ago, the government started to privatize Railtrack — and I started looking at it. And I realized that there was all kinds of hidden stuff there....

The U.K. investors didn't know what it was because there hasn't been a publicly traded railroad for 60 years. The folks who run it are Brits, but they [had] worked in the States. And it came public very cheaply....

Hidden assets, excellent management and a cheap price.

Price: What David *didn't* tell you is that he knows more about Railtrack than anyone else in the world. He went to London — or wherever they're based — and, like Rob said, he shook the tree. And he discovered that they [were] sitting on *tons* of real estate.

Bob Horton, who ran Sohio ... and did a great job in cutting their costs, is Railtrack's chairman. We've met with him on several occasions. David spent several days in London with them and connected all the real estate values, the turnaround in the railroad and Bob Horton — who's a terrific manager.

It's been spectacular. And we haven't even fully *paid* for it.

Price: So far, that investment's worked out spectacularly well. We haven't even paid for all of it yet — because when the U.K. government sold it, they only asked you to pay for 50% of the stock and loaned you the balance for a year. So it's been fabulous....

WE FIND OPPORTUNITY IN THE NEW LOWS LIST.
RECENTLY, WE'VE BEEN FINDING IT IN HEALTH CARE.

OID: At your annual meeting, Michael Price said that the press gives him far too much credit for the success of the Mutual Series funds.

Rob Friedman: He's very generous.

OID: I can't speak for the press in general, of course. But I know we've never given him any credit...

David Winters: Michael [Price] provides the intellectual foundation for what we do. But there are a whole group of people here who have contributed in a major way to our returns for years now.

OID: He seemed to be giving you guys credit for the ideas — Rob Friedman for Sears, Ray Garea for Chase, David Winters for Railtrack — actually acknowledging that they weren't his ideas, but yours. Is that the way the process actually works?

Winters: Yeah. He's well aware of the importance of running the place that way to give his analysts the opportunity to learn and grow.

As Michael said, Chase was Ray Garea's idea. In fact, a lot of the smart things we've done around here have originated with him. So I think he'd be a good guy for you to speak with.

OID: That's what Michael says.

I seem to keep hearing good things about you. What's your role around here?

Ray Garea: I do all of our financial stuff, except for the insurance companies, and all of our health care stuff, except for the pharmaceuticals.

Plus, I look at anything new that's located in the U.S. that people want to put into our portfolio. In other words, when anybody wants to buy something new — be it a lumber company, a media company or whatever — they run it by me. Before, they used to run it by Michael.

OID: So, in effect, you're the gatekeeper.

Garea: For new stocks that are located in the U.S. And Rob Friedman fulfills that role for things that are overseas. Then, again, that wouldn't apply to people like Larry Sondike or to Jeff Altman and Peter Langerman for ideas in the distressed area. They function on their own. Michael takes care of them — just like it's his job to take care of me at different times or if positions get big enough, etc.

But we've made a few changes just to recognize the fact that we're a bigger organization and we need to be doing things a little differently.

OID: As I recall, at the annual meeting, you said that it was getting late in the day for financial stocks.

Garea: Yes, it is. They're not bargains today. And that's not to say that we don't still own 'em. However, financials are making the new highs list. And that's not where we poke around. We poke around in the new *lows*.

OID: And I gather that today that's health care.

Garea: Yeah.

OID: At your annual meeting, Michael pointed to HMOs as an area that was still cheap and offered opportunity in a generally expensive market.

Garea: That's right.

OID: I've developed a twitch from stocks rocketing up, up and away lately. So is what he said still true?

Garea: In some cases, yes. Others have rebounded quite a bit. For example, we owned a pretty big position in United Healthcare. And that one's gone to $48+ from maybe the high $30s. So that's a 30% move in a month. And Pacificare has popped maybe $10 in the same period.

OID: Hold on while I medicate...

Garea: But there are others that we own like Foundation Health [FH/NYSE] and Health Systems International [HQ/NYSE] — which are *incredibly* cheap.

OID: For good reasons or bad reasons?

Garea: For *bad* reasons.

OID: Then time's a wastin'.

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HEALTH SYSTEMS WAS ALREADY DIRT CHEAP.
ONLY NOW IT'S *EXTRAORDINARILY* SO.

Garea: Health Systems International is acquiring Foundation Health in a stock for stock swap. It's paying 1.3 shares of its stock for each share of Foundation. So Health Systems will be the surviving entity. And its management will manage the surviving company.

The two of them together are an interesting pair in the sense that Health Systems was very thin — there wasn't much float. A charitable foundation owned a big part of it. And we bought a lot of Health Systems International in a public offering from that foundation — I think we bought it at $30 — and we bought more as it went lower. And it's at $24 today. So it hasn't exactly done well.

OID: Those are our favorites.

Garea: Ours, too. And we owned it before — we bought it in the mid-$20s or thereabouts. But we bought more at $30. Then there was this big correction in HMOs.

OID: So Health Systems' decline is industry-related?

Garea: Absolutely. They've pretty much delivered OK numbers that were reasonably in line with expectations. But it was taken down with the whole group.

Then they announced this deal with Foundation. At that time, Health Systems was at $27. And now it's down to $24. And I think the reason why is that it's underfollowed. Nobody pays any attention to it because Health Systems is very thin. And Foundation has a very checkered past. People don't like the management. They don't trust 'em. The CEO is not highly regarded. People think that they were playing games with their numbers.

OID: Were they?

Garea: To some extent. But the area that was focused on most was the workers' comp business. And we've always felt that their workers' comp business was fine and that, in fact, they'd actually done a very *good* job in that area.

But if you put these two companies together, look at what they can earn, and give 'em even modest credit for taking out costs, they're mighty cheap today.

OID: How cheap?

Garea: Health Systems was going to earn $2 in 1996 and $2.40 on its own in 1997. So the combined company will probably earn $2.60 in 1997. And the stock's at $24. What is that — 9 times earnings?

OID: About 9-1/4. But is that good?

Garea: For a 20%+ earnings grower? You tell me. And something that's *really* interesting — to me, at least — is that Health Systems' earnings are net of $1 per share or so of goodwill amortization. So their cash earnings are actually much *higher.*

OID: That is really interesting.

Garea: But nobody pays any attention to that either. We do though. We think it's by far the off-the-chart, cheapest HMO out there.

OID: I see what you mean. As of June 30th, it looks like Health Systems had nearly $500 million of cash. Divided by its 50-odd million shares outstanding, that's roughly $10 per share.

Garea: That sounds about right — although, again, that's before the acquisition of Foundation Health.

OID: So deducting that $10 from its current price of $24 per share, you're paying less than $14 per share for an HMO with nearly $70 per share of revenues. That seems dirt cheap.

Garea: And it's even reasonably well managed.

OID: Again, it would certainly seem so. Despite the heavy goodwill amortization you mentioned earlier, Value Line shows them earning a return on equity in the mid to high 30s in 1993, 1994 and 1995.

Garea: Also, it's very well positioned. It's in California and lots of other states. And it's going to expand. So it'll ultimately be one of the larger HMOs out there and just generally continue to do well.

OID: Could the unfavorable response to the Foundation deal indicate that Health Systems is overpaying and/or di-worse-ifying?

Garea: I don't think so. Because they're paying 1.3 shares of Health Systems, they're, in effect, paying $32. And Foundation's selling at a little over $30.

OID: And I see that Foundation has about $900 million in cash — which divided by its 60 million shares outstanding comes to about $15 per share. So Health Systems is effectively paying $16-17 per share for slightly over $70 per share in revenues.

Garea: That's right.

OID: So it's only mildly dilutive in terms of revenues. And you say it should be additive to earnings.

Garea: Exactly. It was the cheapest HMO *before* the acquisition by a lot. And now it's even *cheaper.* Meanwhile, almost every other HMO's moved up sharply. And Health Systems has barely moved at all. So now it's *extraordinarily* cheap.

OID: On the other hand, Health Systems' earnings estimates have been declining for at least six months.

Garea: That's right. But that's probably been true for *every* HMO.

OID: How would you rate management?

Garea: I think they're OK. I don't think they're the best. These companies all have strengths and weaknesses. But I don't think most industry observers would put them in the top two or three in the industry.

OID: Where would they put them. And where would you put them?

Garea: In the next tier from the top.

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OID: In fact, they appear to have earned well above average net profit margins historically — up around 8%. But does their relatively low P/E perhaps suggest that those margins are unsustainable?

Garea: In 1996, their margins are lower — as are everyone's. I think their margins are reasonably in line.

OID: And in 1996, they're...

Garea: They're like most HMOs — around 5%.

OID: Value Line shows them having net profit margins of 8.0% in 1994 and 7.7% in 1995.

Garea: Yeah. But 1995 was the last really good year. Many of these guys *lost* money in 1996, you know.

OID: And you're assuming $2.60 of earnings in '97?

Garea: That's right.

OID: And did I understand you to say that that's actually after significant goodwill amortization?

Garea: Correct. Prior to the merger, Health Systems had $1 of goodwill amortization. But, of course, it's going to be less than that after the merger because that amortization gets spread over more shares. Foundation had a little goodwill amortization, but not nearly as much.

OID: So cash earnings would actually be more.

Garea: I could figure it out, although I haven't yet. It's more than 50¢ and less than $1. So it's probably in the 70-75¢ range — something like that.

OID: But even if it's 70¢, you're talking earnings of $3.30 on a $24 stock — or just over 7 times earnings.

Garea: That's right.

CONCERNS ABOUT FOUNDATION ARE OVERDONE.
AND EVEN IF THEY WEREN'T, NOW THEY'RE MOOT.

OID: On the other hand, I don't see any insider buying and lots of insider selling. What's that about?

Garea: I assume that's because the foundation shows up as an insider. And they recently sold stock in an offering.

OID: It certainly looks like they have lots of company.

Garea: I don't know.

OID: Are there any other reasons why Health Systems is so cheap?

Garea: Not that I'm aware of. Before the offering, the charitable foundation owned pretty close to 50% of the company. Now, as I recall, their ownership is down into the low 30s. And institutional ownership is pretty concentrated. Malik M. Hasan, who's the chairman of the company, owns a big piece of it [20.8% as of year end 1995]. So, again, there's not a lot of float. As a result, people don't get too interested in it. So it's underfollowed by the Street.

OID: Because there's not enough shares outstanding to generate much commission volume...

Garea: Exactly. As I mentioned earlier, Foundation Health has a pretty checkered past. There are different schools of thought about its CEO. And its financial guy has had his share of credibility problems.

So the combination of those two elements makes most people uninterested in bothering to figure it out. However, I think they will soon because the fundamentals are compelling.

OID: What would critics of Foundation's management say about them?

Garea: I think critics have focused on two areas: The first was the workers' comp business. And there was a charge that they were basically underreserving and, therefore, overstating earnings. But I don't believe that was the case. We did a fair amount of work — talking to different people and looking at the underlying statutory convention statements and so forth. And you can always argue or debate about these things, of course. But clearly — at least in our opinion — they weren't out on the curve.

Could they have been more conservative? Sure. *Anybody* could be more conservative — by definition. But it looked to us like they were being reasonable and even reasonably conservative. So that was one issue. And we're extremely comfortable there.

OID: And the concerns about the CEO and the CFO?

Garea: They used very questionable judgement in the way they dealt with their accounting for doctors practices.

However, that got taken care of because they sold that business to a company called FPA Medical. And that rendered moot all of the accounting questions. So that's no longer an issue.

OID: What role will those people be playing in the company going forward?

Garea: Foundation's CEO will be on the board for up to a year. But then he'll go away. He'll have no role in its ongoing operation. The CFO will be there for a short while. But then he'll be gone, too. As a practical matter, neither will have a role in the surviving entity's ongoing operations. It's going to be run by the Health Systems' people.

Lower down, there will be people from Foundation — because they have some very good people. For example, their workers' comp guy will run the workers' comp area. He's *very* good. And some of the HMO people will be involved with the successor, too.

OID: Will they operate as one entity or continue, in effect, with two brands?

Garea: They'll merge the HMOs in the states where they both operate — although it won't happen immediately just because it takes some time to get the regulatory approvals they need to do that.

Foundation Health is a little different in the respect that they have a fair amount of earnings coming from the workers', comp area. And that has two characteristics that a typical HMO would not have: First, it's inherently a lower ROE business. And second, balance sheet equity for that business *matters* — unlike HMOs where it *doesn't*.

OID: Interesting.

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Garea: What Foundation has done very successfully — and this is what most people couldn't comprehend or accept that it could happen — is to apply the concepts and techniques of managed care (which has been more of an *acute* care phenomenon) to the workers' comp business. So they've had a dramatic effect on the health care costs of workers' compensation — the claims costs, etc. And that's allowed them to maintain profit margins during a period when the workers' comp business was under pressure. And now when that premium pressure has sort of abated, they've also been able to grow that business dramatically because they have a much better cost structure.

OID: How much overlap is there geographically?

Garea: The biggest overlap is in California. They're both California HMOs. Plus there's some overlap in Colorado and the Northwest. Also, Foundation has some CHAMPUS contracts — which are a government contract.

OID: And that stands for Civilian Health and Medical Program of the Uniform Service.

Garea: That's right. That's the government healthcare program for the military. And Foundation's CHAMPUS program is already in Arizona, Texas and places like that. So that foothold will help Health Systems be more effective in their development of their HMO outside of that program in those places. So I think that's a plus.

Other than that, there's the usual corporate overlap. You don't need two of everything. So margins will go up. And their SG&A as a percentage of sales should go down.

THERE WILL BE COMPETITION AMONG HMOS —
BUT PROBABLY RATIONAL AND MARKET-SPECIFIC.

OID: Health Systems' fundamentals — even before adding back goodwill amortization — are striking. The adjusted price-to-sales ratio, for example, is tiny — especially given that it's historically managed a 30%+ ROE.

Garea: Absolutely.

OID: On the other hand, the price-to-book here prior to the acquisition must be up around 3-1/2 times.

Garea: Book value in the case of HMOs is not a

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particularly relevant valuation criterion.

OID: Because?

Garea: Because it's more like a service business — and capital isn't an issue in this business. It's not like it's a financial institution or a real insurance company where statutory capital matters. If you look at a company like United Healthcare, for example, their statutory capital requirement may be something around $7 per share — which they have in cash. But they have $20 per share in cash on the balance sheet. It's just excess cash. These are just huge cash flow generating companies.

Equity capital is essentially meaningless. It doesn't give them the ability to do more business, be more effective in the business or anything. It's just not relevant.

OID: Even if that is true today, aren't their returns ultimately likely to get forced down by competition to the point where price-to-book becomes more relevant?

Garea: I don't think so.

OID: I read a statistic recently that HMOs already have a 25% market share in the U.S. As that share continues to grow and they increasingly compete with each other, aren't margins likely to get forced down — perhaps substantially?

Garea: That's an interesting question. But you could make the same argument about newspapers: "Now that *The Cleveland Plain Dealer* has a 70% market share in Cleveland and *The Detroit Free Press* has a 60% market share in Detroit, because they have this high penetration rate, won't they compete with each other and drive down returns for each other?"

But it doesn't work that way, does it?

OID: And that's a very interesting analogy — regulatory issues aside. But I'm not sure...

Garea: It's not a perfect analogy. But I'm not sure a higher penetration rate necessarily leads to lower returns. Four or five years ago, most HMOs were making so much money that they thought they were geniuses and that they could make that money anywhere. So they willy nilly decided to expand into all kinds of new markets.

But they learned that it really doesn't work that way. It's not that simple. If somebody has 20-40% market share someplace already and you're trying to start up there, it's not so easy to make money. In fact, it takes a long time before you can make money. The competition can make it take as long as they want for you to not make any money because they already have doctors' networks in place.

OID: And have already achieved serious economies.

Garea: Exactly. They're in that market. So when you come in and talk to the local doctors or local hospitals and say, "Hey, I have 3,000 members here. Tell me about the discount you're going to give me.", the guy is likely to look at you and say, "Take a hike."

So it doesn't work that way. And I believe that HMOs have discovered that.

OID: Gotcha. And Health Systems is well rated, etc.?

Garea: Yeah. I'm not saying there's not *competition*. There's competition in almost *every* business. But the idea

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that all these guys are going to be dominant in one market and then just go into another market where they're not particularly well positioned and drive pricing down is pretty farfetched.

IT'S BEEN MIGHTY NASTY OUT THERE PRICE-WISE, BUT 7-1/4 TIMES CASH EARNINGS WORKS FOR ME.

OID: If it does turn into a mistake, what do you think the epitaph is likely to read?

Garea: The pricing environment would have to continue in 1997 like it was in 1996.

OID: So a continuation of today's pricing environment would turn it into a mistake?!

Garea: Where people would basically significantly undercut each other on pricing relative to actual costs and where medical costs continue to rise as they have in 1996 — and, therefore, you have another year of declining margins.

OID: So competition could turn it into a mistake?

Garea: It's kind of funny, but I have to tell you that some of the worst damage is self-inflicted.

OID: There's no need to get personal.

Garea: Yeah. Some of it is certainly competition. But a big part of it has been self-inflicted. These guys just kind of missed the boat.

OID: They thought they could hold down costs more than they did?

Garea: They made incorrect assumptions about medical cost trends. They basically all assumed that 1996 was going to be a continuation of the trend in 1995 — which was a decline in medical costs. And medical costs didn't go down in 1996. They turned around and went up.

And when medical costs started to rise and HMOs had priced their product assuming a decline, that obviously wreaked havoc on their bottom line.

OID: Gotcha.

Garea: Clearly competition plays some role in that. But I think that it was, to a pretty significant extent, a case of people just mismanaging the business. In contrast, today, people are talking about price increases on average at HMOs of 5-6%. And medical costs are going up, but not anywhere near that much.

OID: I understand that Oxford...

Garea: I know what Oxford does. And I have looked at it. But it's not our kind of stock.

OID: Because it's selling for a high P/E?

Garea: "High" isn't the word.

OID: It's been accused of being well run.

Garea: I don't doubt that it's a well run company, but it trades at 50 times earnings.

OID: But they look like they have net profit margins since 1995 of something around 3%.

Garea: Yep.

OID: And if they're efficient operators and they're willing to operate that way, couldn't that set a ceiling on the margins their competitors can hope to earn?

Investors in Health Systems at today's price would probably still be fine. But...

Garea: I don't think you should necessarily equate Oxford's lower margins with efficiency. Remember that growth has its price.

When you're growing at 50-60% a year, there's a cost that you have to pay in order to keep up with that growth. You can't possibly run a company as efficiently as someone who's growing 10% a year.

OID: And you may be pricing more aggressively, too.

Garea: Correct. It's not that we don't *like* growth — because we *do*. However, here I can buy Health Systems growing, I think, at 20% per year for the next several years and maybe 15% per year thereafter for only about 8 times reported earnings and 7 times *cash* earnings.

OID: Not bad.

Garea: It works for me.

HORIZON HEALTHCARE IS INCREDIBLY CHEAP. AND, LONGER TERM, IT'S A GOOD BUSINESS, TOO.

OID: At your annual meeting, Michael said that Horizon/CMS Healthcare [HHC/NYSE] was also cheap.

Garea: That's right. It's incredibly cheap, too. Horizon runs nursing homes. And nursing home stocks have been battered because of a series of pronouncements out of HICVA — which is the federal agency which sets government rules for Medicare and so forth regarding reimbursement rates for different rehabilitation subacute kinds of therapies — which all of the nursing homes are in. Horizon and others have been under a cloud because of some different kinds of OIG investigations relating to various things that we just don't think are that significant.

OID: So Horizon is cheap because of industry fears?

Garea: In part. Plus, they made an acquisition which most people, including us, didn't think made sense — although we didn't own it then. And it caused them a bunch of problems. They bought a company called Continental Medical that's in the rehabilitation/therapy business — acute care, outpatient and subacute — and in contract therapy.

And, finally, they're in the pharmacy business — they provide pharmacy services to their own nursing homes and other smaller nursing homes that can't afford to be in that business on their own. It's just cheaper to outsource it.

OID: Quite an array of businesses...

Garea: Yes, indeed. So now Horizon's businesses need to be rationalized. They have to figure out which

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businesses it makes sense for them to be in, which ones it doesn't and how to approach each.

And, meanwhile, they've also been beaten down because of fears about inadequate reimbursement rates and all of this investigation stuff that I mentioned earlier.

OID: Sounds pretty nasty all right.

Garea: It sounds that way. But we think they're overblown.

So we believe these things are way too cheap. And we believe that the nursing home business, longer term, is a good business. So we want to be there.

OID: At today's price?

Garea: Well, we actually started buying Horizon in the mid-teens in March — although we bought very little then. But from $13 down to $10, we bought a lot more — until we probably own 8-9% of the company today.

OID: And Horizon's current price?

Garea: It's at $11 and change.

HORIZON PLAYED THE WALL STREET GAME,
BUT NOW THE MUSIC'S STOPPED.

OID: You say that you think it's incredibly cheap,

Garea: That's right.

OID: By what measure?

Garea: Enterprise value to operating cash flow, earnings — you name it.

OID: We asked first.

Garea: It trades at 10 times reported 1997 earnings and 6-7 times operating cash flow.

OID: For Horizon to be fairly valued, what should those multiples be?

Garea: It depends on who's operating the assets and what they're doing with 'em. These are all businesses that have excellent growth prospects and big advantages. And some of them — like Genesis and Multicare — trade at 18, 19 or even 20 times earnings. But they have better margins, they're growing faster, and they're just better run generally.

OID: I see that. Horizon's returns on capital and equity look very unimpressive. And they've increased their shares outstanding by nearly 700% since 1987.

Garea: All of these guys began as little start-up companies and grew like weeds by acquiring other things. And they kept using stock because they traded at such high P/E multiples.

OID: Which may explain how their book value could compound at more than 18% per year since 1987 despite the company having earned single-digit returns on equity for most of that time.

Garea: The nursing home business is capital intensive. You have to build the facility. And since they were doing all of these poolings of interests in their acquisitions for stock, they were just sort of adding the balance sheets together. So that does make sense.

But then the music stopped.

OID: I'll say. I see that Horizon is selling well below its $13 book today.

Garea: That's right. And you mentioned earlier how their returns haven't been that great. Well, that's because they were busy playing the old Wall Street game — you know, where if Wall Street's willing to capitalize you at some outrageous multiple, you keep issuing your stock.

OID: In other words, if Wall Street could take a joke, they could, too.

Garea: And, basically, all of the nursing homes traded at something north of 20 times earnings.

OID: But, in effect, Horizon's behavior wasn't altogether irrational.

Garea: Exactly.

HORIZON PROBABLY WON'T BE A CONSOLIDATOR.
SO THEY'LL PROBABLY BE A CONSOLIDATEE.

OID: At your annual meeting, Michael said, "We think [Horizon's] cheap.... We're trying to make it not cheap. We're trying to get it up." Can you translate that?

Garea: I don't think he had anything specific in mind.

OID: What's your assessment of management?

Garea: They're tired.

OID: How do you mean that?

Garea: When you've been through the wars too many times, you just get too tired to do it again. You can run Gillette for a long time — well up to an age where most people would just think, "Maybe I should think about doing something else."

OID: It's not like dog years or, even worse, OID years...

Garea: Exactly. Running a company like Gillette just doesn't wear you down the same way. But when you're in a business where you have to go through one big problem after another — you're always dealing with the government and so forth — it just takes its toll.

It's tough. It's like Tenet Health Care — what used to be National Medical Enterprises. They started their company with a single hospital and built it into an enormous company with psychiatric, rehab and acute care hospitals — until it was one of the biggest health care companies in the country. They had problems at different points, but it was a great story.

But they got to a point where they had huge problems and they just couldn't deal with 'em. It got to where *they* became the problem. That's just the way it works.

OID: Interesting. And the implications for Horizon?

Garea: It's not like we're going to throw management out or anything like that...

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OID: In the words of the recent cover story on Michael in Fortune, you're not going to "Michael Price" 'em?

Garea: No. Actually, the guy owns a lot of stock. But we just believe the nursing home industry is fragmented and that it's consolidating. The nursing home industry has some larger players. But the market share of the larger players is diminimous. There are just thousands and thousands of mom and pop players. So the business is going to consolidate.

OID: And Horizon will make someone an attractive acquisition.

Garea: All the little guys we've never heard of because they're not public companies are going to get absorbed.

Look at what happened in the hospital business: People saw that 85% of the hospital area was nonprofit and only 15% was for-profit. So they thought that all of the guys who were on the for-profit side were going to go out and grow like crazy. And there were eight or nine major players. So people expected them to go out and grow, take on the nonprofits and consolidate the industry until somewhere down the line maybe only 50% of the industry would be nonprofit and the rest would be split among those eight or nine for-profit players.

OID: Don't leave us in suspense.

Garea: The nonprofit share has declined — from maybe 85% to 80%. However, what people *didn't* expect was that one or two of the major for-profits consolidated the rest. Now there are only *two* big for-profit players left.

OID: So?

Garea: So I think you're going to see some of that in the nursing home business.

OID: And the implications for Horizon?

Garea: Well, I don't think Horizon's a consolidator.

OID: Consolidator meaning a buyer.

Garea: Right. The keys to who's going to be a consolidator and who isn't are one part financial valuation — in other words, do you have the currency — and one part management. And the two tend to go hand in hand in industries like this. So the best-managed companies are the ones that the market likes because they're best able to grow and do things. So they get a good financial valuation. Those are the candidates to be leading consolidators.

You saw it in the acute care business where Columbia was the main guy. And now Tenet's come along because they've done a very good job of pulling together things and doing a couple of deals. And I think that the same thing is going to be true in the nursing home area.

THE PAYOFF MAY ARRIVE WITH A TAKEOVER
OR IT MAY COME THEREAFTER — AS WITH CHASE.

OID: If someone were to buy Horizon, what kind of price do you think they'd be likely to pay?

Garea: It's like everything else. It's one part that the acquiring company trades at a higher multiple. So that helps them out. And it's one part cost savings, rationalization, etc. So some of that will go to shareholders of the acquirer and some of that will go to shareholders of Horizon. And one part of it will be, "What can I negotiate?" But it'll be a price above where it is today.

And if it's a stock deal, we'll end up with stock in a company that has better prospects. So we think it'll be a win-win.

OID: If forced to look into your crystal ball by, say, some pushy newsletter editor and guess where all of the factors you mentioned were likely to converge, what would you guess?

Garea: It depends on the whole range of alternatives that I've mentioned earlier. I've seen in the banking arena with Chase and Chemical where there wasn't such a big premium where the stock price was, but where the cost savings were so dramatic and the fit was *so* good that the big payoff came after the merger — although you did get a reasonable premium considering that Chase did move up prior to the announcement of the deal.

So that's an example where you got a *little* bit of a premium — although perhaps there was already some speculation in the stock — plus you got a huge win from the deal itself because it was a win-win merger and a great fit.

On the other hand, if it were more of a pure takeout, you'd probably get a higher price. It also depends on what currency's used. If someone's going to pay cash, then they'll pay more.

OID: Assuming it was all cash, do you have any sense of what the range might be?

Garea: Maybe the upper teens.

YOU CAN BUY US WEST MEDIA GROUP CUM AIRTOUCH
AND GET EVERYTHING ELSE AT ROUGHLY 65% OFF.

OID: At your annual meeting, you also talked about U.S. West Media Group.

Larry Sondike: We bought old U.S. West before it split into two stocks — U.S. West Media Group [UMG/NYSE] and U.S. West Communications [USW/NYSE]. Then, we traded out of the latter — which is the local telephone piece. So we set up U.S. West Media Group and its cable, wireless and Yellow Pages directory publishing very cheaply.

But, then, we bought more after the restructuring.

OID: May we ask the range of what you've paid?

Sondike: Since U.S. West Media Group was spun off, we've probably paid between $15 and $20. So we've made money on this one.

OID: No idea's perfect. But, in any case, you've obviously paid the current price of $18-5/8 and more.

Sondike: That's right — and less.

OID: At your annual meeting, you said that you come up with a mid-$30s value for this one.

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Sondike: That's right. And that's applying what I think are reasonable private market values to its pieces.

OID: I won't ask you what value you come up with when you apply unreasonable values.

Sondike: Some analysts believe it's worth more.

INVESTORS FEEL BETTER ABOUT CABLE TODAY, BUT THEIR FEARS ARE STILL OVERDONE.

OID: In that case, tell us about it, please.

Sondike: They just closed on the purchase of Continental Cablevision — which significantly increased the size of their cable business. But even after the deal, cable still only represents about half of the value here.

The other half consists of wireless and yellow pages directory publishing. Both businesses generate free cash — although they are clearly very different businesses. Wireless is a high growth, moderate risk business whereas Yellow Pages directory publishing is a modest growth, highly cash generative business. And they also have some international assets in all three areas.

OID: At your annual meeting, I believe you mentioned that the cable area was already out of favor, but that they overpaid for an acquisition, too?

Sondike: The cable area fell out of favor right after they announced the acquisition — which was dilutive — in late February. People were fearful of satellite competition and somewhat concerned about the RBOCs offering video. Also, a couple of large cable companies had weak operating results. So there was substantial selling of cable equities.

OID: And today?

Sondike: Satellite penetration has since slowed. Satellite companies have materially lowered their expectations for subscriber growth. And there are increasing questions about the satellite value proposition.

OID: Relative to traditional cable.

Sondike: That's right. Plus, the competitive risk of the telcos offering video seems to have abated some. They don't seem to be as interested in offering video today. They've slowed or distanced themselves from the broadband buildouts that will allow them to offer video services. And some have turned their backs on wireless cable acquisitions.

So investors feel a bit better about the cable business. And cable stock prices have bounced somewhat.

OID: Fortunately, not enough to take U.S. West Media out of the price range you've paid.

Sondike: The area's still out of favor. So I think that fears about competitive risk are still overdone.

OID: Why do you say that?

Sondike: In addition to the factors that I've already mentioned, there's concern about the cable companies taking longer than expected to offer new services like digital video, telephony and internet access. But those services are for real.

And I believe cable companies — with their embedded customer base and their ability to offer improved digital service as well as other services — will continue to dominate the video industry. They'll be able to offer an improved video product [digital video] and internet access — which I think will be a key product.

OID: Although we'll have to edit out any references to the internet to avoid humiliating our editor.

Sondike: I do think that they'll be very successful in the internet access business. Also, some cable companies will offer telephony and services besides those I mentioned. So not only will they be offering *improved* service, but also *expanded* service — that will include additional products.

And I don't mean to say that the dish competition doesn't offer a good product — because they do. I just think that the cable companies will be able to compete and, in effect, offer a bundle of services including the ones that I've mentioned and others.

YELLOW PAGES IS VERY UNDERAPPRECIATED — VERY STABLE, LOW CAPEX AND VERY STRONG.

Sondike: And, again, U.S. West Media Group isn't just a *cable* company. It's half wireless and Yellow Pages directory publishing. And their Yellow Pages directory publishing segment alone generates roughly $500 million per year in pretax free cash flow.

OID: Really!?

Sondike: Really. They are using that cash flow today to fund the very substantial sums that they're spending to upgrade their cable networks in order to be able to offer advanced services to their subscribers and just be more competitive generally. But that's what it's generating.

Also, it's a terrific business. Almost no recurring capital expenditures are required. And, competitively, it's very strong and very defensible. It's truly a very underappreciated asset.

OID: In more ways than one, you no doubt hope.

Sondike: It's not a fast growing business — it's probably growing only in the mid-to-high single digits. It's perceived not to grow as fast as cable, although perhaps it might. But it doesn't have the risk of cable either. And it doesn't require the capital that cable does. However, because it isn't fast growing — despite its free cash characteristics — investors don't value it that highly.

I happen to like this business very much though — because I think it's a low risk, stable business.

AND WE'RE SETTING UP THOSE TWO DIRT CHEAP — AT ONLY ABOUT 35¢ ON THE $1 (MAYBE EVEN LESS).

Sondike: And they've structured an excellent deal with Airtouch whereby they have the ability — subject to certain conditions — to put their domestic wireless assets to Airtouch at *private* market value in exchange for Airtouch equity securities at *public* market value.

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OID: That sounds favorable enough.

Sondike: And U.S. West Media Group has indicated that they intend to exercise that option and that they may do so in the very near future. Those equity securities could be worth $10 per U.S. West Media Group share alone.

OID: Very interesting.

Sondike: And they hope to distribute these securities to shareholders as soon as possible.

OID: Even more interesting.

Sondike: And it gets better. That $10 is only for their *domestic* wireless assets. I estimate that they have about $3 of *international* wireless assets, too.

OID: And could you give us a roughcut thumbnail on how you get to your mid-$30s value?

Sondike: I figure that their cable and media assets are worth about $19 billion — or roughly 50% of the company's total value. And, then, I figure that wireless assets represent another $8 billion — 75% of which is attributable to domestic wireless.

And, finally, I estimate that the balance — which is roughly $5 billion — is attributable to their Yellow Pages directory publishing business.

OID: Which would get you up to about $32 billion.

Sondike: That's right. And, as I recall, there's around $11 billion of debt and preferred and approximately 610 million shares outstanding [on a fully diluted basis].

OID: If so, deducting that $11 billion of liabilities from those $32 billion of assets and dividing by your 610 million shares would get us to $34+ per share.

Sondike: That gets us to my mid-$30s value. And, again, there's a significant likelihood that the company realizes the value of its domestic wireless business within the next few months.

OID: So if you pay $18-5/8 today and sell off the $10 of Airtouch securities you hope to receive soon, you figure you're only paying $8-9 for $25 worth of assets — pretax, anyway.

(continued in next column)

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Sondike: Exactly. And, as I said, some analysts think that U.S. West Media Group's assets are worth more. There are private market value estimates on the Street which are substantially higher than mine. For example, Lehman and DLJ come up with 1997 private market values close to *$40* per share.

OID: I'll remember that the next time we're recruiting.

Sondike: And, in any case, we believe those values are growing nicely.

MY FAVORITE SITUATION ON THE PLANET — A NAME FAMILIAR TO LONG-TIME *OID* SUBSCRIBERS.

OID: Tell us about your role at Franklin Mutual Series.

Winters: I'm pretty eclectic. Basically, my charter is good businesses worldwide. I have investments in the U.S. and Canada, Europe and Asia. The bulk of the $1.5 billion I'm responsible for is in 12 names. I use a rifle and not a shotgun and concentrate in the ones that I really like and that I have a lot of conviction about.

OID: Rather than have an industry focus.

Winters: That's right.

OID: Is there any common theme?

Winters: You tell me. The positions I'm responsible for include Railtrack, Canadian National, Cheung Kong, Van Melle, Nutricia and Brown Foreman. So they include railroads, beverages, candy, niche foods, specialty media — mostly what you might call the good business camp.

I like those because that's how most people get rich: by investing in a good business that generates cash, that has significant sustainability and that's managed by someone honest and competent. As you know, that's a very powerful combination. And, needless to say, I want to do it at the right price — when their virtues are temporarily obscured for one reason or another.

OID: Are there any of those you can tell us about that are at the right price today?

Winters: Well, I know that you like to talk about things that are selling at 50¢ on the $1 or less and that your contributors are buying at current prices.

OID: You noticed.

Winters: And that's very tough in today's market. Actually, it's hard to be a value investor in *general* today. It's really, really tough.

Nevertheless, I believe I have one to tell you about that's a *wonderful* bargain. I've been buying it. And I think it's a great story. In fact, it's even an old *OID* name...

OID: If you're going to tell us about some idea from a past edition that didn't work, we can stop right now. I don't want our subscribers to get the impression that all of our contributors' ideas don't work beautifully...

Winters: Actually, it's been a *great* investment. And the idea has worked out beautifully.

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***OID:* In that case, by all means...**

Winters: You spoke with Tom Russo back in 1991. As you know, he's one of the best and brightest...

***OID:* Are we talking about the same Tom Russo?**

[Editor's note: Winters is referring to Tom Russo of Gardner Investments and Semper Vic Partners. You'll find Russo's comments on this idea, among others, in our editions of July 1, 1991 and October 7, 1993.]

Winters: And one of the things he talked about was De Telegraaf [TEAC NA]. As longtime *OID* subscribers know, it's the dominant national newspaper in the Netherlands. Like most well positioned newspapers, it just spits out cash. Also, management has a wonderful record of having done very intelligent things with that cash for many years. But I'm getting ahead of myself.

***OID:* Absolutely. In fact, maybe you should tell us one more time how you learned about this idea and how it's done so far...**

Winters: After reading Tom's comments, I did my own research and learned that De Telegraaf's annual report was available only in Dutch, that it had no investor relations department and that they make it challenging to learn about the company at all.

***OID:* So far, so good.**

Winters: Let's just say that De Telegraaf isn't one of the world's most transparent situations by any means.

***OID:* Especially if you don't speak Dutch, no doubt.**

Winters: And even *then*. But we did what we could — including having their annual report translated from Dutch and speaking with our contacts in the Netherlands. And I was able not only to confirm what Tom said, but I think I may have even gotten more excited than *he* was. Some of what I found out was amazing.

***OID:* But is it still a bargain today?**

Winters: Its stock has come down recently. Its high was 42.38 guilders. Today, it's selling at 36.3 guilders. Even with that decline, it's been a great investment. And we've been accumulating it. And it's my favorite situation right now on the planet and my best idea today by far.

***OID:* I'm going to assume that's a "yes"...**

A PACKAGE OF FIRST RATE MEDIA PROPERTIES
AT BETWEEN 3.7 AND 4.5 TIMES EBITDA.

Winters: This is a great story. It's one of those situations I call, "The gift that keeps giving." The stock's gone up, but the valuation really hasn't in a lot of ways because they've also created value in the meantime.

***OID:* If that's true, that would be saying quite a lot — because, as I recall, it was dirt cheap.**

Winters: Its valuation isn't quite as low as it was. When Tom talked about it, it was selling at 87 guilders. Again, today, after an 8-for-1 split, it's at 36.3 guilders.

***OID:* So that split-adjusted, De Telegraaf is up from 87 guilders to 290 guilders?**

Winters: That's right. And, actually, an unhedged U.S. investor has done even better during that time — because the exchange rate's gone from slightly more than 2 guilders to the $1 down to approximately 1.7 guilders — actually 1.745 guilders. So he's earned an extra 18% from currency gains, too — although we do hedge.

And that's another thing that makes De Telegraaf so interesting — the Netherlands is a very well run country. And its currency has historically appreciated against the U.S. dollar.

***OID:* And you've actually paid the current price?**

Winters: The current price and more. As I recall, we've paid as much as 40 guilders. I absolutely think it's still really, really cheap.

And the way that I look at it may be a little different than the way most investors do. But after I make all of my adjustments for their net cash and hidden assets, I figure De Telegraaf is trading at about 4-1/2 times 1996 EBITDA and 3.7 times 1997 EBITDA.

***OID:* That sounds really, really cheap, all right.**

Winters: Like I said. It's about *half* the multiple that most U.S. newspapers trade at today.

THE MARKET SEES A P/E OF 18+,
BUT IT LOOKS MORE LIKE 8 TO ME.

Winters: But most people just look at De Telegraaf's current stock price of 36± guilders, divide by its 2± guilders per share of reported earnings and figure that it's selling for 18+ times earnings.

***OID:* You prefer more creative accounting?**

Winters: You have to be a bit of a detective to figure it out. Plus, it is somewhat complicated.

***OID:* Can you simplify it enough so that even a newsletter editor can understand it?**

Winters: That's asking a lot, but I'll try. I figure that De Telegraaf currently has about 8 guilders per share of net cash. Then, it has a 21.7% stake in Wegener Arcade — another publicly traded Dutch company that has interests in regional newspapers, among other things.

[Editor's note: In those same features, Russo mentioned buying Wegener and told us about it, too.]

Winter: De Telegraaf owns 1,435,195 certificates in Wegener that currently sell for around 160 guilders each. So those shares have a current market value of about 229.6 million guilders — or approximately 4.4 guilders for each of De Telegraaf's 52.5 million shares.

And Wegener's shares are themselves depressed right now because they did an acquisition which seems to have gone astray. As a result, their stock is down from a high of 203 guilders to only about 160 guilders today.

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OID: Super.

Winters: Finally, I add their non-core assets at cost. And they add up to roughly another 1 guilder. Actually, they have other things tucked away — including 30% of Planet Internet — that I *haven't* included.

OID: You'd never make it in the high stakes world of newsletter publishing.

Winters: I'll take that as a compliment — although, honestly, they aren't very significant in any case.

So, anyway, adding up De Telegraaf's 8 guilders per share of net cash, its 4.4 guilders per share of Wegener certificates and its 1 guilder per share of miscellaneous non-core assets, I estimate that it has total net cash and securities of approximately 13.4 guilders per share.

And, therefore, when I deduct that 13.4 guilders of net cash and securities from De Telegraaf's current stock price, I figure I'm really only paying *23* guilders per share for its core business.

OID: Although that's still over 10 times earnings. And you know how we feel about double-digit P/Es...

Winters: More than 10 times *reported* earnings. There's reported earnings and then there's *real* earnings. One of the things that I've learned to do working here at Franklin Mutual Series is to look at reported numbers and then try to determine the economic reality behind them.

De Telegraaf may only report 2.1 or 2.2 guilders of earnings per share in 1997. However, they're amortizing the goodwill [the excess of purchase price over tangible book value] resulting from their recent acquisition of Bonaventure — a magazine property — over only five years.

OID: Wow.

Winters: In the U.S., that kind of acquisition would be written off over *40* years.

OID: Unless management could justify amortizing it even more slowly — or, of course, not at all.

Winters: Exactly. Therefore, to understand what they're actually earning, you have to add back that goodwill amortization. Plus, they depreciate much of their equipment over only five years — much more rapidly than most American newspapers. As a result, their depreciation is much *higher*. So I adjust it to U.S. GAAP levels.

And, then, they have a television joint venture — SBS6. Not so surprisingly, it's reporting start-up losses today — as are some other of De Telegraaf's operations. Therefore, I add those back. Then, finally, I back out their interest and dividend income...

OID: In order to avoid double counting their net cash and securities.

Winters: Exactly. And after incorporating all of those adjustments, I estimate that De Telegraaf should actually earn about *2.75* guilders per share.

And since, as we calculated, I'm really only paying about 23 guilders for its core business net of other assets, I'm actually only paying 7-1/2 to 9 times earnings or less for what I believe is clearly a great, well managed business.

OID: And given that you estimate it's selling at only 3.7 times 1997 EBITDA, I get the impression you think your estimate of adjusted earnings per share and, therefore, P/E may be a little on the conservative side.

Winters: That's true. In fact, I do. But, again, De Telegraaf isn't the world's most transparent situation.

DE TELEGRAAF IS A LANDMARK PROPERTY,
BUT IT'S SELLING AT A DISCOUNT PRICE.

OID: How does its valuation look revenue-wise?

Winters: De Telegraaf's core business has revenues of about 1.150 billion guilders — or 22± guilders per share. So if you net out their cash, their Wegener stake and so forth, De Telegraaf is only selling for about 1 times sales. By comparison, including long-term debt, I believe Gannett is selling at something closer to *2-1/2* times sales.

OID: Actually, including its debt, Gannett looks like it's selling at closer to 3 times sales. But it looks like the average publicly traded newspaper company in Value Line may trade closer to 2 times sales.

Winters: They usually trade at a *multiple* of revenue. But Gannett is well run — as is De Telegraaf. So Gannett may actually be more comparable.

OID: And price per subscriber? As I recall, when we spoke with Russo in '91, he said that De Telegraaf was selling at only $250 per subscriber. Do you know what the comparable figure is today?

Winters: Again, any figure I give you is an estimate. But De Telegraaf has 52.5 million shares outstanding, more or less. And, as we've discussed, you're really only paying about 23 guilders per share today for its core assets — which is about 1.2 billion guilders.

OID: For how many subscribers?

Winters: Today, the national version of De Telegraaf has 756,000 subscribers. Plus, they own a local version in Amsterdam which has another 56,000 copies. Therefore, all told, it has roughly 800,000 subscribers.

OID: Rounding down from 812,000...

Winters: Then it owns regional newspapers which — after the pending acquisition of Gooi-En-Eemlander — will have another 400,000 or so subscribers. And, therefore, De Telegraaf has roughly 1.2 million subscribers in all.

Therefore, if we divide our 1.2 billion guilder cost by De Telegraaf's 1.2± million subscribers, the implied price per subscriber is around 1,000 guilders. And, finally, dividing that 1,000 guilders per subscriber price by the current exchange rate of 1.745 guilders to the $1, I estimate that De Telegraaf is selling at only $575± per subscriber.

OID: Is that good?

Winters: No. It's *great*! That's a *massive* discount to what U.S. companies typically command. For example, Knight Ridder recently paid $1,868 per subscriber and, reportedly, 14 times EBITDA for a package of newspapers in the San Francisco area. Again, I estimate De Telegraaf

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is selling at only *3.7* times 1997 EBITDA.

OID: Quite a contrast.

Winters: That's right. And those properties were actually much less desirable than those of De Telegraaf because they were in a much more competitive market. More comparable, I think, were *The Raleigh News and Observer* for which McClatchy paid more than $2,300 per subscriber or the four small Virginia newspapers that Media General paid more than $2,800 per subscriber.

OID: Pretty striking, all right.

But are all of De Telegraaf's newspaper properties monopoly newspapers?

Winters: I wouldn't go so far as to call them *monopoly* newspapers. But they're certainly *dominant*.

OID: Do Dutch newspapers generally sell at lower multiples or is De Telegraaf particularly cheap?

Winters: According to a 1995 research report — and I'm not aware of any research report on this company since — De Telegraaf's peers commanded EBITDA multiples of 5.2, 7.7, 12.0, 12.3 and 12.5, respectively.

OID: Two to three or more times De Telegraaf's multiple of 3.7 times EBITDA.

Winters: That's right. And, interestingly, the lowest of them, other than De Telegraaf itself, was Wegener. And, as I mentioned, De Telegraaf owns 21.7% of it.

But, candidly, the companies listed as peers in that report include Elsevier and Polygram — which are far faster growing and much sexier than De Telegraaf.

OID: Then, what the heck is the author of that report doing including them among De Telegraaf's peers?

Winters: I don't think he *should* have. But I think he was trying to show the spectrum of media companies in the Dutch stock market and the multiples at which each was trading. I think his point was very simply, "Here's the dominant national publisher trading at the lowest multiple. Isn't that strange?" And he's *right*.

OID: Are any other Dutch newspaper publishers besides De Telegraaf and Wegener publicly traded?

Winters: None that I'm aware of. The Netherlands is a small country. And except for one private company which is controlled by a foundation, De Telegraaf and Wegener have basically *bought* almost everything.

So you could always argue that dollar bills in the U.S. are too expensive. But it's also selling at a big discount to comparable properties almost everywhere else in the world.

OID: Although even if the core business was worth a multiple of its 23 guilder imputed price, De Telegraaf as a whole probably wouldn't be because of the large component of cash.

Winters: That's probably a fair assessment. It's not for sale anyway. It's basically a family-controlled business that accidentally has a quote.

But don't forget that this is *the* landmark newspaper in the Netherlands. It's the dominant national newspaper. Therefore, it would probably command a landmark price. You might be very surprised at just how much these assets could sell for. It's not inconceivable to me that the enterprise could be worth twice what it sells for today or even actually *sell* for that much.

If you'd ever told anybody that Conrail would sell for the multiple it's getting, no one would have believed you. But there's only one Conrail. Well, De Telegraaf is a collection of fabulous assets. And it's also one of a kind.

OID: It certainly sounds like it.

But what does it look like on a look-through basis — cash assets and all?

Winters: Including the earnings from Wegener and the dividends from their cash, I estimate that De Telegraaf is selling at about 6.4 times 1996 EBITDA and 5.7 times 1997 EBITDA [on a look-through basis]. But, of course, that's a *very* conservative way to view it — because it includes the drag of their cash, but doesn't give them credit for Wegner's higher valuation.

In any case, I'm buying a very good business and setting it up at a cheap price. And that's what I try to do.

IT HAS BEEN A LOUSY TIME FOR DE TELEGRAAF,
ONLY NOT NEARLY AS BAD AS REPORTED.

OID: In 1991, Russo said that De Telegraaf's earnings had grown about 14% per year in the prior five years.

Winters: That sounds about right.

OID: What can you tell us about its results since?

Winters: Again, they had an 8-for-1 split this year. But shares outstanding stayed pretty constant since 1991 at around 6-1/2 million. And, again, today they have about 52-1/2 million shares outstanding.

But they have so many exceptional items today. Plus, they dividend account for Wegener. In other words, they only include the dividends from their investment in Wegener, not its earnings. And it pays a very small dividend.

OID: Just for the heck of it, then...

Winters: In 1990, De Telegraaf earned 12.22 guilders per share after tax. Split adjusted for their 8-for-1 split, they earned 1.53 guilders. By 1995, their net had grown to 15.44 guilders pre-split — which is roughly 1.93 guilders post-split. So their earnings per share have grown less than 5% per year.

OID: In other words, not so hot.

Winters: Not so hot. And De Telegraaf's stated ROE has declined from 15.5% in 1991 to about 12.8% in 1995.

OID: So this thing is slowly transforming into a dog?

Winters: Not at all. Newsprint prices went through the roof during that same 1990-1995 time period. And they've come down quite a bit of late — which means that De Telegraaf's costs of goods *sold* is going to head down. Some of that decline is already reflected in their earnings, but there's more to go. We understand that 10-15% newsprint price declines should start to be reflected in cash flow and

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earnings around March or April. So that's significant.

Also, the advertising market is improving. These are some of the most conservative folks I've ever run across. And even they reference the fact that advertising volumes are up 5.2%. Plus, they're raising their subscription rates and their classified ad rates 2%.

And I know that doesn't sound overwhelming. But this business has huge operating leverage. So, if your cost of goods sold is declining and business is getting better, that's a very powerful combination.

These aren't exactly salad days for De Telegraaf.

OID: You've convinced us.

Winters: But, despite all the factors I've mentioned, when I back out its cash and marketable securities from its book value — and the interest and dividends that they earn on those assets from their reported earnings — I estimate that De Telegraaf's ROE is actually more than 36% on 1995 end-of-year equity today.

OID: Wow.

Winters: And that's before adding back anything for their goodwill amortization, their conservative accounting or anything else.

OID: That's downright hard to believe.

Winters: In part, it's because there's not much book required. But it's also very clearly a highly profitable, cash-generative business. And reported earnings and return on equity obscure reality more than anything.

FREE CASH FLOW IS GROWING VERY NICELY
— UP TO 8.8% IN 1997 AND MORE TO COME.

OID: What measure doesn't obfuscate reality?

Winters: I used to *not* be a believer in using EBITDA [earnings before interest, taxes, depreciation and amortization]. However, as I've gotten more and more into the esoterica of accounting and trying to understand the economic reality vis-a-vis the reported numbers, I've concluded that EBITDA is actually the best way to look at this kind of company.

OID: Where there usually isn't nearly as much in the way of recurring capital expenditure requirements.

(continued in next column)

Winters: That's right. The media industry lends itself especially well to the use of EBITDA.

OID: And what can you tell us about how De Telegraaf has done by that measure?

Winters: From 1990 to 1995, EBITDA grew between 9% and 9-1/2% compounded — which is nearly double the reported EPS growth. But, again, both have been in the face of a stiff headwind.

OID: And free cash flow?

Winters: Of course, that's jumped around depending on their capital expenditures. But here's my estimate for each year since 1990 pre dividends [in millions of guilders]:

1990	1991	1992	1993	1994	1995	1996	1997
40	34	6	85	173	132	120*	167*

*Estimates for 1996 and 1997 exclude the upcoming acquisition of Gooi-En-Eemlander.

OID: I see what you mean — although the trend certainly looks healthy.

Winters: I think so. If you take De Telegraaf's average free cash flow for '90 and '91 and compare it to the level that I'm estimating for '96 and '97, you'll see that it's been compounding over 25% per year during that time.

OID: Despite paying out a third of reported earnings, more or less, from 1990 to date — although I imagine it was a much lower percentage of its cash earnings.

Winters: That's right. And, of course, it would be even higher using actual 1994 and 1995 figures.

OID: I understand that they're approaching the end of a multi-year printing plant modernization program on which they've spent big bucks in 1995 and 1996.

Winters: That's right. And because their accounting is so conservative, that's temporarily depressed not only their free cash flow, but their reported earnings, as well.

OID: Which may help explain why you think their results have been depressed and your optimism that they're likely to get better.

Winters: Correct. The completion of that program should definitely contribute to higher free cash soon. But they could always go out and spend it on something else. And, of course, my estimates may be overly optimistic. But management says there are no major capital expenditures planned for the next few years.

They are building an office building over the next several years which will probably cost 70± million guilders in all. So maybe their capital expenditures will decline from 85 million guilders to 50 or 60 million guilders.

OID: Which would be a decline of 30 million guilders — or something around .57 guilders per share.

Winters: Correct. So if De Telegraaf's free cash flow does turn out to be *167* million guilders in 1997, that would be nearly 3.2 guilders per share. And that would be a free cash flow yield of 8.8%.

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OID: Is that good?

Winters: It's excellent. Long-term Dutch bonds, by comparison, have a yield to maturity of less than 6.6%. So, in effect, you're buying a very good business at a discount to the long-term Dutch government bond yield. And I'd argue that De Telegraaf should actually sell at a *lower* yield — in fact, *much* lower — because, unlike a government bond, its free cash flow should *grow.*

THERE ARE PLENTY OF REASONS WHY IT'S CHEAP.
BUT IF THE LONG TERM IS RIGHT, THAT'S FINE.

OID: What can you tell us about its revenue growth?

Winters: Revenues are also distorted looking back — and even more so in 1996 and beyond. They had revenues of 775 million guilders in 1990 and 1.151 billion guilders in 1995. So they've grown about 8% per year — most of it from acquisitions. So we're not talking about rapid growth in any case.

OID: On the other hand, as Buffett and others observe, a monopoly newspaper shouldn't require much capital to grow. So its earnings stream may nonetheless be very valuable indeed.

Winters: Exactly.

OID: So why is De Telegraaf so cheap?

Winters: First, most Dutch investors pay attention to reported earnings per share and earnings per share growth and little else. And, as I laid out, reported earnings and earnings per share growth haven't been all that impressive — less than 5% per year for the last half a dozen years. Therefore, Dutch investors are completely ambivalent about it.

OID: Sounds familiar.

Winters: Then, first half earnings were down 17%. And management said that they expect an earnings decline for the full year. So *that* really spooked the market.

OID: Are you sure this isn't a short?

Winters: Then De Telegraaf makes an acquisition. And investors know that whatever goodwill results from it is going to be written off over five years. Therefore, the accounting obscures just how good this company really is.

And they all say, "What in the world is De Telegraaf doing in the TV business?"

OID: Not earning money can fuel comments like that...

Winters: The biggest negative in investors' minds right now may be disappointment at the bankruptcy of Sports Seven — a soccer cable network in which they're a minority partner that just went bust. But they only own 5% of it. So it's virtually insignificant to them.

Also, as in the U.S., most of the bull run has been within the very liquid, relatively glamorous stocks. And, obviously, De Telegraaf isn't one of those.

OID: And I gather the relative paucity of information that the management makes available to investors probably isn't viewed as a positive by most.

Winters: That's right. It's almost like buying shares in a private company. But as long as the business and the management are right — and the reporting is honest — that's perfectly fine with me. Where it becomes a problem is when the assets are being mismanaged. However, that's definitely not the case here.

But that actually reminds me of a recent development that I find very interesting. De Telegraaf just published an English version of their semiannual report. And other than a two-page summary in the back of their annual report, that's the first time in their history — that I know of — that they've published *anything* in English.

So we have what may be an indication — just possibly — of them opening up a little to the world.

OID: That is very interesting.

NEWSPAPERS & *DE TELEGRAAF* FACE MANY THREATS.
BUT, AT LEAST, ONE OF THEM HAS BEEN LESSENED.

OID: But what, then, could turn it into a mistake?

Winters: If people decide they're never going to read a newspaper again.

OID: Your turn of phrase makes it sound impossible. But declining readership is certainly feared by many — especially given recent trends, new media, etc.

Winters: And that was a nightmare scenario I feared. In fact, at one point after I started buying it, it was down. And younger people aren't reading newspapers as much.

So, at Berkshire's annual meeting, I asked Warren [Buffett], "What do you think about the newspaper business now?" I said, "Twenty years ago, you said that you loved it. A few years ago, you said it's not as good as it *used* to be. How do you feel *today?*"

The reason I asked him that is that we were right on the cusp of increasing our position to just over 5%. And, frankly, I was a little concerned.

And he said, "It's not as wonderful as it used to be. Newsprint prices are up. But if I had to own one business forever, it'd be a monopoly newspaper."

I'd say that's pretty awesome conviction.

OID: You really think he understands this business?

Winters: He's done all right. And at this year's annual meeting, Warren talked about how the market for printed encyclopedias had basically imploded. So I asked him whether newspapers were likely to do the same.

And, again, he said no, that newspapers have a niche as the preferred source of local information — although, clearly, their franchise isn't as wonderful as it used to be. But he said it's still wonderful.

OID: And it sounds like you agree.

Winters: I do. I think newspapers are here to stay — because they're portable and tangible.

OID: Russo said that fears about competition from TV were one reason why De Telegraaf was so cheap —

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although he thought those fears were overblown.

Winters: People did criticize De Telegraaf for years for resting on its laurels and not doing anything in the television business. People felt like they'd missed the boat.

With the advent of commercial television in the Netherlands and Europe, generally, TV's taken a greater and greater share of advertising revenue in recent years. And it's likely to take an increasing share over time — just as it has in the U.S.

OID: He suggested that De Telegraaf might ultimately get into the television business itself — and, as you mentioned earlier, they now have.

Winters: That's right. In March, they acquired a 30% interest in SBS6 — which is a television joint venture with Scandinavian Broadcasting. Incidentally, 23% of Scandinavian Broadcasting is owned by Disney through Capital Cities/ABC. And I believe that Viacom has an equity stake, as well. So now they're in that business with a wonderful partner to boot.

OID: But what kind of price did De Telegraaf pay to enter that business?

Winters: Nobody's really making any money in that area right now. For example, RTL4 is twice their size and they're not making any money either. However, SBS6 is the #2 commercial player today. And they're gaining market share. I understand that they just reached breakeven in November with a 10%± share of the advertising market.

Also, I understand SBS6's 1996 revenues were about 100 million guilders. So they're not huge by U.S. standards. I believe De Telegraaf paid 55 million guilders — not including start-up losses — for their 30% interest. But that's just my estimate.

OID: But using your 55 million guilder figure, that would imply a valuation of about 185 million guilders for the entire enterprise — or 1.85 times revenues.

Winters: That's right.

OID: Is that good?

Winters: An equivalent property in the U.S. might command 2 to 3 times revenue. And, again, they have a fabulous partner — probably the best in the world. Also, RTL — the dominant player in television in the Netherlands — has RTL3, RTL4 and RTL5. And the EEU has ruled that RTL5 can no longer be a general interest channel — because there's too much concentration.

OID: What does that mean exactly?

Winters: That they can't have everything on it — like the networks in the U.S. RTL5 fought hard against SBS6. So with RTL5 changing its format, that could help them.

OID: And, in any case, it sounds like you think having Disney as a partners bodes well long term.

Winters: Absolutely. But, De Telegraaf does still have far more exposure to print than it does to TV. So the increasing share of ad revenue to TV is still a negative. However, it's less of a negative than it was.

OID: And you don't see competitive risk within the newspaper business itself for De Telegraaf?

Winters: No. There are people who don't like its style — in the same way that some people like *The Daily News* and others prefer *The New York Times*. But *De Telegraaf* is by far the dominant newspaper.

There is a larger newspaper *group* — Perscombinatie — which is itself controlled by a foundation. And they have four different national newspapers. But *De Telegraaf*'s the Netherlands largest *single* national newspaper by *far*.

OID: Might we trouble you to define "by far"?

Winters: As I mentioned earlier, their flagship newspaper, *De Telegraaf*, has about 800,000 subscribers. I believe that the #2 newspaper has more like 500,000 or 600,000 subscribers.

OID: And you see no trend of share loss or gain...

Winters: I think it's been pretty steady.

OID: Why does a margin of 800,000 versus 500,000 or 600,000 make for dominance? Does it result in their gaining a disproportionate share of advertising?

Winters: Good question. It may just be because it's essentially the flagship newspaper of the Netherlands.

OID: By reputation — which translates into share of advertising, economics, etc.

Winters: I think that's right. It has a solid franchise. And, as a result, the margin of safety here is just so big — price-wise and quality-wise — that I think it discounts every risk out there and then some.

DE TELEGRAAF'S SINGLE BIGGEST PROBLEM — MORE CASH (& CASH FLOW) THAN OPPORTUNITY.

OID: Assuming that everything you say is correct, why isn't this management buying back their shares?

Winters: Their valuation is definitely *screaming* for them to buy back shares. Sadly, it's very difficult to do in the Netherlands because it's very onerous tax-wise.

OID: That is a shame — and a big negative, actually.

Winters: No question about it. It really is. So, here, you have a basically debt-free company with lots of cash and lots of free cash flow that can't buy back its own stock.

OID: In combination with the fact that they're already carrying around 8 guilders per share of net cash, that sounds like it could be a big negative.

Winters: Absolutely. I agree. But these guys have an excellent 50-year track record — not only in terms of management, but also in terms of capital allocation. The Van Puijenbroek family bought control of De Telegraaf in 1946. And based on their original price, I understand that they've compounded their original investment at about 20% per year ever since.

OID: Even starting with Europe in shambles following

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World War II, that still sounds pretty wild.

Winters: It really does. They have a wonderful record of investing the cash generated by their newspapers — not only to enhance their core newspaper business, but also to make niche acquisitions in the newspaper area.

OID: But anyone with a track record starting in 1946 is probably nearing retirement, if they're not retired already. What's the story management-wise today?

Winters: Their managing director is a guy by the name of Drs. Ad J. Swartjes. He's probably in his 40s. He's been with De Telegraaf for approximately 10 years. And he's done a beautiful job of running their newspapers, running their overall operation, redeploying their cash and growing shareholder value generally.

As I mentioned, De Telegraaf is a minority partner in a cable soccer network that recently declared bankruptcy. So they haven't been *perfect*. However, it's tiny. And they only own a 5% stake.

OID: Gotcha.

Winters: But De Telegraaf has limited its activities to the Netherlands — which only has about 15 million people. So there are limits to what they can do with their capital. One of the things people say about De Telegraaf is that their pond's almost empty — that a few little newspapers and other things are left for them to buy, but then that's it.

OID: Are they right?

Winters: People have made that criticism for *years*. And, yet, they've always seemed to find something to do with their capital. And, for the most part, they've proven to be *very good*.

Fortunately, these folks only want to do *smart* things. Many companies are driven by ego rather than intelligence. These guys seem driven by intelligence. And I *like* that.

But you're right. The biggest question mark and the biggest challenge for De Telegraaf going forward is how they deploy their free cash flow in a sensible manner.

DE TELEGRAAF IS JUST A CLASSIC, GREAT COMPANY — WHERE YOU'RE IN DANGER OF *DROWNING* IN CASH.

OID: And not only is their capital allocation tied to the Netherlands, but so are their revenues and profits.

Winters: And that's another negative — absolutely. But, until very recently, people thought Dutch companies *should* sell at a discount. And that was primarily because of the provisions which make it difficult to engage in hostile takeovers — including the prevalence of nonvoting certificates — in the Netherlands. And Dutch companies *did* generally sell at steep discounts. But De Telegraaf is one of the few that *still* does.

And maybe I'm dreaming. But here's a debt-free, dominant, well-run company that trades at a much lower valuation than comparable companies around the world. And I don't see why it shouldn't be valued like any *other* media company — especially now that we're seeing the globalization of media companies, cross-border deals, etc.

OID: In which case, De Telegraaf might no longer sell at a half to a third of what a comparable property might sell for in the U.S.

Winters: Exactly. So being more or less a Netherlands-only company is a negative. But if I'm going to be exposed to a single developed country, I'm very happy for it to be the Netherlands — because it's had a great past and, I think, it's going to have a great future.

And, again, the guilder has historically tended to strengthen against the U.S. dollar long term.

OID: And I understand there are far worse problems than having too much cash and too much cash flow — for example, not having enough. However, I'd like to test out that hypothesis personally...

Winters: Exactly. So there are plenty of reasons why it's cheap and why it could even stay cheap for awhile. But since we expect them to compound their underlying value at a very nice rate over the long term, that's just fine with us.

Again, I call it the gift that keeps giving. And maybe it'll stop one day. However, they own basic businesses — *very* basic. And it's one of the very few situations I know of that's still trading at a very cheap valuation and being run by people who know what they're doing and keep making it better. De Telegraaf is *such* a fabulous story. I love it.

OID: I somehow got that impression...

Winters: It's just a classic, great company — where the accounting is so conservative and the cash just keeps coming at you — almost faster than you can invest it — every day.

OID: The kind of business Charlie Munger recommends: where "you drown in money if you pause for breath".

Winters: That's *exactly* what it is. De Telegraaf is absolutely a free cash flow *machine*.

So I could very well be off on any of these figures...

OID: Now you tell me.

Winters: But the margin of safety is so substantial here that whether it earns a little more or a little less, it doesn't change the fundamental thesis.

De Telegraaf was a great idea when Tom pounded the table about it in *OID* in 1991. Its returns have proven that it was. And I think it's *still* a great idea.

OID: Thanks for the update. And thanks, also, to both Ray Garea and Larry Sondike, for sharing some of your thoughts and your ideas.

Winters: Our pleasure.

—OID

For additional information
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BARON ANNUAL CONFERENCE
RON BARON
(cont'd from page 1)

HAVING A LONG-TERM PERSPECTIVE
LETS YOU FOCUS ON WHAT'S IMPORTANT.

Some professions are easier to enter than others....

Ron Baron: My youngest son, age 15, asked me to read an English paper due in school the next day. His topic? A homeless man who had found a baby in a carriage on the streets of New York.

My son's hero discovered the child's name and address taped to the side of the carriage and returned the baby to its home. The child's parents were grateful and offered the homeless person a place to live until he could find a job. A short while later, the no-longer homeless person became gainfully employed as a financial analyst on Wall Street....

I was pleased my son had learned that good deeds and kindness are rewarded. I guess he's also learned after carefully observing me during his 15 year lifetime that nearly anyone can become a securities analyst.

People worry about *everything* — except the *right* things....

Baron: ...Most people who invest consider themselves long-term investors. That's because they're saving for retirement, a home or a college education. However, investing for a long *time* is a lot different than being a long-*term* investor.

Most people worry about current events — the impact a strong economy will have on interest rates and the impact a weak economy will have on earnings. They worry when the Democrats win the Congress and they worry when the Republicans win the Congress. They worry about the deficit, about too much unemployment and about too little unemployment. And, amazingly, they worry when the average worker in this country makes 9¢ more an hour. The stock market actually fell 100 points in one day on July 5th when it was announced that average wages had gone up 9¢ from the prior month.

In short, they worry about everything except what they *should* worry about — which is the prospects for the businesses in which they're investing and the integrity and the competency of the managements of the companies in which their hard earned money is invested.

A long-term perspective lets you focus on what's important.

Baron: We believe you gain an investment advantage if you have a longer-term perspective, ignore chatter about the market and focus on the long-term prospects of the businesses in which you invest. We try to identify and analyze well-managed, fast growing businesses, buy their shares at attractive prices and hold them for the long term — for *years*.

We won't invest in a business unless we believe we have the opportunity to earn at least 50% on that investment over a two-year period. In most cases, our objective is to at least double our money within three to five years. And we've held many stocks that long and even longer.

A long-term perspective clearly requires patience. When stocks fall because of irrelevant fears and concerns, you must have the conviction to hold your investments and buy more. We believe you can achieve this confidence by doing extensive research in individual businesses — [in effect] by being better informed about the companies in which you invest.

A long-term perspective lets you focus on mega-trends and investment themes, invest in great businesses run by terrific managers, worry about business risk rather than stock market risk and profit from market inefficiencies.

We're looking for passion & intensity in our managements.

Baron: Warren Buffett says when a great manager is hired to run a terrible business, it's [usually] the reputation of the *business* that survives. Few investors attach more importance to management than Buffett. But his message is that not even great management can make much difference to a business with bad fundamentals.

We admire Buffett's investment philosophies. And like Buffett and many others, we also won't invest in a company in whose management we don't have confidence. We have to think they're smart and ethical and honest and hard-working. We don't invest in businesses run by 9 to 5 guys with low handicaps. We're looking for passion and intensity. We're looking for entrepreneurs.

J.P. Morgan used to say, "It's all about character." We want to invest with executives who are inspiring leaders — who treat not only their *customers* well, but also worry about their *employees*. Billy Joel says, "It's all about soul."

BENEFIT FROM POWERFUL, LONG-TERM TRENDS.
HERE ARE FOUR POWERFUL DEMOGRAPHIC TRENDS.

A lesson from George Soros: Focus on long-term trends.

Baron: However, before we even get to management, we normally first focus on trying to find good businesses with strong growth prospects in which to invest.

How do we do this? I managed money for well-known investor George Soros for seven years during the 1980s. When we spoke regularly about our investment portfolio, George always seemed much more interested in underlying trends and themes than in individual businesses. He taught me the importance — the power — of long-lasting economic trends and investment themes like *demographics*. Changing demographics create long-term demand for products and services.

Trend #1: Hispanic population growth....

Baron: A few examples: the Hispanic population in the U.S. is growing five times as fast as the Caucasian population.

Who's going to benefit? We've invested in a radio business that serves the Hispanic populace. Studies show Spanish language ads are much more effective in creating demand in this population segment than English ads. Hispanic radio and television stations not only do not receive the share of advertising dollars justified by *current* ratings — and this is going to change — but station *ratings* will grow as the Hispanic population increases.

Who else is going to benefit? We've [also] invested in a value-oriented, urban California and Florida-based cash and carry retailer of ethnic foods. This business also caters heavily to Hispanic customers. And we've invested

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BARON ANNUAL CONFERENCE
RON BARON
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in a business that provides small loans for furniture, TVs and cars to borrowers in Hispanic neighborhoods.

Trend #2: The aging of America....

Baron: [Here's] another demographic trend — the U.S. population is *aging*. Persons over age 85 are growing 3 times as fast as the general populace.

Who's going to benefit? When you get older, you need more medical care. So we've invested in nursing homes and other low-cost providers of quality health care for the elderly.

Trend #3: Increasing education/educational requirements.

Baron: Another demographic trend: the number of high school graduates will increase 25% in the next five years. Government studies indicate that 80% of the jobs available by the year 2000 [will] require education/training beyond high school.

Who's going to benefit? We've invested in education companies, private colleges providing technical training and a college degree and computer training businesses.

Trend #4: Baby boomers moving through the snake.

Baron: Finally, the baby boomers are the largest U.S. population segment.

Who's going to benefit? Financial services companies that address the needs for boomers to save for retirement. We've invested in businesses that provide these services.

Four non-demographic long-term trends....

Baron: There's a lot more to theme investing than demographics, of course. Take government privatizations. There's almost no service governments provide that can't be provided better and cheaper by private businesses. We're investing in private companies that manage prisons for a lot less than the government now spends.

Temporary help: a just-in-time work force helps businesses better manage their costs. And with the explosion of technology use, demand for temporary programmers and analysts has exploded.

Wireless communications — explosive growth in mobile communications offers lots of opportunities.

And casino gaming — a more affluent society wants to be entertained and baby boomers like to gamble.

IT'S VERY SIMPLE: (1) IDENTIFY GREAT BUSINESSES, (2) FIGURE OUT THEIR VALUE, AND (3) BUY 'EM RIGHT.

We focus on *business* risk, not *market* risk.

Baron: Once we've identified industries we believe have very favorable long-term prospects which are often the result of demographics or changing government programs and policies, we study the businesses in those industries. We identify the companies — and importantly, the managements — in which we would like to invest. And we then value these businesses.

As long-term investors, we consider risk. And stock market risk — stock price fluctuations and volatility — is *not* what we're looking at. We look at *business* risk. What could go wrong...? What's the likelihood that it will happen? A satellite blowing up, for example, is a business risk. The government changing reimbursement programs for health care or education — that's a business risk. Competition — that's a business risk.

A stock falling in price for no good reason is a stock market risk. Just because you own a stock that goes *up* doesn't mean you're *right*. And just because you own a stock that *falls* doesn't mean you're *wrong*. We just worry about business risk and try to take advantage of stock market volatility.

Businesses change very little. Stock prices change a lot.

Baron: We target our investments. We value them. Then, we just wait and wait until we can buy the shares that we want at a price where we have the opportunity to earn a very high rate of return. We try to be opportunistic.

To again quote J.P. Morgan — or was it Mark Twain or Will Rogers — "Stocks fluctuate." Almost no stock that we own or that we consider buying doesn't fall 20% or 30% from time to time. Why? They just *do*. *Businesses* change very *little* day-to-day. But *stock* prices change a *lot*.

After Manor Care's [MNR/NYSE] stock price fell this summer — it went from $40 to $31, I think, and now it's back to $41 again — there weren't any fewer residents staying in their nursing homes. When Robert Half's [RHI/NYSE] stock price fell, businesses weren't using any fewer of its temporary accountants and programmers.

When Learning Tree's [LTRE/Nasdaq] stock price fell, there weren't any fewer students attending their computer programming classes. When DeVRY's [DV/NYSE] stock declined last year, no fewer students attended its colleges. And when American Radio's [AMRD/Nasdaq] stock price fell recently, no fewer listeners tuned into its programs.

Identify great businesses, value 'em and buy 'em right.

Baron: The trick, we think, is through careful research to identify great businesses you want to own. Figure out what they're worth. And then, buy their shares only when you can earn a good return.

CLEAR CHANNEL BROADCAST ITS INTENTIONS, BUT AT LEAST ONE ANALYST DIDN'T TUNE IN.

Bad management gets taken over by good....

Baron: A few examples: Heftel [HBCCA/Nasdaq]. Here's one where an analyst's mistake gave us an opportunity to make a lot of money:

Heftel is the leading Hispanic radio broadcaster. And we considered investing in this business earlier this year, but decided against the investment since we felt that it was poorly managed.

About 3 months ago, Clear Channel [CCU/NYSE], one

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RON BARON
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of the best managed radio companies, acquired Heftel founders stock at $23 a share and tendered for the balance of the company at the same price.

Clear Channel broadcast its intentions quite clearly.

Baron: That afternoon, I went to a sparsely attended luncheon to hear Clear Channel's management explain the rationale for their investment and how they expected to use Heftel to acquire other Hispanic radio businesses.

I sat next to the chairman's son who explained to me that Clear Channel, although they had tendered for all of Heftel's shares, would like to buy no more at this time than the founders stock — and leave the balance publicly held so this entity could make acquisitions using its shares. Then, in the formal presentation, their chairman (the father of my luncheon partner) stated the same thing.

We were now given a chance to buy a good business with very favorable prospects that would soon be run by great managers. And it was at an attractive price — the same price that Clear Channel had just paid.

But one analyst's channel apparently wasn't so clear.

Baron: So we began to buy Heftel's shares. They soon began to rise in price though — $24, $25, $26.

However, within a few days — and to this I credit our good luck — a large brokerage firm recommended to its retail and institutional customers to sell Heftel's stock because Clear Channel was going to buy the entire company at $23 a share — and wasn't it ridiculous because the price was now above this level.

The analyst hadn't [even] spoken to the company. But hundreds of thousands of shares were suddenly offered for sale. So we bought them. It would have been nearly impossible [for us] to do so had it not been for this analyst's recommendation. In fact, we bought 7% to 8% of Heftel's outstanding shares this summer for an average price of about $27 a share. Its stock price is now $41. And it's only 3 months later.

THEIR NEW WAREHOUSE WAS SMART
AND THEIR BUGS WEREN'T FINAL.

Smart and Final's new warehouse was good news.

Baron: Smart and Final [SMF/NYSE]. Here's a company that had a short-term problem with a new warehouse — and its stock price fell 20%. And this was only because of a short-term problem. And again, this was the result of an analyst's recommendation:

We've been shareholders of Smart and Final since 1991. Last year, the company opened a new and highly automated food distribution warehouse that replaced an older, less efficient facility. And when the new warehouse operated properly, Smart and Final's food distribution expense would fall a full percentage point of sales — a very significant amount for a company that earns 3% pretax.

Thankfully, one analyst focused on the bugs.

Baron: But they experienced start-up problems with their facility during 1995's second quarter. And during September 1995, an analyst reported that the company was still having difficulty with the new facility. This report caused a lot of shareholders to try to sell their shares.

Since we believed the company's operating problems had been solved — or even if they hadn't, would be soon — we bought more shares at prices that would not have been possible had this analyst not recommended sale.

Smart and Final's stock is currently about 50% above the levels we paid last September.

UNKNOWN GREAT BUSINESS + IMPRESSIVE MANAGER
= AN ABSOLUTE HOME RUN (UP NEARLY 1,300%).

No analyst error on this one — aside from not *covering* it....

Baron: And finally, Robert Half. Unlike Heftel and Smart and Final where Wall Street analysts made the wrong recommendations, when we began to follow Robert Half, there were no — zero, not a single one — recommendations by Wall Street analysts about the company. We had the opportunity to study the company for five years before we bought a single share.

> PORTFOLIO REPORTS estimates the following were Baron Asset Fund's largest equity purchases during the quarter ended 9/30/96:
>
> 1. MANOR CARE INC
> 2. COX RADIO INC
> 3. MERCURY FINANCE CO
> 4. CIRCUS CIRCUS ENTERPRISES INC
> 5. SAGA COMMUNICATIONS INC
> 6. AMERICAN MOBILE SATELLITE CORP
> 7. GENESIS HEALTH VENTURES INC
> 8. DOLLAR TREE STORES INC
> 9. AMERICAN RADIO SYSTEMS CORP
> 10. INTL CABLETEL INC

Unknown great business meets young impressive manager.

Baron: During the late 1980's, Dole Food [DOL/NYSE] was our largest investment. I visited the company and its chairman, David Murdock, annually. Few other analysts did. On my visits, I met and was overwhelmingly impressed by their newly hired young president, Max Messmer. (He spoke here a couple of years ago, by the way.)

When I learned in 1986 that Max had left Dole to become chairman of Robert Half, a company I was vaguely aware of, I was curious and phoned him. Max told me that Robert Half was a great business, but it had been very poorly managed — and there was a lot of work to be done before it would become an interesting investment for me. But he invited me to visit — which I did — and, in fact, I began to follow the company and visit regularly whenever I was in San Francisco.

Five years later, our investment is up nearly 1,300%....

Baron: In 1990, Robert Half's problems had been repaired and it was clearly beginning to grow. The company became the subject of an unfriendly tender offer which, after it had been rejected, caused the company's stock price to fall 50% — from $22 to $10. We began to

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purchase Robert Half's shares in 1991 at the current split adjusted price of $2.75 a share.

When we began to buy shares, Robert Half's annual revenues were $206 million. Last quarter — during the last three months — its revenues were $210 million — more than their revenues for the entire year in 1991.

Today, Robert Half's stock is trading at $38 a share. So it's been an absolute home run for us — up 14 times since we first bought shares in 1991....

THINK FOR YOURSELF. AND THINK LONG TERM.
DON'T FORGET THAT NOT EVERYONE *CAN*.

You have to judge for yourself. No one can do it *for* you.

Baron: So the lesson is that you can't rely on experts — you can't always rely on Wall Street security analysts. You've got to do your *own* research. You've got to make your own judgements and form your own opinions. No one can do it *for* you.

Conventional wisdom and even informed opinions are often wrong — and not just about the likely prospects for individual businesses, but also about the stock market. We just don't think it's predictable. Magazine covers, news headlines and widely quoted pundits certainly can't seem to get it right. And consensus opinions about businesses and mega-trends fare little better.

Predictions are hazardous — especially regarding the future.

Baron: A few of the more memorable quotes by opinion leaders of their times:

Popular Mechanics forecasted the relentless march of science in 1949 and said computers in the future may weigh no more than 1.5 tons.

Ken Olsen, the innovative president, chairman and founder of Digital Equipment, in 1977 said, "There's no reason anyone would want a computer in their home." And David Sarnoff's associates argued against his investment in radio in the 1920's by saying, "The wireless music box has no imaginable commercial value. Who would pay for a message sent to no one in particular?"

Harry Warner in a 1927 classic remark stated, "Who the hell wants to hear actors talk?" And my personal favorite, "We don't like their sound — and guitar music is on the

(continued in next column)

"The best! I love it!"

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way out." That was Decca Recording Company in 1962 when they rejected The Beatles.

Become well informed and think long term.

Baron: So we believe that your best opportunity for investment success will exist if you're well informed about the businesses and industries in which you intend to invest. And use your knowledge to invest for the long term — even though it's more popular to buy and sell stocks quickly and guess what the market's going to do next.

It just seems so logical. Identify industries with long-term favorable growth prospects which are often demographically driven. Visit personally companies in those industries and get to know managements well. Target managements with whom you'd like to invest and businesses in which you'd like to become a shareholder. Figure out what they're worth. And don't purchase stock unless you can make a good return.

Most managers' investment objectives include job security.

Baron: So the next question is, obviously, "Why doesn't everyone do this?" We think the answer is simple.

Current communications technologies have become so advanced that short-term market moving information is widely available and instantly disseminated. Most portfolio managers are more concerned about losing their jobs (getting fired) and rightfully so — they have great jobs that are interesting, fun and that pay a lot of money — than about earning long-term attractive returns for their shareholders.

And the way they keep their jobs is to perform relatively well — as well as their competitors. They don't want to be criticized for not reacting to information that their peers have perceived and already reacted to.

No one can fire me — except me and you. And that helps.

Baron: We're different. I own my business. No one can fire me, except for me — and you, of course. So I don't have the same job concerns as other managers. And, as a result, we're able to buy when others feel compelled to sell. We can often invest in attractive businesses at great prices when others can't. So, as you can see, I'm a long-term kind of guy.

Even my own sons have a short-term investment horizon....

Baron: As an aside, my two teenage boys, age 15 and 16, are most interested in sports — maybe also in girls. However, I think their first interest remains sports.

Last year, they joined an investment club in their high school — and I was thrilled. I was describing one of my investments to my sons one evening when I thought I had a perfect opportunity to give them a stock idea for their club. "Dad, you're a great long-term investor," one said, "but your ideas take five to ten years to work out. A lot of the kids in this club are seniors. They have to double their money by June." So they weren't interested....

OUR SELL CRITERIA: OUR BUY CRITERIA REVERSED
PLUS A COUPLE OF WRINKLES FOR TAXES, ETC.

Our sell criteria is similar to our purchase criteria....

Client: When you make these very wonderful purchase

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decisions, by what criteria do you make selling decisions?

Baron: Obvious question — and a good one. What we do when we buy stocks is we don't buy a stock unless we feel we can make at least 50% over two years. And that's a low hurdle rate.

If we're making a riskier investment, we have to make a lot higher rate of return than that. If we're going to invest in a satellite company, I'm not going to be satisfied with a 50% return in two years. I'm going to have to make eight or ten times my money in five years. That's not a high enough return if it's risky. We'd be willing to accept a lower rate of return for Manor Care because it's not risky.

So what makes us *sell* stocks? When they go up, what happens is we're valuing companies all the time on computers by their potential rates of return. So we value what they're worth and what we think they should sell at. And we have to continue to be able to earn a reasonable rate of return or we won't [continue to] own it.

For example, Schwab is very attractive again.

Baron: And the way we do that often times [is represented by] stocks like Schwab [SCH/NYSE] a year ago or maybe Learning Tree now. Temporarily, stocks do better than the businesses. And, then, what has to happen — for awhile, the stocks don't do anything. We bought Schwab in 1992 at $6. It's now selling at $25. But last September, it was selling at $28. The reason the stock is down is because it had done so well at the beginning of last year — it had done better than the business. The business is now 40% bigger and the stock price is 10% lower. So now the stock is very attractive again.

Learning Tree, on the other hand, may have to rest.

Baron: Learning Tree just tripled from where we bought it a year and a half ago. We bought it at $13 and it's now selling at $40. So, in my mind, the stock's clearly done better than the business. So maybe the stock has to rest awhile. It wouldn't surprise me at all. People are paying up because they think more exciting prospects lie ahead....

If we can still earn our return going forward, why sell?

Baron: But what I think is that most managers, if that was the case and they recognized that was the case, as we do, then they would say, "Well gee. If we're not going to make money in this for awhile, we ought to *sell*."

So when Schwab was selling at $28 last year, why didn't I sell? Even though I thought the stock wouldn't do anything for awhile, I didn't sell it because I felt that in 1998, it would sell at $60 — which would be a double. So it was an adequate rate of return.

And when the stock fell below $20 — as it did in the fourth quarter of last year — we increased our holdings by about 50%. Now, it's $25 again. But the bottom line is that below $20, we felt we could make a triple and at $28 we weren't buying it. So we're valuing companies all the time.

Tax implications are factored into our sell decision.

Baron: If we'd sold then, we'd have incurred a tremendous tax liability for our shareholders. Most investors would do that. We won't. So we're willing to penalize our short-term performance to avoid paying taxes if we're very positive about a company's long-term prospects.

If we see negative developments or lousy returns, we sell.

Baron: But if we can no longer earn a reasonable rate of return or if negative fundamental developments occur in the company — I don't care *where* the stock is selling. Whether we're *making* money or *losing* money, we *sell*.

TECHNOLOGY COMPANIES RIDE A SLIPPERY SLOPE. WE INVEST IN THE *BENEFICIARIES* OF RAPID CHANGE.

Being #1 in technology today means very little tomorrow....

Client: Tell me what your policy is with regard to technology stocks.

Baron: We've never invested in technology stocks — at least knowingly. It seems that some of the things we do *get* that way. But ... we've always *avoided* that area. So we've never invested in companies that make computers, software, or chips — because we felt that just because you make the best chip or the best computer or the best software *today*, it has no predictive value about whether you'll have the best chip or software or computer five years from now.

PORTFOLIO REPORTS estimates the following were Baron Growth & Income Fund's largest equity purchases during the quarter ended 9/30/96:

1. CIRCUS CIRCUS ENTERPRISES INC
2. MANOR CARE INC
3. SUN INTL HOTELS LTD
4. DELTA & PINE LAND CO
5. AMERICAN RADIO SYSTEMS CORP
6. MERCURY FINANCE CO
7. PHP HEALTHCARE CORP
8. SCHWAB CHAS CORP NEW
9. OM GROUP INC
10. SAGA COMMUNICATIONS INC

We prefer to invest in the *beneficiaries* of change.

Baron: We've chosen to avoid industries with rapid product obsolescence — with guys making bad returns after they've invested a lot of money. We've chosen instead to invest in companies like Learning Tree — which trains computer professionals. They benefit from a rapid change of technology.

Or DeVRY which offers a college education and gets you a job when you get out of their college — and it costs a lot less to go there than it would to go to a normal college. Plus, you get technical training in addition to a degree.

Or Schwab which invests heavily in technology and benefits from that investment by creating competitive advantage for itself. It distinguishes itself by extra services and lower costs than others against whom it competes.

We don't know why Olsten's down, but we'll see them soon.

Client: Are you still upbeat on Olsten? And can you explain the recent pressure on the stock price?

Baron: I *can't* explain it. The stock's fallen from $30

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to $22. In fact, Susan Robbins, our health care analyst, and I are going to see Olsten [OLS/NYSE] next week, I think, in Long Island.

I presume it relates to concerns regarding changes in reimbursement programs for the beginning of next year and their acquisition of Quantum Health which happened a couple or three months ago — problems integrating it. To our knowledge, it does not have serious problems.

We just want to understand what's going on in the business better. And we're not going to know that until next week.

DELTA HAS A COMPELLING PRODUCT, A HUGE MARKET AND HUGE MARGINS.

All in, their seed costs *less*. And, strangely, it yields *more*.

Client: Can you please tell us what's happening at Delta and Pine Land these days?

Baron: Delta and Pine Land's [DLP/NYSE] share price fell. It did great for a few years. We bought it and it was stable for, I guess, about a year after we bought it — and then it tripled. Recently, it's fallen by about a third. Now it's come back and gained back about half of that loss.

What's happened is that they just started to introduce this B.T. Cotton — and that's genetically engineered cotton. What happens is that normally a farmer spends $10 an acre on seed and $50 to $100 an acre on insecticides. And with this B.T. Cotton, it's genetically engineered so that when the bug bites the cotton, instead of the bug killing the cotton, the cotton kills the bug. And they're just gearing up to do it, but instead of selling the seed for *$10* an acre, they sell it for *$40* an acre. So they get $30 extra per acre for it.

Farmers want it because not only does it eliminate the insecticide cost, but also, for some strange reason, it also gives them a 10-15% higher *yield*.

Delta had some problems with their Texas plants....

Baron: What happened this summer to cause the stock price to fall? There are 13 or 15 million total acres of cotton planted.... And they had their cotton available for the first time this summer. I think 2 million acres were planted with B.T. Cotton. And of those 2 million acres, 4,000 were in Texas. And the farmers there either didn't propagate right or irrigate right or plant right. Anyway, something went wrong — and it didn't work properly.

Monsanto, their partner, went down and tried to show the farmers what to do. And they're making good — because there's a lawsuit going on right now.

A far superior product, a huge market and huge margins....

Baron: But the bottom line is that what this company has is far superior to anything else in the market. They are the leading guy in the business with a 55% or 60% share. And there's a huge opportunity in the U.S. as more and more cotton becomes planted in this. And the margins on the incremental revenues are enormous.

And now they're going into China where they are probably going to get approval pretty soon — in the next couple or three weeks. And maybe the entry into China is causing the stock price to go up again. When the stock price fell below $30 to $26 or $27, we were buying some stock — in July, I guess it was — and now it's $38 again.

WE LIKED CORRECTIONS CORP.'S STRATEGY BETTER, BUT WE'LL PROBABLY OWN WACKENHUT FOR AWHILE.

We're a little concerned about Wackenhut's strategy....

Client: What about Wackenhut?

Baron: Wackenhut Corrections [WHC/NYSE] is a corrections company we own — the second largest company in this industry — and a competitor to Corrections Corp. [CXC/NYSE]. The chief executive there recently left and gone to be the chief executive of Youth Services — another smaller company in which we are investors.

We think that Wackenhut has been extremely aggressive in seeking contracts — and has sought to get contracts at prices that are lower than we think they should accept. And, as a result of that, we were a little concerned for the long-term profitability of their business from those contracts.

We understand Wackenhut's strategy — which is, number one, you gotta get the business; and, number two, once you've got it, you can upgrade it by adding more services and increasing profitability....

We like Corrections Corp.'s pricing strategy better.

Baron: In contrast, Corrections Corp., won't take the business unless they are making a big margin to start — and their margin is getting bigger. They're raising prices.

So we sort of liked Corrections better than we liked Wackenhut. And when Wackenhut was, I think, $40, we sold about two-thirds of our stock....

But we don't expect to sell our Wackenhut any time soon.

Baron: It's recently been around $18 because they lost a 3,000 bed contract that they were expected to win. However, the governor went back to the state.... And, now, it's probably attractively priced again.

We own 200,000 shares in our mutual fund. It's selling at $18 or $19. And our cost is $5. So I don't think that we're going to sell our stock for a long time.

SKYC COULD BE A DOUBLE OR A GRAND SLAM. HOWEVER, IT'S ALSO VERY RISKY, I THINK.

The original concept — serving cellular blind spots....

Client: American Mobile Satellite's been languishing.

Baron: *Languishing*? It's off a *third*!

Client: As a long-term investment, how do you feel about American Mobile Satellite now?

Baron: What happened to American Mobile Satellite [SKYC/Nasdaq] is that their concept was originally that there were going to be a lot of areas in the country where ... you're driving around where there weren't going to be enough people to justify the expense of building a cellular telephone tower. Therefore, you'd have to use a satellite. Therefore, we thought that it was a neat investment.

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BARON ANNUAL CONFERENCE
RON BARON
(cont'd from preceding page)

Eight years ago, a number of other companies did, too — AT&T (McCaw Cellular), GM Hughes and Singapore Telephone, among others. And they funded this company originally. Their cost over this eight-year period — and they were granted spectrum which is extremely valuable — was somewhere around $17 or $18 a share.

Three strikes and they were out — of money, anyway.

Baron: After eight years, they launched the satellite. And a problem occurred in that there was a mistake after the satellite was launched and it burned out one of the transponders. Presumably, they lost some of their capacity — for which they just got paid $65 million. So that's #1.

Then, #2, their distribution wasn't properly set up. And, problem #3, Mitsubishi and Westinghouse delivered late on software and telephones.

As a result, American Mobile Satellite ran out of money. So they either needed more money to keep going or they'd have to sell the company.

And they couldn't get it on commercially viable terms. So they got a $200 million loan guarantee — $150 million by GM Hughes, $25 million by Singapore Telephone and another $25 million by one of our partnerships. Incidentally, our mutual funds weren't allowed to do this by their prospectus. But we were given warrants at $24 a share for this guarantee.

If it *doesn't* work, it's worth 2-1/2 times today's price.

Baron: What do we think is going to happen? The company now has a stock market value — with 24 million shares at $12 a share — of $300 million.

Well, a new satellite today costs $300 million today. And their ground station costs another $100 million plus $50 million for insurance. And their spectrum is worth $250-500 million. So it's worth a lot of money.

The bottom line is that the stock — if the business doesn't work — is going to be sold to someone where it will become part of an integrated network. In that case, it will be worth 2 to 2-1/2 times what it's selling for now. So, it will be at $25-30 in a couple years if it *doesn't* work.

But we think it *will*....

On the other hand, being a year behind and now having all the money that they need and having great management which they've just brought in, we think it *will* work. And the new guys have slowed the installations to make sure they're all going right. Demand for the services is great — and they're getting orders for phones.

Instead of retail, they're getting them in a private voice dispatch network. Therefore, AT&T, when they want to work on a cable across the country — because they have crews in New York and crews in California and crews in Chicago who want to talk to each other all the time — well, this is the only company that can enable them to *do* that. So they're getting orders for hundreds of phones and thousands of phones at a time. And as they are able to competently install these phones — which I think they *will* be able to do by the end of this year — then we're going to make a lot of money in this stock.

They're now installing 1,000 [phones] a month. We think that by the end of the second quarter of next year, they'll be installing *4,000* a month. And they think that they'll break even next year.

If we're right, it'll be a grand slam. But it's also very risky.

Baron: As I said, the company has a market value of $300 million. We think that they'll be able to generate $200-250 million of cash flow within three years. And [they] think that they can do $275-300 million of cash flow.

So, if it *works*, we'll have a *home run* — 8 or 10 times our money. And if it *doesn't* work, we'll *double* [our money from today's price] when they sell the business.

However, it's a very risky investment, I think.

WORRYING ABOUT THE MARKET IS A WASTE OF TIME.
WE JUST WORRY ABOUT OUR COMPANIES.

If Alan Greenspan doesn't know, how can you or I?

Client: Some brokers talk about a coming correction. Do you believe that? And what are you doing to prepare for it?

Baron: I worry about the market every now and then like everyone. But I've ever seen anyone be able to predict what the market is going to *do*. It's not *predictable*.

And one of the things I do in presentations often is to show how unpredictable it is by using what widely quoted pundits say about the markets at specific points in time. One of my favorites is the *Business Week* cover in 1978 — and that's the "Death of Equities" when the Dow was 800. Another one was where Alan Greenspan was on the cover of *Fortune* magazine in 1987 saying he was bullish — in September 1987. And who could know *better*?

You can't predict the market. Trying is a waste of time.

Baron: So I think you can't predict the market. Just look at what happened in *July*. At the very bottom of the market, the people who were supposedly most knowledgeable *about* the market were all recommending *selling*. And then you had people in the Spring recommending *selling* who had just recommended *buying*. You just can't *predict* it. So we think that when we spend time *worrying* about it, we're wasting our time.

We just worry about our companies and the prices we pay.

Baron: Instead, what we do is worry about the companies in which we're investing. We don't buy 'em until we can buy 'em at a good *price*. And as long as we're buying stocks at a good price, we feel like that's our protection against *whatever* the market's going to do.

—OID

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG
(cont'd from page 1)

While still a senior in high school, he even placed seventh in the national *collegiate* competition.

As a 31-year-old salesman for a local securities firm specializing in mutual funds, Van Den Berg became upset with how those funds had performed in 1969 and 1970. To understand why, he began to research security analysis and became an avid reader of Ben Graham and a student of security analysis.

He soon decided he wanted to manage money. But lacking the background or the credentials to enter the field, he was stymied — until someone suggested that he apply the same commitment that he'd applied to rope climbing nearly 20 years before. Then and there, he made the commitment that however long it took, he'd begin his own advisory firm. And apply that same commitment, he did — converting his small studio apartment into a virtual research office — moving everything out save his desk, his books and his bed.

One of his first discretionary clients, Robert Phillips — who joined him in mid-1974 — also loaned him the $2,500 that he used to start his firm. Incidentally, that gentleman is still a client (and, Van Den Berg adds, a good friend) today. He recounts how he was so grateful at the time that he said to him, "I'm going to make you a million dollars." — although the comment was made in jest and the idea was so farfetched at that time that they both had to laugh.

Today, having earned a compound return of 18.82% per year after all fees and expenses for 22+ years on his investment, he says he's actually now made him more than *$2* million. And, he tells us, the (audited) performance of his account is comparable to that of other equity accounts during the same period.

We'd like to credit (and thank) our late contributor and friend, Jerry Carret — son of living legend, Phil Carret — for introducing Van Den Berg to us by introducing us to Sam Hale prior to his affiliation with Century Management.

Incidentally, in preparing this feature he displayed a passion which we imagine was similar to the passion he displayed in his pursuit of excellence in rope climbing and money management. Only limitations of time and space (you probably didn't realize that we had those) kept this feature from being longer and more wide-ranging.

The following material was excerpted from a series of extended interviews between November 21st and right up to press time. We hope you find his thinking process and the ideas discussed as intriguing as we do.

BELIEVE IT OR NOT, HERE'S A CLASSIC VALUE PLAY AT A MERE 55% OF A SOLID ADJUSTED BOOK.

OID: I understand that you're actually finding some compelling bargains in this market?

Arnold Van Den Berg: *Absolutely*. For example, Moore Products [MORP/Nasdaq] is a *classic* value play today. Moore Products produces metrology equipment — that is, fairly sophisticated measurement equipment — for companies that need to measure and control the pressure, flow and/or temperature of fluids. Their customers are companies in industries as diverse as chemicals, oil and gas, medical, pharmaceuticals, textiles, food and beverage, utility, agriculture and pulp and paper — you name it.

OID: Why do you say that it's a classic value play?

Van Den Berg: Well, its stock is around $19. It has no debt. And the values are absolutely all *over* the place. It has net working capital of $10.82 per share. It has a LIFO reserve after tax of $2.50 per share. And its pension plan is overfunded by $9.50 per share after tax. So that's nearly $23 per share of liquidation value right there.

[Editor's note: Moore's 1995 annual report states that the current cost of domestic inventories exceeded the LIFO (last-in, first-out) value by $9.8 million at 12/31/95.]

OID: Which doesn't sound all bad for a $19 stock.

Van Den Berg: And it gets even *better*. They also own about 130 acres of excess real estate. And we've talked to real estate people in Spring House, Pennsylvania, who tell us that land is selling for $100,000 per acre right down the street. But rather than use that $100,000 per acre figure — which would imply a value of *$13* million — let's just say it's worth *$10* million.

OID: We must not have explained the ground rules. You round up...

Van Den Berg: And that $10 million divided by Moore's 2.6-odd million shares outstanding would add another $2.50 per share after tax. That would bring their adjusted liquidating value to more than *$25*. Meanwhile, their stock's at $19. So you can buy Moore today at a discount of about 25% from its *liquidation* value.

OID: It sounds like the values are all over the place, all right.

Van Den Berg: And if you add their $9.50 of overfunded pension after tax, their $2.50 of LIFO reserve after tax and their $2.50 of real estate after tax to their current book value of approximately $20.70, you can see that their adjusted book value is north of *$35*.

So today's price is over 45% off adjusted book. And Moore doesn't have any intangibles on their balance sheet. So that $35 adjusted book is *solid*.

OID: That sounds like a classic value play, all right.

BASED ON OUR ESTIMATE OF PRIVATE MARKET VALUE, TODAY'S STOCK PRICE IS 40¢ ON THE $1 OR LESS.

OID: I don't mean to look a gift horse in the mouth. But what does it look like on a non-liquidating basis?

Van Den Berg: On a going concern basis, given the cash flow and the earnings potential, we believe Moore has a private market value of at least $45 to $50 per share.

OID: So that it's selling at 40¢ on the dollar or less business-wise — according to your estimates?!

Van Den Berg: That's right.

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG
(cont'd from preceding page)

OID: May we ask how you arrived at your estimate — and, of course, why you say "at least"?

Van Den Berg: Actually, we always do our valuations several different ways. But, in a nutshell, Moore is on track to have sales this year in excess of $140 million — which is more than $50 per share.

OID: Closer to $54, but who's counting...

Van Den Berg: So their market cap plus their debt — which is easy to calculate since they don't *have* any debt — is only about 35% of sales.

And we've done a lot of studies of price-to-sales and price-and-debt-to-sales. When you get down below 45%, you're getting down near bear market multiples.

OID: Depending on the type of business, of course.

Van Den Berg: That's exactly right. And I am making a generalization. However, for this kind of company, 35% of sales is *cheap.*

OID: If they were earning decent returns, maybe so. But it looks like they lost money in 1993 and 1994, only made 9¢ in 1995 and only earned about 24¢ in the first three quarters of this year.

Van Den Berg: I knew you'd be asking that question.

OID: How long have they been earning subpar returns? And what makes you think they'll get better?

Van Den Berg: Their subpar results go back three or four years. But a lot of it, I think, is due to their R&D. During those years, they had the highest expenditures on R&D that they've *ever* had. To give you some idea, here are Moore's R&D outlays per share the last five years: $4.32 in 1991, $4.65 in 1992, $4.54 in 1993, $3.96 in 1994 and $3.77 in 1995.

But now they've finished their new line of products. Plus, they've increased their shares outstanding from about 2.1 million to closer to 2.6 million by selling 500,000 new shares to their pension fund. So we believe that they can probably normalize their R&D going forward at about $3 per share.

OID: That's very interesting, although it doesn't explain why Moore lost $2.20 per share in '93 and didn't earn more than it did in '95 when their R&D was only $8.1 million — although management points to depressed sales as the culprit in 1993.

Van Den Berg: That's right. Another reason why their margins are depressed is competitive pressures worldwide. However, their sales are picking up enough that we believe that they'll be able to raise their margins as well.

OID: In fact, I see their sales have been increasing at a 20% annual rate for the last half a dozen quarters.

Van Den Berg: That sounds about right. They've been showing a *very* nice increase in their sales. Likewise, they've announced that their *bookings* are up 20%. That's a mighty good sign that the higher R&D was well spent.

OID: And that eventually translates into earnings?

Van Den Berg: We think so. In fact, we believe that Moore will get its net profit margin back up to about 5%.

OID: That's what they've earned historically?

Van Den Berg: They have. We're not expecting them to do that next year, mind you. But they *certainly* have the capability to do it in the next three or four years. And 5% margins would give them close to $2.70 of earnings power on '96 sales — and, therefore, something north of $3 on the sales they're likely to achieve in '97.

OID: In which case the current price would represent slightly over 6 times normalized earnings.

Van Den Berg: You've got it. So the only leap we're making is that higher sales eventually lead to something near historical margins. And we're *very* comfortable there.

ACTUALLY, MY $45-50 VALUATION MAY BE LOW.
IT COULD VERY WELL BE $60 OR MORE.

Van Den Berg: And based on the multiples of the closest acquisitions that we can find, we'd be talking about a private market value of 20-25 times.

OID: They sold at 20-25 times earnings?!

Van Den Berg: They sure did. And, in fact, that's not so surprising. Our studies suggest that the average P/E paid for acquisitions tends to peak at 22-24 times earnings in markets similar to today's. That's approximately what they tended to be, incidentally, in 1968, 1972 and 1987 and what they've averaged since 1994.

OID: And we thought double-digit P/Es were unholy...

Van Den Berg: Still, absent an actual acquisition, stock prices very rarely exceed 80% of acquisition prices and, therefore, tend to peak at more like 20 times earnings.

But getting back to Moore, the closest acquisitions that we can come up with suggest a P/E of 22-24. And so there's our private market value estimate of $45-50.

OID: Actually, using your figures, we come up with $60 to $75...

Van Den Berg: We don't use peak multiples in our valuations. During the 1970s, the average P/E multiple on acquisitions got as low as 13 and probably averaged 16-17. And that's what we're using. We try to be conservative....

OID: Please get that out of your system right now.

Van Den Berg: The best comparable sale that we can find for Moore Products is Elsag Bailey's acquisition of Fischer & Porter. They paid $29.90 per share — or approximately $157 million. Their earnings and cash flow were as depressed as Moore's. So we used normalized figures to calculate their multiples.

And using our normalized figures, we estimate that Fischer & Porter sold for .77 times price-and-debt-to-sales, .69 times price-to-sales, 13.6 times cash flow, 8 times EBITDA, 2 times book and 22 times earnings.

If we apply those same multiples to Moore's normalized figures, we come up with $38.93, $37.10, $53.18, $49.38, $41.40 and $55.00. Averaging those

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG
(cont'd from preceding page)

figures, we come up with $46.67. And that figure doesn't include their overfunded pension, their LIFO reserve or their excess real estate — which would add about $14.50.

So we believe our estimate is very conservative. Someone could *very* easily make the case that Moore's private market value is higher.

OID: Actually, I thought you just did...

Van Den Berg: We do look for a bigger discount here, too, because this company only has 2.6 million shares outstanding. It's a small cap stock. It's highly illiquid. And it isn't exactly the kind of company many institutions are going to look at.

But we operate in this area. So we're not concerned about what institutions do.

OID: Marty Whitman says the same thing — that he's not into studying abnormal psychology...

Van Den Berg: We don't care if Wall Street follows it. We do our own research. And given everything we see, we're convinced that not only is it selling *well* below liquidation value, but that it's selling at a *tremendous* discount to private market value.

Between their increase in sales, the slowing down of outlays on R&D and the fact that their capital expenditures are more or less equal to their depreciation, their earnings are going to be true *free* cash flow.

OID: In other words, available to their shareholders, not to their suppliers.

Van Den Berg: We can calculate free cash flow another way by starting with their gross cash flow and deducting capital expenditures. However, I expect their free cash flow to very closely parallel their earnings anyway. And when it does, their stock's going to trade more in line with the kind of valuation it's gotten in the past.

OID: Which is?

Van Den Berg: Well, its price-to-book multiple got as high as 1.7, 1.6 and 1.63 in 1983, 1986 and 1987. And its price-and-debt-to-sales ratio got as high as 1.32, .93 and .97 in 1983, 1986 and 1987. So if they get a price-and-debt-to-sales ratio of 1.00 — and again, they'll have $54± per share in sales this year — well, you can do the math as well as I can.

OID: Your confidence in my ability to multiply by one is much appreciated. But I imagine your point is that, again, it supports your valuation of $45-50 or more.

Van Den Berg: Exactly.

PRICE TO REVENUE CUTS THROUGH THE FLUFF
FOR MOORE AND THE S&P 400. AND IT AIN'T PRETTY.

OID: But is 1 times revenue really reasonable?

Van Den Berg: I think so. The S&P 400 is selling for 1.10 times sales and 1.27 times price-and-debt-to-sales. Once again, by contrast, Moore is currently selling at 35% of price-and-debt-to-sales.

And we could argue back and forth about whether Moore *should* be worth as much as an S&P company. However, it's certainly not worth *70%* less.

OID: Although one can also argue about whether the S&P is worth more than 1 times sales.

Van Den Berg: Absolutely. Again, the S&P 400 is trading at over 1.10 times sales as we speak. And the highest price-to-sales multiple at which the S&P 400 has ever traded in this interest rate environment is 1.16 times sales in 1968-69.

OID: So that the S&P 400 has been more expensive in other interest rate environments.

Van Den Berg: Yes. In 1961, it hit 1.29 times sales. But that was with a AAA rate of 4.3%.

OID: Which still puts today's prices too close to the record highs by that measure for comfort.

Van Den Berg: And in 1968-69, that 1.16 multiple was with AAA rates at 6.2% — which is lower than where we are today. After all, AAA rates are around 7%. But it's close enough.

OID: It works for me.

Van Den Berg: So, by that measure, we're within 5% of the all-time record highs. By comparison, the S&P 400 has traded 38-40% of sales at bear market bottoms.

Incidentally, relative to cash flow and earnings, the story's quite similar. In 1968-69, the S&P 400 sold for 19.15 times earnings and 11 times cash flow at its peak. And those are about the same valuation levels we're at today — 19.5 times earnings and 11 times cash flow.

OID: If you think you can scare me, you're right...

And I gather that one of the implications is that either interest rates decline or valuations do.

Van Den Berg: That's right. Valuations are unlikely to go much higher absent a lower interest rate/lower inflation environment. And we'd need higher growth — because the economy was growing a little bit better than it is today.

But getting back to Moore Products, the only thing I'm pointing out is that sometimes you can cut through the fog by looking at valuations relative to sales — because it gets around questions about margins and accounting gimmickry and all the other things you can do internally.

MANAGEMENT ISN'T 100% SHAREHOLDER-ORIENTED,
BUT THEY ARE ENGINEERS THROUGH AND THROUGH.

OID: What can you tell us about their management?

Van Den Berg: They're honest, hard working and competent. But they're not the focused kind of management that's totally shareholder-oriented. If they were, they could probably realize the $45-50 value that I've mentioned.

They're extremely conservative though. For example, when we ask them about the real estate — why they don't sell it and redeploy the capital into the business — they say, "Well. Yeah. It's good real estate. But why sell it and have to pay taxes? And the excess pension? Yeah. That's true.

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG
(cont'd from preceding page)

But we used the pension when we needed money to fund our R&D and our sales growth."

So they're not really driven to move their stock.

OID: What are they driven by?

Van Den Berg: This management is engineers through and through. And what they're driven by are engineering-related considerations — in other words, by their desire to do research and produce quality products.

OID: Still, how much of Moore's subpar margins have been a result of subpar management or other factors?

Van Den Berg: As I mentioned, they just completed a tremendous surge in their spending on R&D.

Sales, on the other hand, didn't go up that much during those years. So part of their subpar returns have been a result of heavier expenditures on R&D — which we believe, and which *they* believe, will be trending down once their new line is funded.

But if you look at their margins, you can also see a deterioration in their pretax margin *outside* of the difference in R&D spending. And that's just because SG&A expenses increased relative to sales.

So part of the lower margins and returns may be due to management not being quite as cost conscious as they might be. In other words, if a shareholder-oriented fanatic were running Moore, he'd probably be able to fine tune their operation and make it achieve the kind of margins that it's earned historically.

A RECENTLY ARRIVED CATALYST AT MOORE:
THE PRESIDENT OF THEIR #1 COMPETITOR.

Van Den Berg: So, you may wonder, "What's going to unlock the value?"

OID: I appreciate you letting us sit in on this interview.

Van Den Berg: Well, it would be wonderful if some major company were to buy them and take over their R&D and their marketing. They'd have $54 per share of sales. And much of their R&D and marketing would probably turn out to be unnecessary duplication.

OID: Begging doesn't help. Believe me, I've tried...

Van Den Berg: There's also a recently arrived catalyst. That catalyst is their new chairman and CEO as of June — Edward T. Hurd — the first CEO from outside of the Moore family.

OID: What can you tell us about him?

Van Den Berg: According to a Moore press release, he has 35 years of experience in the global process control area. And prior to joining Moore, he served as president of Honeywell's industrial service division from 1990 to 1995. And that division is one of Moore's primary competitors — probably their prime competitor.

OID: Interesting.

Van Den Berg: So, in effect, they brought in someone who really knows the business and who knows how to compete against them.

Obviously, since he was heading up their major competitor, they were especially happy to get him. Clearly, he had experience within the industry with a major, well-run company. And from everything we can tell, he did a great job at Honeywell.

But the most important thing that he's bringing to the company is a fresh approach and a systematic way of focusing their product line. He's looking at every item in their product line and asking, "Do we want to keep it? Is it material to our operation? Do we want to focus on it more? Or should we eliminate it?"

And, more important still, when a family-run business goes out and brings in someone from outside, I think that it signals something very significant.

OID: That the kids have unrelated interests or that the acorns fell too far from the tree?

Van Den Berg: They're saying, "We're engineers. And we do a good job in that area. And we've done a good job running this company in the past. But it's not as profitable as it should be today. So maybe we should bring somebody in whose primary focus is to run the business."

I think they realized that there may have been too much emphasis on engineering and not enough on marketing and other facets of the business. But they wanted someone who really understood their business, knew their products, knew their competitors, etc.

OID: And, what the heck — if it happened to handicap one of their prime competitors, all the better.

Van Den Berg: I think it came about partially based on the recognition that their margins aren't as good as they should be and partially because they're getting more conscious of their stock.

OID: Sounds familiar...

Van Den Berg: And one of the things that brought it to light is that they needed to fund their recent sales growth and R&D. So they sold some stock to their pension plan, which is mostly them anyway. So I guess that didn't bother 'em.

OID: I imagine not.

Van Den Berg: But I think that they're realizing that, "Geez, if the stock price were up a little higher, maybe we'd sell some to the public and get a *real* price instead of $16." — which in my opinion is a *giveaway*.

[Editor's note: The price at which 500,000 shares were sold to their pension fund.]

OID: And they made him chairman?

Van Den Berg: Yes.

OID: That sounds serious.

Van Den Berg: I believe it's *very* serious. And I think you've put your finger on a key item: They brought him in as chairman and CEO and have given him free rein. He presides over many Moores. The fact that they were willing to bring him in as chairman and CEO speaks volumes.

And we believe Hurd is going to start stirring the pot.

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OID: What makes you say that?

Van Den Berg: As we talk to this management more and more with the first outsider taking over the reins and starting to look at the way they do business, it's becoming increasingly clear to us that they're starting to think about ways of unlocking their shareholder value, too.

Prior to Hurd's arrival, we got the impression that the chief financial officer agreed with us, but that these things just weren't a very high priority. Now they're doing strategic planning and are open to reviewing all options — which may be the very reason that they brought Hurd into the company.

BUT EARNINGS AND CASH FLOW WILL IMPROVE
WHETHER THEY REFOCUS OR NOT.

Van Den Berg: It's not that they're *anti*-shareholder today — because they do own 38% of Moore *themselves*.

OID: So they're only hostile to the shareholders who own the other 62%.

Van Den Berg: Not at all. They're the kind of people who are focused on doing the job, on the engineering, etc. I feel *very* good about this management. I feel very good about their character and dedication and about the product that they put out. There's never been any problem with it.

I think the only thing missing is someone thinking, "What can we do to raise the consciousness of the Street about our stock, raise our value and get our stock price up from the $18-19 that it trades at today closer to the $30-35 where it *should* be trading?"

OID: I thought you said $45-50 or more?

Van Den Berg: I said $45-50 private market value. Usually, unless a company is acquired, it rarely sells above 80% or so of its private market value.

That said, our feeling is that enough is happening that their earnings and cash flow are going to improve even if they stay right on the track they're on and *don't* focus directly on shareholder value — because their new products are starting to hit and, again, their sales are up.

You can talk about R&D being well spent all you want. But the proof's in the marketplace. When the R&D produces sales, you can have a lot more confidence that it was actually well spent. So, again, we believe that it's simply a matter of time until their earnings follow.

HOW DOES MOORE STACK UP COMPETITIVELY?
THAT'S EASY. JUST LOOK AT THEIR SALES.

OID: What can you tell us about how Moore Products stacks up competitively?

Van Den Berg: It's interesting that you ask that — and maybe that accounts for some of the pressure that they've experienced on their margins.

But International Paper — a major player in one of their fields — selected Moore as its supplier just last year. They entered into what they call an alliance agreement.

OID: Meaning?

Van Den Berg: Meaning that International Paper was so enthused about it that they took it beyond just the normal relationship. They entered into a long-term corporate alliance agreement in which International Paper will use Moore Products as the primary supplier of distributed control systems. The agreement covers all International Paper production and R&D facilities worldwide, all subsidiary companies in which International Paper holds a controlling interest, and all engineering contractors used by International Paper.

OID: Do you know Moore's current market share?

Van Den Berg: I think they're a leader in most of the niches they're in. And they're in some pretty good niches. My sense is that they're so specialized — like this deal they put together with International Paper — that it's almost like they're the only ones doing it. A lot of their products and services are more or less tailored to the individual customer. They're selling the hardware, the software and the consulting in one package.

However, we've asked Moore the same question. And they tell us that even *they* don't know. Apparently, this is an extremely fragmented, highly specialized market. So it's been very difficult to nail down market shares.

OID: But isn't Moore competing with companies that are far larger — with distribution capabilities and R&D budgets to match?

Van Den Berg: Moore's competitors include Siebe and ABB Asea Brown Boveri, Inc., although we believe the Industrial Automation and Control Division of Honeywell is the one they meet in the marketplace more often than anyone else.

So how do they compete against larger competitors? Well, again, these guys are engineers first and foremost. This is their area. They're totally committed to it and have been for many years — since the company was founded in 1940. And that commitment and focus translate into developing excellent products.

Also, in the scientific world, anything having to do with measurement and process control is a very necessary and valuable service — in part because it relates to plant safety.

OID: Interesting.

Van Den Berg: Second, they're a niche player. They operate in niches that are too small for bigger companies. For example, Moore has developed proprietary software to run some of its measurement products. Well, you know that Microsoft isn't going to get into a field like that where potential sales are so limited. There's just no way for them to *justify* it.

OID: And you don't expect IBM to set up a division to compete with Moore, either.

Van Den Berg: Exactly. And there are many, many different niches available for them to serve — although the main industries they serve are probably oil and gas, paper, textiles and chemicals. They serve pharmaceuticals. They even have some services and devices specifically designed for the *metal* business. So they're able to serve quite a few

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industries and, therefore, also not be dependent on any *single* industry.

Wherever you need measurement — which is in almost *every* technical industry — they sell their products. Some they sell right off the shelf and others they design particularly for that industry. They're a $120+ million company.

OID: Actually, it's closer to $140 million in 1996.

Van Den Berg: So they do have substantial sales. And 22-25% of their sales are foreign. So it looks like they have global potential, as well.

OID: And I believe I read somewhere that they have offices in Brazil, the U.K. and Hong Kong, among others.

Van Den Berg: I think that's right. And they're very well thought of from a service/product quality perspective in their industry and among their customers. But the Street doesn't know about 'em — and the few that do aren't too fond of 'em because of their stock price and because of the way they manage the company, etc.

OID: Plus, it's hard to imagine anyone making a living trading this company's shares.

Van Den Berg: That's right. I don't think anybody follows this company. With only 2.6 million shares outstanding, nobody at a major brokerage firm would bother writing about this thing — even if they thought it was a good idea.

OID: That's a great sign.

Van Den Berg: Yes. It's not followed at all. If you talk to management, you'd see another reason why not: This management doesn't really want to bother with it. They're obviously not in there trying to promote their stock. They're just running their business. They just say, "If you like the stock, buy it. And if you don't, don't."

On the other hand, I really believe that if you were to take Moore Products to 10 value players, I don't think too many of them would disagree with the basic premise that this thing is worth twice what it's selling for.

[Editor's note: In fact, Moore Products' latest proxy shows Peter Cundill & Associates and Quest Advisory owning 7.6% and 6.3%, respectively.]

OID: And, certainly, the arrival of the president of their leading competitor is an encouraging sign. Apparently, he thinks Moore has what it takes.

Van Den Berg: That's certainly true. However, again, they have some very strong market positions that you can count on — where they're pretty firmly entrenched.

But, frankly, their sales are growing 20% a year. What *more* do you need to know?

OID: Good point — for now, at least.

Van Den Berg: So I think they're *very* competitive. Also, they're not necessarily in markets that are experiencing explosive growth. For example, we've seen some perk up in oil and gas, but it isn't exactly like that business is booming. And I don't think the chemicals, textiles, utilities and agriculture areas are doing anything that would suggest that Moore should be in any kind of boom period or anything of the sort.

So the fact that they're increasing their sales at a time when the industries they serve are kind of in neutral indicates to me that their products are competitive and that they're finding some good opportunities.

OID: Although, in their latest annual report, management points to "strong economic conditions" in their "traditional process control markets".

Van Den Berg: Certainly, their business has picked up. But my point is simply that business is not exactly booming for their major customers — and yet Moore's sales are growing very nicely.

OID: Also, for whatever it might be worth, although total sales were up 20% in '95, it looks like their domestic sales were only up slightly over 15%, whereas their international side was up over 40%.

Van Den Berg: They're trying to build their business in the Asia Pacific region and Europe and Latin America. So that's fine with me. It just suggests they're *succeeding.*

MOORE HAS HIGHER RETURNS THAN IT APPEARS.
ONLY THEY'RE HIDDEN BY EXCESS CAPITAL.

OID: Given that this company seems to be cyclical and in a state of flux, this is probably an unfair question. However, based on your knowledge of this company, do you have a sense of its normalized ROE?

Van Den Berg: I don't know if I necessarily agree with your premise that Moore is *cyclical.* There's nothing in its history other than the last few years that suggest it is.

OID: Really?

Van Den Berg: Really. And, even if it *is* cyclical, then it's not cyclical in the classic sense — where it goes from making money to losing money, etc. Its earnings may peak out and plateau for awhile before they move on to a higher plateau. But I think this company is capable of having better margins than they've had historically.

Moore just serves so many industries — at least eight to ten different industries. And they're all *big* industries. So while someone might make the case that this industry is cyclical by definition, Moore is so small that once they get their products and their marketing right and their costs under control, I don't think they *need* to be cyclical. Their market is big enough that once they start growing, they could *keep* growing very smartly for quite awhile.

OID: What Rob Friedman of Franklin Mutual Series calls a cyclical growth stock.

Van Den Berg: You can do pretty much anything that you want with their numbers.

OID: So you are familiar with our publication...

Van Den Berg: But we figure that they can earn a 15% return on equity and a 5% net profit margin. And both are roughly equivalent in their earnings implications.

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Either way, that's $3.00 of earnings per share.

***OID:* And I gather that they've earned those kinds of margins and returns in the past?**

Van Den Berg: That's right. For example, between '83 and '87, their net profit margin ranged between 4.5% and 5.9%. And I think they're in a much better position to generate those margins today.

***OID:* Having spent the R&D.**

Van Den Berg: That's right — and having developed their markets. Again, I happen to feel that if this company is well managed — which it may be soon with Hurd — Moore's margins could in fact be even *higher*. But, given the current stock price, you don't *need* higher.

And $3 on their current $20.70 book would give them an ROE of about 14% on beginning of year equity.

***OID:* Roughly what Buffett says is around the historical average for American industry.**

Van Den Berg: But don't forget that they have all of these excess assets: all of their excess real estate, all of their excess pension assets, etc.

So if they were to sell some of these excess assets and buy back stock with the proceeds above the current book, they'd raise their return on equity considerably.

***OID:* In other words, they don't need those assets. And, therefore, they dilute shareholder returns.**

Van Den Berg: That's right. So this doesn't look like a very high return business. But, as you can see, appearances can be deceiving.

***OID:* As can assumptions, of course.**

Van Den Berg: That's always possible. But I'm very comfortable with the assumptions we're using here.

And I know we're going to call them earnings. But, as you know, $3.00 of earnings can be *$1* in free cash flow or *no* free cash flow. But, *whatever* Moore's earnings are, they're also going to be *all* free cash flow — because their depreciation and their capital expenditures are roughly the same. So this company has the potential to generate $3.00 of free cash flow.

(continued in next column)

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***OID:* That sounds good.**

Van Den Berg: And in these figures, we haven't even factored in anything for share repurchases. Again, they have excess assets in a number of categories. But even if you just take the most obvious ones and the ones that are most easy to verify...

For example, $38 million of excess pension funding is equivalent to $24 million after tax. And, again, there's the $10 million of excess real estate. That winds up being about $6.5 million after tax. And that's not including anything for their LIFO reserve of $6.4 million after tax. But when I add up those two numbers, I come up with about $30 million.

***OID:* In after-tax proceeds available for share repurchases.**

Van Den Berg: And let's say that you pay $30 a share — a 57% premium over its current stock price. That would lower their shares outstanding from its current 2.6 million to 1.6 million and boost their normalized earnings — with only a 4% margin — to nearly $3.50 per share. And if they could get back to a 5% net profit margin, we'd be talking about nearly $4.40 of earnings per share — which wouldn't be too shabby on an $18-19 stock.

***OID:* And even if they paid $50 per share, we estimate that they could have earnings of $2.75 to $3.50.**

Van Den Berg: I'm not suggesting they *need* to pay that much or even that they *should*. In fact, I think that they could buy back a very significant number of shares at $25 to $30 by way of a Dutch auction. But those figures illustrate the impact that share repurchases could have.

However, the mindset of the company — up until recently, at least — has been that of typical engineers...

***OID:* They wear pocket protectors?**

Van Den Berg: They do. In fact, they even wear pocket protectors on their *financial statements*. They're absolutely bulletproof. They don't need *remotely* as much in the way of assets as they have.

They haven't thought in terms of buying back shares historically. But I don't think the implications are lost on their chief financial officer or Edward Hurd.

BETWEEN THE PEOPLE, THE ASSETS AND THE PRICE, IT'S HARD TO SEE HOW MOORE BECOMES A DISASTER.

***OID:* What could turn Moore into a mistake — fraudulent accounting?**

Van Den Berg: No. I worry about almost everything. However, this is one company where I *don't* worry about fraudulent accounting. You very rarely find engineering companies involved in cases of fraudulent accounting. You generally find that sort of thing in marketing companies and fad companies where people with the nature to do that type of thing tend to be located.

***OID:* So all you worry about is bad engineering?**

Van Den Berg: No. First of all, I don't really think there *is* much risk simply because of all their assets. They'd have to be blind to turn this into a disaster.

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And even with their high R&D and everything else, they're *still* going to earn 40¢ this year and have $1.75 of cash flow. And that's spending $3 to $4 of R&D.

OID: I see what you mean.

Van Den Berg: So let's assume they run into trouble. Short term, they could cut their R&D in half and have *$3* per share of cash flow — with no debt. Plus, these people all have their whole life's work tied up in the company.

Therefore, it's hard for me to see how anyone could lose a lot of money in this company.

OID: You're obviously not very familiar with the Emerson Pittance...

Van Den Berg: And if it ever *did* start to bleed, I think that there are enough assets that you could get out of this thing without too much trouble. I'm not saying you would get out without a loss, but it wouldn't be a disaster.

This is the kind of company I feel very comfortable just sitting on. And I say that for a number of reasons: First, its assets are increasing. Second, its sales are growing. Third, people are addressing its deficiencies. And, fourth, they've got a good name.

So if they ever *did* start to get into trouble, any number of companies would view them as a very desirable acquisition candidate.

OID: Although companies in trouble very frequently don't command a premium price.

Van Den Berg: No. But from *today's* stock price, shareholders might *still* make out fine.

OID: What, then, do you worry about?

Van Den Berg: Not much. Frankly, our only problem with this company has been not being able to buy *enough* of it. It's very thinly traded. And we want to buy it right. So we don't chase it.

OID: Then we're especially grateful for you sharing it with us. However, to activate the Emerson Curse, all you had to do was buy a few shares in my name — although, for the full effect, may I suggest margin...

Van Den Berg: I don't want to *mislead* you. We have a very good position in Moore Products today — and, obviously, we're very happy to own it.

OID: I definitely got that impression.

Van Den Berg: You mentioned accounting fraud. And after having been in this business for 25 years, very little surprises me. But, frankly, that *would.*

As we follow this company and learn more about them, we find lots of evidence that they are solid, conservative people. You can see that in everything from their annual reports, financial statements, their salaries and in the contact that our analyst, Jim Brilliant, has on a regular basis with their management.

OID: As I recall, this year's proxy showed no one making more than $160,000±.

Van Den Berg: That's right. None of the Moores need the money. And they're very straight-up people. I think very highly of them. And none of the fingerprints in their proxies or their annual reports indicate any kind of self-dealing whatsoever.

I wouldn't give 'em an "A" for managing the company. But I wouldn't say anything negative either — because their main concern hasn't been to get the stock price up. They're trying to build a company with a great deal of pride in their products and a reputation to match. And, unfortunately, sometimes when someone focuses too much on *one* thing, they can slip up elsewhere.

But, again, to their credit, I believe they're correcting that imbalance with their new CEO.

AS LONG AS WE DON'T *LOSE*, THEN WE *WIN*.
AND IT'S HARD TO SEE HOW WE LOSE HERE.

OID: So, given all of that, why is this thing so cheap?

Van Den Berg: That's easy. In this kind of a market, what people are looking for is earnings momentum and earnings growth. These people would be a little too stodgy for your average hot money manager.

OID: That's what we keep hearing — that the market today is almost entirely momentum driven.

Van Den Berg: I can see it by looking at the stocks that are moving. This company's really cheap. But people probably won't look at it until there's a bear market and they want a place to hide and they know that there's some downside protection here.

OID: After the wounds have been inflicted.

Van Den Berg: I would think so. One of the things that impressed me about the value approach is that the portfolios of the Schlosses and the Tweedy, Brownes of the world — the diehard value guys — held up amazingly well in the 1973-74 bear market.

On an absolute basis, obviously the performance wasn't great — when you compare it to a Treasury Bill or something like that. But when you go through a market that declines 14% and 26% in successive years and show very little in the way of losses, I think that pretty much says it all.

OID: Or as Bill Ruane likes to say, "To win the race, you first have to finish it." — just the reverse of the newsletter credo of "Live fast and die ~~poor~~ young."

Van Den Berg: My answer to this has always been that if you don't lose, you win. If we buy 20-25 companies like this one, some of them will continue to disappoint and lag and so forth. But there'll be enough winners in there to make up for the losers as long as we don't lose a lot.

And it's very difficult for me to see how you can lose a lot in a company that is potentially a very desirable acquisition, that has all of these assets — including excess assets that aren't needed — that has high R&D that can be cut and on and on and on...

So I tell my clients to look long term. If we don't lose money on any of these and we have the winners that are invariably some percentage of this group, then we'll be fine. In other words, as long as we don't *lose*, we *win*.

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OID: Or, as Buffett says, there are only two rules.
Rule #1: Don't lose money.
Rule #2: See rule #1.

Van Den Berg: Exactly. And as long as we do that, when I look out 20 years, I don't know if we'll earn 15%, which would be 16 times our money, or 18%, which would be 27 times our money, or 20%, which would be 38 times our money. However, who would be unhappy in any case?

OID: You obviously married well...

Van Den Berg: I understand that demand for Ben Graham's books is inversely correlated to the stock market: The worse the market gets, the more demand goes up — because people start thinking about the *down*side. Well, that's *always* our approach — not just after a market decline.

OID: And I assume this relates to Moore Products...

Van Den Berg: When we discuss private market value, price-to-sales multiples, etc., we're talking about the *upside*. But the most important thing always is not to *lose*. The assets I just mentioned are your *downside* protection. I'm very comfortable buying it well below liquidation value. And if the company does better than it has historically, then that's fine, too. We're just not *counting* on it.

OID: I somehow gathered...

Van Den Berg: A true value investor might just say, "This one's selling at only two-thirds of liquidating value. What more do you *need*?"

OID: You're not a true value investor?

Van Den Berg: That isn't the only thing we look at — because even liquidating value can be deceiving. You can have inventory and plants that aren't worth what they're being carried for on the books. And even if they are *today*, they can evaporate pretty quickly.

In this case, however, we think this is a pretty solid liquidating value. The excess pension is there. And so is the LIFO reserve and the real estate. All are solid assets that we'd be happy to own at the prices I've mentioned.

So even if Moore Products' private market value is "only" $45, I think you can buy it pretty safely at $19.

OID: And you have?

Van Den Berg: As I recall, we've paid as little as $15± and as much as $19±.

I'VE SEEN THIS KIND OF SITUATION BEFORE.
AND TWICE THEY BECAME OUR BIG WINNERS.

Van Den Berg: But I've seen this situation before — you know, where a company clearly has great products, but doesn't quite have it all together — and then they bring in a guy who can put the ribbon on the package and make it a very attractive gift. I think this guy from Honeywell has the potential to do just that.

The same thing happened at the other two companies that became our big winners...

OID: Only one war story per customer, if you please — or, at least, one winner...

Van Den Berg: Exactly the same thing happened at both companies we thought were just boring value plays. We bought Galileo at an average cost of $5. And it's selling for between $23 and $25 today. And we've sold a lot of our shares at that price. And another one was Maxwell Labs. There, our average cost was $8. And today it's at *$42*.

But if you'd told me that those two were going to be our big winners, I wouldn't have believed you — because they were just two boring companies that were selling below book value with good products, good technology and good things going on generally that weren't being reflected in their stock price.

But, in both cases, all of a sudden...

OID: "All of a sudden" is right: The gains in Galileo look like they all came in a one-year period. And the gains in Maxwell appear to have all come since April.

Van Den Berg: That's right. Maxwell brought in a new guy. And within six to nine months, he had their product line repackaged, one of their product lines just caught on, their sales went up and their earnings followed. So now we're *realizing* their value. And the same thing happened with Galileo.

However, they weren't bought as growth stocks, although they're being bought as growth stocks *today*. They were being bought as value stocks — just like Moore.

OID: You sound like FPA Paramount's Bill Sams.

Van Den Berg: In fact, when we started buying Galileo, it had a book value of $8. And our average cost basis is $5. When we started buying Maxwell Labs, it had a book value of $15. And we were buying it at $8.

OID: But aren't you paying more for Moore?

Van Den Berg: Only using *stated* book. Again, the adjusted book here is much higher for all of the reasons that I've already mentioned.

And one more parallel: One thing that we used to always hear people say about Maxwell Labs was that they had more PhDs per square foot than M.I.T. But they brought in a guy who did some marketing, some refocusing and so forth.

If Hurd turns out to be like this guy from Maxwell, then we could have a lot to look forward to in Moore, too.

OID: And the odds of that?

Van Den Berg: In all candor, I'm not suggesting that Moore Products will be a great winner or anything of the sort — because Galileo and Maxwell Labs were the two big winners out of 15 or 16 companies.

But they both had the same kind of factors present: Things weren't going well. They were a little bit sloppy, but they were good people. They produced good products. And they wanted to do a good job. They just needed somebody to refocus 'em.

And based on everything I can see, that seems to be exactly what's going on at Moore. There seems to be a slow, evolutionary process going on — partially from within the company and partially from Hurd — to bring the

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company into focus and to increase shareholder value. And, as that occurs, that increased shareholder value will eventually be recognized in their stock price.

OID: Interesting.

Van Den Berg: So we're beginning to get a hint of this new, more shareholder value-oriented thinking. And as they continue to evolve that way, I think the Street will recognize it, too.

OID: With a higher stock price.

Van Den Berg: Exactly. You wanted something selling at 50¢ on the $1. There's no question in my mind that this one fits the bill there. It's just a classic value.

OID: It sure sounds like it.

Van Den Berg: If you take their excess pension of $9.50 and their excess real estate of $2.50 per share and their LIFO reserve of $2.50, you have $14.50. And the stock's at $19. So for $4.50 per share, you can buy a company with $54 per share in sales, $3 per share in normalized earning power and a $20+ book.

OID: Thanks for the offer. But we're too busy to get involved in any LBO until we finish this edition.

But do you know where we could borrow $4.50?

Van Den Berg: I'm afraid not. And that's too bad because somebody could get themselves a real bargain — although, again, it won't happen on an unfriendly basis. But I think something's going to happen on *their* side.

OID: If you get an investment banking commission, do you think we could get a deferred advertising fee...

Van Den Berg: So there's a lot of things going on. But I don't need *any* of these other things to convince me that this is a great buy.

INVESTORS AND ANALYSTS ARE DISGUSTED,
BUT MANAGEMENT IS BUYING BACK SHARES.

OID: Do you have any other bargains for us today?

Van Den Berg: I've got another one for you that's just as cheap as Moore Products, but that has *other* things going for it, too.

OID: You're kidding.

Van Den Berg: No. It's just as cheap. However, it's also further along to proving that it's on the right course. It's also selling at a 50% discount to private market value. It's got a great balance sheet and a great product line. And Eastman Kodak just bought a stake in one of its divisions.

OID: And you haven't told us about it yet?

Van Den Berg: The company's name is CPI [CPY/NYSE].

OID: A couple of our contributors have mentioned CPI.

But given how it's done since, we would appreciate it if you'd keep that strictly between us...

Van Den Berg: I can keep a secret if you can.

[Editor's note: *Portfolio Reports* estimates CPI was one of the top purchases of Baupost Group & FPA Capital Fund and a new position for each in the quarter ended 9/30/96.]

Van Den Berg: But, of course, that's one reason why CPI is so *depressed*.

OID: I beg your pardon...

Van Den Berg: When we get on the conference call with this company, you ought to hear the analysts. In fact, only a few analysts even *follow* it. And they don't sound too happy.

Of course, it's easy to understand why. In 1991, CPI was selling at $34 per share — which was 1.1 times sales.

OID: You'll no doubt understand if we have to edit that last comment out because of space constraints...

Van Den Berg: We haven't been making money in this one since October 28, 1993. That's when we bought our first shares. So we're not a hero in this one either.

But it doesn't bother me a bit. I have great faith. Actually, we're buying more shares every chance we get. Below $17.50, we think CPI is just a *great* purchase. And it's at $17 today.

OID: That certainly qualifies as a contrary opinion.

Van Den Berg: The next time CPI has a conference call, you really ought to listen in. It's fascinating. This is a company that at one time had the eye of Wall Street. And you'd think more than a few guys would be following it. After all, this isn't some unheard of company. But that's what produces values.

OID: In other words, disgust.

Van Den Berg: That's *exactly* what it is. And let me tell you something: If I'd been in CPI at $34 five years ago, I probably wouldn't feel much different — in fact, I *know* I wouldn't. There's a kind of psychological drip there that gets to you when you're holding a stock.

OID: As one of our contributors says, the stock may not know where it's been, but you do.

Van Den Berg: We had one stock that was a loser for seven or eight years. In that case, we continued to buy it. And I'm glad we did. It's contrary to conventional wisdom on Wall Street. However, I'm a big fan of averaging down. The only time I don't is when we believe a company's value has materially declined.

OID: And I gather that's not the case with CPI.

Van Den Berg: Not at all. So why has CPI's stock been such a disappointment? Very simple. In this market, stocks of companies that report disappointing earnings are taken out and shot.

OID: You noticed that, too?

Van Den Berg: One of the problems with the Street is that they sometimes focus exclusively on earnings and ignore free cash flow, depreciation, R&D or anything else.

We do expect CPI to report earnings the Street likes

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CENTURY MANAGEMENT'S
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somewhere down the road. But when it does, I don't think anyone is going to be buying its stock at *$17*. Once it starts to show what it has boiling in the soup, anyone wanting to buy it is going to pay a lot more. And it may not be such a bad purchase at *that* point. After all, in the recent Dutch auction, although the company only paid $19, they were *willing* to pay up to $22.

OID: Share repurchases are generally a good sign. But what makes you think they weren't overpaying?

Van Den Berg: I can assure you they didn't overpay. CPI's management is very sophisticated. For example, they've managed to establish a strategic partnership with Eastman Kodak. And Kodak CEO George Fisher isn't going to partner with CPI or anyone else unless he believes they're bringing something very significant to the party.

OID: You don't think a discount on his kids' pictures might have been what brought things into focus...

Van Den Berg: The people at CPI absolutely understand free cash flow and shareholder value and all of the things we look for. If they're willing to pay up to $22, what do you think *they* think it's worth?

OID: More than $22.50?

Van Den Berg: Let me answer you this way. We own a lot of CPI already. And we have no hesitation whatsoever about buying more — especially since the company is a lot farther along today in what they're doing than they were when we first started buying it.

CPI REMAINS THE LEADER IN TWO SEGMENTS.
BUT COMPETITION HAS GREATLY INTENSIFIED.

OID: In that case, howsabout a snapshot view?

Van Den Berg: CPI is the leader in several segments. First, they're the leader in Preschool Portrait Studios with about 1,000 stores — 900 of them located in Sears' stores.

OID: Nobody's perfect.

Van Den Berg: And they're dominant in that niche — with 29-30% of the market for preschool portraits. That area had sales last year — CPI's fiscal year ended on February 3, 1996 — of $279.5 million.

Then, CPI's second biggest division is Photofinishing. That segment has over 550 stores. And it's grown from $6± million in '82 to about $188 million in fiscal 1996.

OID: Although it looks like Photofinishing sales were actually flat from 1993 to 1995.

Van Den Berg: Competition has really intensified for both of those divisions the last few years. For example, on the Portrait Studio side, CPI says that the number of permanent, directly competing photographic studios has increased from 600 to 3,600 in only the last six years.

OID: That sounds serious, all right.

Van Den Berg: And, in photofinishing, competition from mass merchandisers has been *particularly* intense.

Incidentally, the growth of CPI's photofinishing area was complemented by their acquisition a few years ago of Fox Photo — which provides a one-hour photofinishing service. And to give you some idea of just how far back my history with this business goes, I owned Fox Photo back in the early 1970s before it was bought by Eastman Kodak, sold to CPI and then resold — or, at least, 51% was resold — back to Eastman Kodak.

OID: Not to worry. I have trouble making up my mind at times, too. On the other hand, maybe you should....

Van Den Berg: Eastman Kodak's CEO, George Fisher, was very excited about CPI's technology. And to give you an idea of how excited, he just paid $56.1 million for that 51% stake — in effect, implying a valuation of $110 million for the division as a whole. Also, Eastman Kodak gave CPI a put guaranteeing it the right to sell its remaining interest for $53.9 million — i.e., based on that same valuation.

So, basically, what it amounts to is that Kodak and CPI are joint venture partners in photofinishing.

And, finally, CPI's third division is a very interesting and very profitable division called Prints Plus. They sell prints of the kind of pictures you put up on your wall.

OID: There's no need to get personal.

Van Den Berg: They include all kinds of scenery and other themes. They provide the photography, create the prints, sell 'em and frame 'em. They acquired that division in the last few years. And it's working out very well so far. The Prints Plus division had sales of $58.7 million last year — up from $49.9 million in '94 and $34.6 million in '93.

So simply adding up the sales of all three divisions, CPI had total sales last year of $526 million.

APPEARANCES CAN BE DECEIVING
— AS CAN REPORTED EARNINGS.

OID: Fine. But, so far, I don't see a picture developing of a stock that's disappointed and had declining sales, margins and earnings for half a dozen years.

Van Den Berg: Appearances can be deceiving. CPI's earnings have been depressed by several things. First, Sears is in the middle of a huge renovation and revitalization today with its new CEO — Arthur C. Martinez. They're spending $4 billion to refurbish their stores.

Well, CPI is *also* spending a huge sum of money redecorating and expanding their studio space at Sears. So *that's* depressing their reported results.

OID: By increasing their depreciation.

Van Den Berg: That's right. And there's quite a bit that I could tell you about Sears and the wonderful job that their new chairman is doing. However, in a nutshell, we're convinced that they're doing all of the right things.

And CPI has a wonderful relationship with Sears. So Sears picking up stride is ultimately going to *help* them.

OID: Gotcha.

Van Den Berg: But here's what's *most* exciting. CPI has always been the leader in the portrait studio business. And, several years ago, they decided that in order for them

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CENTURY MANAGEMENT'S
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to *continue* to be the leader and to dominate it even more, they needed to come up with new technology. And that's part of the same new technology, incidentally, that Eastman Kodak is so interested in.

So they established a budget of $147 million — of which $88 million has already been spent. And they developed a portrait concept which I can try to explain, but that you have to experience to fully understand.

OID: Only if you'll be the kid...

Van Den Berg: Perhaps I *could* explain it to you. There is a video camera — and as the pictures are taken, they are captured and displayed on the monitor from which the customer can choose the pose or poses she likes. A color proof sheet is then instantly printed for her to take home. From these proofs, she orders, pays and comes back in a week to pick up her portraits.

OID: And this is the technology that Eastman Kodak is so excited about?

Van Den Berg: What impressed Kodak is how CPI built a better mousetrap –- even better than Kodak itself. With CPI's technology, customers don't have to wait 2 weeks to view their pictures before ordering. She views the portraits and has proofs suitable for framing right on the spot. The customer orders her prints when all the excitement and emotion of the moment is fresh in their minds, which generally results in higher sales per ticket assuming of course that she has attractive children.

OID: It sounds like a great idea — although it's hard to see any reason to be excited technologically or why competitors couldn't do the same for that matter. Actually, I have a videocamera, a personal computer and a VCR. If Eastman Kodak is interested...

Van Den Berg: Even if you have all of that equipment and happen to be a dedicated photographer, you'd have to print with a color printer. And you couldn't begin to approach their quality.

To give you some idea, CPI's Austin location just coincidentally happened to be one of their test sites for the new system. So Jim Brilliant — our analyst who follows this company — took his wife and children to try it out. And they were *thrilled* with the quality of the photographs.

And in their photofinishing operation — which, again, is 51% owned by Eastman Kodak — they have the same idea. You can take your picture there. They can digitize the image and put it on a computer. And then you can crop it and enlarge it any way you want. You can even alter it and move elements of it around. It's very exciting.

OID: You certainly can't tell it by CPI's stock price — or earnings estimates, for that matter.

Van Den Berg: Patience. What's happening is that they're expanding it all over the country right now.

So the long and short of it is that CPI is the leader in photofinishing and the portrait studio area. They're the leaders revenue-wise and technologically. But they've been spending huge sums of money — most of it having been spent *already*. And it's depressed their reported earnings.

OID: Actually, I see what you mean. According to Value Line, CPI's net profit dropped by almost half from 1990 to 1995. But if you add back depreciation in both years, it was virtually flat.

Van Den Berg: That's exactly right.

OID: But why would you expect there to be a decline in their capital expenditures?

Van Den Berg: This company is over 50 years old. They spent $65-70 million developing this new technology. It was a massive onetime outlay. And now they *have* it. So it shouldn't have to be repeated for I-don't-know-how-many years. Now all they need to do is to refurbish a few of their stores. And all they have to expend going forward is maintenance capital expenditures.

Therefore, their capital expenditures are going down. As a result, their depreciation *will* be going down.

OID: In effect, simply trailing capital expenditures.

Van Den Berg: Exactly.

EVEN UNDER ULTRACONSERVATIVE ASSUMPTIONS,
CPI WILL EARN SERIOUS MONEY & SERIOUS RETURNS.

Van Den Berg: Let me give you some figures that I think will make very clear why we believe that CPI is worth at *least* twice today's stock price.

But, first, let me point out that these figures *exclude* Photofinishing. Before selling a 51% stake in that division to Kodak, CPI consolidated the sales of that division in their own income statement. However, going forward, CPI will carry its remaining 49% interest in that division as a minority interest.

OID: So?

Van Den Berg: So CPI will no longer continue to itemize that division's assets and liabilities on their balance sheet. Its ownership will show up as an equity position. And its earnings will also be included as earnings from "minority interest" near the end of their income statement. But you won't see that division's revenues and expenses in CPI's financial statements.

OID: So financial editors and other non-sophisticates will simply think that CPI's sales have fallen.

Van Den Berg: That's right. So here's what's going to happen: For the reasons that I've mentioned, depreciation will top out this year at $27 million. However, in the next five years, depreciation will decline from that $27 million — which, again, is abnormally high — to a more normal level of around *$15* million.

And after recently buying back 2.25 million shares, they only have about 11.6 million shares outstanding.

OID: So declining depreciation expense could provide 80¢ per share of additional earnings all by itself.

Van Den Berg: Exactly. Meanwhile, those outlays will start generating additional sales and profits.

Let me show you what happens to CPI's earnings when you look out a few years using some of the most

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CENTURY MANAGEMENT'S
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conservative assumptions imaginable. And I believe you'll be very surprised what happens to their earnings *anyway.*

OID: I imagine that I'm not the first to point out your flair for the dramatic...

Van Den Berg: Let's do the exercise first *without* including anything for Photofinishing revenues or earnings.

First, we assume Portrait Studio operating earnings in fiscal 1997 will be what they were in the 12 months ended November 11, 1995 — which was $47.25 million. So we're assuming no growth whatsoever.

And we assume that Prints Plus [which, incidentally they refer to as Wall Decor in their annual report] will have 1997 operating earnings of $4.5 million — which is less than they earned in 1993, 1994 or 1995.

OID: Although neither may be as conservative as it sounds since its earnings look like they'll be down a bunch in its fiscal year ending February 1997.

Van Den Berg: True — 1995 earnings were $1.26 whereas 1996 earnings will end up at $1. They did some tweaking to their portrait offerings and ended up giving away too much. So they have room to raise prices.

As for sales and corporate expenses, we use what they were actually running in the most recent 12 months — ending November 9, 1996. And using those assumptions, for purposes of this analysis, we estimate 1997 earnings of $1.40 per share.

OID: And that sounds more than reasonable given analyst estimates of $1.40-1.50.

Van Den Berg: We think it's *very* conservative. And how's *this* for conservative: Between fiscal 1997 and the year 2000, I'm going to assume that there's *no* increase in sales or margins in either of their remaining segments. So the *only* improvement that I'm assuming is a decline in their depreciation expense, as I mentioned earlier, because of a decline in their capital expenditures. OK?

OID: With a lead-in like that? Are you kidding?

Van Den Berg: If they keep their operating margins at their current 15% and we do the same calculation we just did to come up with their $1.40 in earnings in 1997, do you know what CPI's earnings would be in 2000?

OID: Do you prefer a drum roll or a dramatic pause?

Van Den Berg: With no increase in either their sales or margins, simply because depreciation is going to decline from $27 million to $15 million — CPI's earnings per share will go from $1.40 to $2.09.

OID: So that today's $17 stock price is equivalent to 8 times what you hope is a near worst case scenario.

Van Den Berg: Exactly. And, clearly, this company is worth a lot more than 8 times depressed earnings. And, again, that's without *any* contribution from Photofinishing.

OID: What kind of return on equity would $2.09 of earnings per share imply?

Van Den Berg: Off the top of my head, I'm not sure how much of CPI's book value we should attribute to Portrait Studios and Prints Plus. But even assuming that CPI's book value is the same $12.54 today that it was at year-end 1995 and that *100%* of that book value is attributable to Portrait Studio and Prints Plus, $2.09 of earnings per share would still equate to a 16.7% return on beginning of year equity *today.*

OID: Which is plenty respectable.

Van Den Berg: Absolutely. And thanks to their recent share repurchases, their book value's probably less. And part of it, of course, is attributable to Photofinishing. So their returns are actually *higher.*

OID: Which would suggest that it might be worth more than 8 times earnings.

Van Den Berg: Absolutely. And CPI's margins are depressed. But the average S&P 400 company has an operating margin of only about 14-1/2%. We're projecting an operating margin for CPI of about 19-1/2%. So they *should* earn a good return on sales and equity — even with margins below their historical levels. This is not your average company, I don't think — even at its *worst.*

TO THE SURVIVOR WILL GO THE SPOILS.
AND CPI WILL DEFINITELY BE A SURVIVOR.

Van Den Berg: And it gets *better.* That $2.09 of earnings per share assumes an operating margin of 19.4%.

OID: But isn't that being a bit aggressive? According to Value Line, going back to 1986, CPI's operating margin has never exceeded 20.4%.

Van Den Berg: Not at all. It gets a little complicated. However, in a nutshell, the operating margins *Value Line* shows for CPI are for the company as a whole — not for their Portrait Studio segment.

Historically, their Portrait Studio operating margins have been closer to *25%.* For example, from 1982 to 1991, it was consistently up around 25%. In fact, it actually exceeded 25% in seven of those 10 years.

[Editor's note: Van Den Berg showed us the figures from an old CPI annual report.]

OID: Of course, the competition since that time has increased exponentially.

Van Den Berg: Absolutely. As I mentioned earlier, CPI says that the number of permanent portrait studios has expanded from 600 to 3,600.

When a concept gets hot, retailers get killed because everybody jumps into it. But the real smart players survive by pulling in their horns and developing an edge — whether it's CPI's better technology or something else. So, when the shake-out comes, they'll be one of the survivors.

OID: And to the survivors go the spoils.

Van Den Berg: Exactly. Well, this industry is going through a shake-out. That's why American Studios was bought out. Despite having over 850 permanent studios in Wal-Mart and over 2,000 locations which they service, they weren't making money. PCA bought 'em as a turnaround.

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OID: And you're not worried about the combination of those two as a competitor?

Van Den Berg: Not at all. CPI actually had the contract for Wal-Mart and didn't want it because they weren't high enough quality and wouldn't be profitable. And American Studios' been *losing* money for two years. They occupy the low end of that business.

Nevertheless, you might be interested to know that we calculate that the price PCA paid for American Studios was actually 10 times peak cash flow, 4 times book and 63% of price-and-debt-to-sales. Applying those multiples to CPI would imply a valuation range of $26 to $46.

And, again, we believe there's no comparison between CPI and American Studios — or PCA, for that matter.

OID: You think CPI is better?

Van Den Berg: By far. CPI has things going for them that other players don't — including better technology. They can actually license their equipment to other companies without even setting up studios. They just have a far superior product. And, therefore, they're going to have better margins than they ever had.

OID: Because the new technology is cheaper.

Van Den Berg: Yes. Nevertheless, our most optimistic scenario assumes margins 20% below what they used to be with the old technology.

OID: And you think that's reasonable.

Van Den Berg: Oh, I think it's *very* reasonable. Again, I'm assuming — and here's the key — their current operating margins without any increase in sales, without any increase in operating margin. All I'm doing is adding back of the excess depreciation. And that's going to *happen*. That's even more of a certainty — or closer to being a certainty — than their sales.

We just wanted the most conservative scenarios we could imagine to make this judgement. And the reason we do that is because we don't want to kid ourselves...

OID: It's really not so bad — once you get used to it...

Van Den Berg: So we asked ourselves: What

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happens if sales don't grow, margins don't improve and all that happens is that depreciation goes down? And the answer is that in three or four years, CPI is going to achieve very meaningful earnings.

UNDER RELATIVELY CONSERVATIVE ASSUMPTIONS, TWO OF CPI'S DIVISIONS ALONE COULD EARN $2.80.

Van Den Berg: Next, let's just assume that they improve operating margins by an additional *2%* —which would bring their operating margin up to 21.4%. Again, that's still well below historical levels.

OID: You make it sound so reasonable.

Van Den Berg: In that case, instead of earning $2.09, they'd earn *$2.40*.

OID: In which case, today's stock price would represent all of 7 times earnings.

Van Den Berg: That's with *no* growth in their sales, no growth in earnings from Prints Plus and no earnings from Photofinishing.

OID: What if Essman holds his breath...

Van Den Berg: And they'd earn *$2.80* with that same 2% improvement in their operating margins and revenue growth of only 3-1/2%,

OID: Actually 3-1/2% in real terms since you're holding corporate expenses steady. However, I believe I understand your point.

Van Den Berg: And, again, this scenario still assumes no earnings increase from Prints Plus and no contribution whatsoever from Photofinishing. If they were able to achieve a 5% net profit margin in that division, that would represent another 40¢ of earnings for CPI right there.

And none of these scenarios allows for operating margins above 21.4% — although they should enjoy a lot of operating leverage as sales increase. And, again, between 1983 and 1990, Portrait Studio operating margins were consistently up around *25%*

Plus, it doesn't include anything for share repurchases.

AND GROWTH WON'T NECESSARILY BE LOW. IN FACT, HISTORY & DEMOGRAPHICS SUGGEST OTHERWISE.

Van Den Berg: And let me give you some idea of the kind of growth this company could be looking forward to. People talk about foreign markets and rush out and buy stock in China and so forth.

OID: There's no need to point fingers.

Van Den Berg: I read an article about how Fuji and Eastman Kodak are slugging it out in the trenches trying to dominate that market. There are literally a billion people. And, as I understand it, studies of spending patterns strongly suggest that the Chinese and Japanese photography markets are an absolute dream.

OID: As is the Chinese market for almost everything...

Van Den Berg: Well, CPI has a little business in

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Canada. But they have the *whole world* to expand into. This is the typical Western product — along with a razor, toothpaste and Coca-Cola. A picture of your kid is just as basic as taking a shave.

OID: So you're not worried about it becoming obsolete.

Van Den Berg: I haven't seen any evidence to suggest it's becoming obsolete. If anything, it's more *prevalent* now. And here's why: There's a very interesting statistic that suggests that the majority of pictures are taken for the grandparents. And as people get older, they live longer. So we're going to have more grandparents.

OID: That's a fascinating point. It's actually a play on the graying of America.

Van Den Berg: It *is*. So, if anything, its business should grow. There are 4 million births in the U.S. each year. It isn't like the market for baby pictures is shrinking.

You have grandparents living longer. You have many different ways to *display* pictures — from standard frames to coffee mugs to calenders.

OID: And the 900-pound gorilla in photography...

Van Den Berg: As your partner. Exactly. And you know the kind of CEO Eastman Kodak's George Fisher is. From everything I've heard, he's as good as they come. And you can already see the results he's achieving there.

And George Fisher thought enough of the technology in CPI's photofinishing business that he wanted a 51% interest. As you may know, they're doing a lot of joint ventures with strategic partners.

So, now, with the new technology that they've developed in photofinishing and earnings estimates assuming 3.5% per year growth leading to the earnings that I laid out earlier, you can imagine what would happen if I started to show you S&P-level revenue growth of 7-8%.

OID: You mentioned CPI being able to license its equipment to others...

Van Den Berg: We do expect them to derive revenue from licensing their technology and/or contributing it to joint ventures with other companies — probably in the next three to four years. But, as you see, we're not assuming any contribution from that source here.

IF CPI CAN RESTORE EARNINGS TO ONLY 5%,
THEN ITS PRIVATE MARKET VALUE MAY BE $40±.

Van Den Berg: So we're not counting on higher profit margins to make CPI's stock a very rewarding investment. Its net profit margin is only running about 3-1/2% today, although it's been much higher historically. For example, it was 7.1% in '86, 8.5% in '87, 9.2% in '88, 8.8% in '89 and 9.0% in '90.

OID: That's certainly much higher than 3-1/2% — although I see they earned those margins before they added $50-60 million of long-term debt. Granted, that shouldn't reduce margins by more than 6/10s of 1%...

Van Den Berg: That's right. So just to see what might happen, let's assume they manage a 5% margin.

OID: Which I gather you don't think is so farfetched.

Van Den Berg: It's only 60% of the margin they *have* earned. And now they have this exciting new technology, this new strategic relationship with Eastman Kodak and a long-term strategic partner — Sears — in the midst of a very successful revitalization. So being *half* as profitable as they have been doesn't seem like very much of a stretch.

OID: I'll assume that's a no.

Van Den Berg: I don't think it's a stretch at *all*.

[Editor's note: Absent $5.55 million of amortization, they were actually already at 4% in 1995 and much more in 1983 and 1984.]

Van Den Berg: And excluding photofinishing, they had $338.2 million of sales in 1995 — $279.5 million in their portrait studio segment and $58.7 million in their Prints Plus segment. Dividing by their 11.6 million shares outstanding, those segments have a little over $29 of sales per share. So looking out to next year, we assume sales of $31 per share. And applying a 5% net profit margin to those sales, we arrive at normalized earnings of $1.55.

And, then, we estimate that private market value would easily be 22-24 times earnings. But let's just take the lower of the two and assume it's 22. So multiplying that $1.55 per share by the 22 would give us an indicated value of $34 — excluding the photofinishing.

OID: And I was getting ready to question your P/E. But 22 times earnings with a 5% net profit margin is the same as 1.1 times sales.

Van Den Berg: That's right.

OID: And CPI frequently sold for more than that from 1986-91 — before they muddied the water in the ways that you've described.

Van Den Berg: That's exactly right. And then you can value their 49% interest in the photofinishing segment using that same method — in which case you'd arrive at a valuation of about $4.65 per share.

So using $4.65 as your value for that interest and adding the $34 valuation we came up with earlier for their remaining segments, CPI would be worth $38+ per share.

CPI HAS EARNED HIGH RETURNS & PROBABLY WILL.
AND SEARS LOVES THEM FOR 42 MILLION REASONS.

Van Den Berg: Incidentally, CPI has historically been a very high return business. In fact, up until the last half a dozen years, they earned anywhere from 19% to 23% on their net worth.

[Editor's note: Using figures in CPI's annual report, we estimate they averaged an ROE of 21% from 1985-95.]

OID: One reason why, I imagine — recent initiatives aside, anyway — is that they wouldn't have much in the way of capital requirements.

Van Den Berg: That's right. Plus, it's historically

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been a very profitable business.

OID: And you don't think the competitive environment you described earlier has changed that permanently?

Van Den Berg: Let me answer you this way: with that new technology, mom and pop stores can just *forget* it.

OID: But since they do business under Sears' name, what protection do they have from Sears assigning their contract to someone else or renegotiating the contract to CPI's disadvantage?

Van Den Berg: Technically speaking, they have none. However, the relationship goes back 35 years.

OID: I imagine you could say the same thing about a lot of marriages that subsequently wind up in divorce.

Van Den Berg: Probably so. But Sears is so happy with CPI that they've given them awards 11 times in the last 13 years. And they were the first recipient of Sears' Chairman's Award and the Partner in Progress Award in 1994 and 1995 — the latter of those, incidentally, being awarded for "CPI's new groundbreaking technology-based marketing program".

OID: And, actually, I imagine their new technology — if it's everything you say it is — might also make them less likely to be replaced.

Van Den Berg: That's right. However, listen to this: "CPI spent 15% of sales advertising the Sears name in connection with their portrait studios primarily directed to women with young children — a highly valued customer base for Sears." That's the *real* reason.

OID: Good answer.

Van Den Berg: How much would I be worth to you if I spent $42 million marketing your publication?

OID: There's only one way to know for sure....

Van Den Berg: I guarantee you that you'd be happy to give me *plenty* of awards. CPI and Sears are so closely tied together in a symbiotic relationship. Sears gets the benefit of a wonderful product, state-of-the-art technology, a company that markets their name and lots of traffic. And it helps CPI's credibility to use the Sears name.

OID: And, according to its 10-K, gives CPI better rates on its advertising, Sears' transaction processing, etc.

THIS COMPANY HAS NEVER LOST MONEY.
AND WITH THIS CHAIRMAN, IT'S CLEAR WHY NOT.

OID: What, then, could turn it into a mistake?

Van Den Berg: First of all, as far as we can tell, they've never *lost* money. I think it's the kind of business that has some stability to it. Again, it's certainly become more competitive. But they can cut their expenses pretty good if they needed to do so. If their sales were declining and some of their studios weren't producing, they could always close studios — just like any retailer.

OID: Sequoia Fund's Bob Goldfarb points out to us that closing locations isn't so easy for most retailers — that their leases, in fact, amount to fixed costs that can overwhelm them in bad times.

Van Den Berg: I don't disagree with the basic concept — although landlords are frequently willing to renegotiate leases during bad times rather than lose a tenant. And, yes, CPI does have an element of liability, too.

Their relationship is much more akin to a partnership — with much more mutuality of interest — than the relationship a typical retailer has with its landlord. Sears gets 15% of sales — which is a pretty big cut.

Consequently, as I understand it, if a CPI location has substandard traffic, Sears allows them to close it. Their flexibility is much greater than it would be with a traditional landlord. Frankly, given how much advertising CPI does for the Sears brand and how much traffic that they attract to Sears' stores, it would be irrational for them to do otherwise.

OID: What should you worry about?

Van Den Berg: Well, we don't have to worry too much about their photofinishing interest because of their put from Eastman Kodak.

Plus, this guy, Essman, is really a class act. He's very thoughtful. He's low key. He's believable. He's *extremely* knowledgable. And he's very shareholder oriented. He understands free cash flow. And he understands what it takes to make a business go.

OID: No matter what anybody says.

Van Den Berg: You can point to the last few years and say that he's not that good a manager. But Buffett says when a manager with a good reputation takes on an industry with a bad reputation, that it's usually the reputation of the business that remains intact. This guy is a good manager, but it's been a bad industry for the last half a dozen years. And the reputation of the industry has won out so far.

But I believe a great manager makes the difference even in a *bad* industry. It may even be *more* important in a bad industry — because I believe a great manager who's in a business where he knows he can't win either shrinks it down, sells it or liquidates it. And it takes a great person to do that because you have to go against the grain of a lot of people.

OID: That's what Mark Cooper says. And I gather that's what Essman's doing with the share buybacks.

Van Den Berg: With the share repurchases, but also with their capital expenditure program. Do you know the kind of courage it took for him to commit that company to a five-year $147 million capital expenditure program to upgrade their technology and their studios? After all, CPI's entire net worth at that time wasn't much more than that and isn't much more today. The easy thing for him to do, after all, would have been *nothing.*

OID: Although nothing is sometimes the right thing. And it looks like they've reported losses from discontinued operations in four of the last five years.

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG
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Van Den Berg: True. They had some small units that they used to test a lot of the digital applications. But they weren't a total loss because they used the lessons they learned in those to formulate today's strategy.

And Essman says that they're now going to *dominate* this business with their new technology and that there just isn't anything on the market like it — not even *close.*

THIS CORPORATE CULTURE HAS THE RIGHT STUFF.
SO THEIR EDGE ISN'T TEMPORARY. IT'S "BUILT TO LAST".

Van Den Berg: And I don't think it's going to be a *temporary* edge. A book I read recently — *Built to Last* — answered my question as to why some franchises last for decades and others squirt out there and just quickly fizzle. The missing link in looking at a company like Buffett does and saying, "Coca Cola will endure forever because..." — or Gillette or any of these other companies — gets back to their core values. It gets back to their corporate culture. In other words, it's their *belief* system.

OID: You're the second contributor in as many editions to highly recommend that book to us — and for almost exactly the same reason.

[Editor's note: Marshfield Associates' Sam Mitchell was the first.]

Van Den Berg: It is really excellent. I've been searching for the answer to that question for many years. And these guys did a study of all the great companies that were leaders in their fields and the also-rans — and did a direct comparison. They concluded and documented that the real difference is the culture that was established by the original founders. And that kind of thought process and culture is what allows it to adapt and adjust.

For example, one of my favorite authors, James Allen, says: "The limit of a person's success is the boundaries of his morality — or his character." In other words, character ultimately determines if you're going to be great forever or you're going to just fizzle — because lots of people have energy, brains and talent, but not the character. And then something falls apart and the company goes down. So, obviously, *character* is one of the core values.

OID: Which is only logical considering that Buffett's notion of goodwill ultimately boils down to trust.

Van Den Berg: Right.

OID: And you're unlikely to be able to successfully build trust — at least over the long term — unless there's in fact a good reason for people to trust you.

Van Den Berg: That's right. Character and/or the lack thereof shows up in the long term. And the longer that the company successfully builds trust, the more all of these factors come in. So, obviously, character is one of the core values. But there are others.

The authors gave the example of Hewlett Packard. They said, "Everybody thinks Hewlett Packard had such great vision to come up with such wonderful products. But if you read their original writings, you'll see that it was anything *but* that. What they had was great *principles.*"

And, obviously, character was one of them. However, another great principle was based on the fact that they were engineers who wanted to provide a platform for other engineers so that they didn't have to choose between working somewhere turning out lousy fad products and being unemployed. They wanted to give engineers the freedom to be able to truly build the best possible product.

OID: Interesting.

Van Den Berg: So because of that one core value, if you were an engineer, that's where you'd want to go work. It was even more important than your salary — because if you were creative and wanted to design something that was worthwhile, you'd rather produce things of quality than make more money.

So that core value made sure that they attracted the best minds and the people with the right ideas — people who were willing to work for less if they were able to build things of quality.

OID: Would you mind if we inserted a help wanted ad in this spot?

Van Den Berg: Not at all. And the other core value they had was that no matter how good the product was already, if they could design a product that was better, they always would — even if it cannibalized their sales.

OID: In other words, that they would cannibalize themselves before someone else could.

Van Den Berg: Right. Now look at that core value. And look at what happened to IBM and other companies because their core value was to protect their domain and try to make up the difference in marketing.

OID: Who could ever forget the chiclet keyboard on the P.C., Jr. or whatever the heck it was called.

Van Den Berg: Right. So core values of character, producing things of quality, attracting the right people and reinventing themselves and their products is what has put Hewlett Packard in a technology field as a leader. It wasn't that they had the foresight to develop these products. Rather these products were an outgrowth of the philosophy and values of the founders.

What would have happened if, instead, they'd been quick buck artists who said, "We're going to grab these engineers, use 'em and, when the cycle's over, spit 'em out. And we're not about to give up our sales. We're going to milk our existing products absolutely as long as we can." You know the answer.

OID: They'd have become management consultants?

Van Den Berg: Over the long run, the company with the right philosophy and the right corporate culture is going to kick ass on everybody because their core values say, "It's character. It's the product. It's the customer." And people who come to work there buy into those values — which means they're going to be reinventing themselves long after Mr. Hewlett and Packard are gone.

OID: I apologize for interrupting your book review. But weren't we talking about some company...

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG
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Van Den Berg: CPI was already the dominant player in the industry. But they have the core value of developing the best technology possible anyway. And, so, they made a $147 million commitment to improve their technology. Doesn't that sound like a company committed to coming out with the very best product that they can?

A lot of people would have milked this thing and never come out with anything like it. But look what CPI's getting out of it: They've managed to get into a joint venture with the leading technology company in their field.

OID: If you ever get tired of money management, may I recommend public relations...

Van Den Berg: In effect, that partnership came out of their core values. Do you think Eastman Kodak would be interested in a joint venture with CPI if all they did was wheel your daughter or granddaughter around, set her up and have some guy take her picture with a camera that they'd been using for 20 years?

OID: If you put it that way...

Van Den Berg: Absolutely not. Kodak recognized the advantages and the quality of CPI's technology. And the public is going to respond to the quality of its product, too.

WE BELIEVE THAT CPI IS A GREAT VALUE TODAY.
BUT, AGAIN, NO GREAT LEAP OF FAITH IS REQUIRED.

Van Den Berg: And even in a disaster-type scenario, we don't think CPI would sell for less than 45% of price-and-debt-to-sales. They have sales of about $31 per share. And adding $8 per share of sales for their 49% interest in the photofinishing business would bring their total sales per share to $39. So 45% of their $39 of total sales per share would be $17.55. And deducting their $3.86 of debt, our worst case scenario price for this stock would be $13.50.

OID: Although it's not unusual for sales to decline in disaster-type scenarios.

Van Den Berg: They do. But that also corresponds to CPI's lows the last four years: $13-3/4, $14, $13-3/4 and $13-5/8. And that was with their earnings falling to as little as 76¢ in 1993. So I'd say $13-15 already reflects an extremely depressed business.

Again, it's a business that's never lost any money and whose capital expenditures will be declining. So I think a mistake would result in a small loss or dead money — but that's about it. And that's what it's been for us so far. We bought it at $16 to $17. And we've lost three years.

Meanwhile, the background music's getting better...

OID: You've certainly got better hearing than I do...

Van Den Berg: The system's been tested and proven. It hasn't translated yet into sales, much less profits. But they say they've had great success with the technology — with the camera and all of that.

In fact, in one of their press releases, they said that when they first introduced it into their studios, they were overwhelmed with customer response. One problem was that it worked so well that they created backed up lines in Sears and therefore missed a lot of opportunities for sales.

OID: And, presumably, that overwhelming response might one day even be reflected in sales?

Van Den Berg: Their comment — and one the Street doesn't like — was that the technology was working fine, but that their people weren't adequately trained to *use* it.

So there's evidence the new technology is working, but no evidence that it's increasing their sales as of yet. We obviously believe they'll be able to address the problem and that it *will* increase their sales — although I can't tell you when.

OID: That all sounds very interesting. But my wounds are still healing from my last concept stock...

Van Den Berg: You should definitely be skeptical. However, we've done enough work on this new technology and this industry to be convinced that what CPI is offering to the public is clearly superior.

Again, competition in the portrait studio business has increased exponentially and become absolutely brutal. However, CPI feels that not only will they be able to offer a *better* product, but that they'll be able to do it *cheaper*, too. So the competitive implications are obvious.

OID: Of better and cheaper? I think so.

Van Den Berg: As you say, it remains to be seen. And that's the uncertainty. There's no real evidence of that yet.

OID: In other words, no proof they can do business without proofs.

Van Den Berg: I'm glad you said that and not me. But that's right. However, if and when there is proof, I don't think we'll be able to buy more of CPI's stock at *$17*.

So whether it comes in next quarter, the quarter after that or several *years* from now, it's not going to shake my position or my conviction. The only thing it might do is give us another opportunity to buy more at a better price.

There's so much value here and so little downside. Today, you're at $17. And now they're going to earn more than $1 per share. It's hard to imagine things getting any worse — unless it turns out that their entire effort has been for naught.

OID: Which usually doesn't happen if I don't buy it.

Van Den Berg: And with the clear superiority of what they're offering the public and Eastman Kodak, in effect, validating that judgement, that's hard for me to imagine.

OID: Even more so if you saw our bank account...

Van Den Berg: But remember the exercise that we did earlier — where we showed that their *earnings* are going to go up even if their revenues and margins *don't*. So all we really need to make CPI a big winner is 3-4% sales growth and a small improvement in their margins.

And remember that CPI sold for 1.2 times sales as recently as 1991. If it were to sell for 1.2 times sales today — including the "hidden" sales of its photofinishing stake — we'd be talking about a $47 stock.

And you might say, "Yes, but they were reporting $1.80 of earnings per share at that time."

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CENTURY MANAGEMENT'S
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OID: No. I'd ask whether you interview yourself often.

Van Den Berg: But that's what they're going to earn two or three years from now even if nothing changes other than their depreciation. And bear in mind that you don't need to believe it's worth $47 for it to be a 50¢ dollar. Even a $34 value would make it a 50¢ stock today. So, here again, no giant leap of faith is required to believe that CPI is a great value.

Plus, you know that management has just paid $19 to buy back 2.25 million shares. And you know that they pay a well-protected dividend of 60¢ per share — which means that you also get a yield of over 3-1/2% while you wait.

OID: If I promise to buy it real soon, do you think that we could proceed to the next one?

Van Den Berg: Definitely. But you won't be buying *our* shares. I'll guarantee you that.

WE'VE BEEN WRONG ABOUT THIS ONE A LONG TIME.
BUT IT'S WORTH MUCH MORE THAN TODAY'S PRICE.

OID: Are there any other bargains you can tell us about today?

Van Den Berg: There are two other companies that I think you might find very interesting.

OID: To hell with interesting. Are they 50¢ dollars and compelling bargains?

Van Den Berg: Yes on both counts. We think that they're *definitely* buys today.

OID: Then fire away.

Van Den Berg: The first one I'd like to tell you about is a competitor of Home Depot.

OID: I didn't realize you also did shorts.

Van Den Berg: We don't. And this one *isn't* a short. And I'll explain why in a moment. However, I know you'll be pleased to hear that we've bought this one a lot higher and that we've been wrong about it for a long time.

OID: Absolutely. Those are our favorites.

Van Den Berg: I'm glad that they're *your* favorites. They're certainly not *mine*. Wolohan Lumber [WLHN/Nasdaq] has a chain of 64 lumber and building supply stores in Michigan, Ohio, Illinois, Indiana and a handful of other states in the Midwest. Their primary market is in building materials, kitchens, decks, bathrooms and so forth for the professional builder, contractor, remodeler and the serious do-it-yourselfer.

And they compete not only with Home Depot, but also with Lowes. When Home Depot came into their markets — just like Wal-Mart does to everybody they compete with — they really shook Wolohan up. With the entry of Home Depot and Lowes, it really put pressure on their margins.

OID: I imagine so.

Van Den Berg: So margins and earnings declined. But they never *lost* money. They're a very good management. They took a step back, took a critical look at their business and said, "We have to surrender the low margin business to Home Depot. That's clear. There's no point in even *trying* to beat these people at that game. We'll focus on providing value-added service to our customer."

OID: Meaning?

Van Den Berg: For example, you can go in their store if you want to build a deck on your house. And instead of figuring out how many pieces of wood you need, they put you on a computer and show you a model. Then the computer tells you exactly how many two-by-fours and how many nails or whatever goes into it. And they sell you a kit with a printout of how to put it together — like an erector set. So you don't waste any money by buying too much wood or too many nails, etc.

OID: Value Line seems to think Wolohan's strategy is sound, too. But isn't everyone from Home Depot to Ikea doing those things, too?

Van Den Berg: Not to the degree that Wolohan is. Also, Wolohan is specializing more in their markets — customizing their offerings — while others are providing products more for the mass market. So Wolohan can sell their value-added service at a premium relative to just selling the lumber and nails.

And they're starting to see results. They earned 50¢ last quarter — up from 22¢ in the corresponding quarter last year. And their same store sales were up 6% in the last three months — which is their first quarterly increase in same store sales in the last couple of years. Sales grew to $132 million in the quarter ended September 1996 from $122 million in the quarter ended September 1995.

OID: May we ask what you've paid for this one?

Van Den Berg: We started buying Wolohan in 1993 at $16. But we averaged down since. And, today, we have a very good average price — between $10-1/2 and $11.

So it's water under the bridge now. However, with Wolohan at $12-1/2 today, it's hardly been anything to write home about. But clearly, we think it's worth much more than $12-1/2. And, obviously, before things started falling apart for them, we thought it was worth even *more*. In fact, we're a buyer of Wolohan today.

ACCORDING TO THE ULTIMATE VALIDATION,
WOLOHAN IS A DOLLAR BILL FOR 45¢ OR LESS.

OID: Why?

Van Den Berg: As you know, we spend a lot of time talking about P/E multiples and private market value and trying to keep track of acquisitions. Well, here's the *ultimate* validation: Sears completed its purchase of publicly-held Orchard Supply on September 25, 1996.

Here's what Sears paid for it by six different valuation yardsticks: 47% of sales, 11.15 times cash flow, 22.58 times earnings, 2.44 times book and 6.23 times EBITDA. And, last, but not least, we looked at it in terms of

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG
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price-and-debt-to-sales — in other words, enterprise value plus debt divided by sales. And, by that measure, Sears paid 71% of sales.

Perhaps, you recall me mentioning earlier that acquisitions tend to sell at 22-24 times earnings in markets similar to today's.

OID: I do.

Van Den Berg: Notice that Orchard was acquired for 22.58 times earnings.

OID: Interesting.

Van Den Berg: Isn't it?

OID: Especially for what sounds like a so-so business at best — based on its industry, margins and returns. I gather that it was only earning a net margin of 2%± and an ROE of 11% or 12%.

Van Den Berg: That's right. So maybe my multiples *aren't* so fanciful — at least in today's environment.

Now, without getting into the argument of whether Orchard Supply is a better business than Wolohan or vice versa — and, believe me, it's easy to see that Wolohan is at *least* as good, if not *better*, than Orchard Supply — let's just apply those same multiples to Wolohan.

OID: Fire away.

Van Den Berg: Wolohan has $59.29 per share of sales for 1996. So 47% of sales would be $27.87. Next, a multiple of 11.15 times on Wolohan's $2.21 of cash flow would be $24.64. And 22.58 times Wolohan's earnings of 90¢ per share is equal to $20.32.

OID: Is that 90¢ of earnings for this year or next?

Van Den Berg: I'm using 1996 earnings — which were 90¢, despite the fact that we're actually projecting $1.30 for 1997.

OID: However, I see that the consensus estimate is only $1.10 — although only two analysts even bother to make estimates.

Van Den Berg: Then use $1.10. Again, we're only using 90¢.

OID: In effect, you see a relatively rosy future, but you're not counting on it.

Van Den Berg: You've got it. And continuing to input Wolohan's figures into the benchmarks from the Orchard sale, we get the following valuation: a multiple of 2.44 on Wolohan's $15.44 book value would be $37.67. Price-and-debt-to-sales of 71% would come to $38.49. And a multiple of 6.23 times Wolohan's EBITDA of $3.32 would give it a value of $20.68.

If you add 'em all up and average 'em, you get $28. And Wolohan is selling for about $12.50 today.

OID: That sounds like a bargain, all right — at least based on those measures.

Van Den Berg: It certainly looks that way to us. And, again, we aren't even using *next* year's figures for cash flow or earnings — which we believe will be $2.60 per share and $1.30 per share, respectively. Using those figures would raise our valuations by those measures from $24.64 to $28.99 and from $20.57 to $29.71, respectively.

OID: And, actually, bring them more into line with the valuations implied by your other measures.

Van Den Berg: Exactly.

OID: Which suggests that Wolohan's 1996 earnings may still be depressed as a result of the competitive pressures you described — whether you're right that their cash flow and earnings rebound in 1997 or not.

Van Den Berg: Again, that's the way it looks to us. However, I'm only pointing it out to you so you know that we're using low end normalized earnings and sales figures — because if you're using peak earnings, you're obviously going to get distorted results.

OID: While we normally encourage that type of thing, it looks like it won't be necessary here.

AND WOLOHAN'S ONLY ON THE *ROAD* TO RECOVERY.
WHEN IT'S IN FULL BLOOM, ITS *VALUE* WILL BE, TOO.

OID: Do you think your 1997 estimates represent Wolohan's normalized earning power?

Van Den Berg: We don't. In fact, we believe that we're very much at the *low* end. We believe Wolohan has normalized earning power of $2.00 per share.

OID: Which doesn't sound like that much of a stretch since it would only require net profit margins of 3%±.

Van Den Berg: Exactly.

OID: And it really does have huge sales per share — what looks like nearly $60 per share in 1996.

Van Den Berg: Absolutely. And we're estimating sales of $63.40 for next year.

I'm not assuming the past is a prologue. However, this company has earned a net profit margin of 4%. So I think a 2-1/2% net margin would be *very* conservative. And if you assume $64 per share of sales and a net profit margin of 2-1/2%, there's $1.60 of earnings.

OID: And the resulting valuation wouldn't be so out of line with the valuation you get using Orchard's multiple to book and its sales to enterprise value — which, after all, are the only measures you included that look past ebbs and flows in profitability and, in the case of the latter, different levels of debt.

Van Den Berg: That's exactly right. Wolohan is near the low end of its cycle. So we wanted to give them a fair private market value in light of this environment and the stage of the cycle they're in. It's not the worst part of the cycle for them. They're sort of on the road to recovery.

However, two or three years from now, we believe that Wolohan's recovery will be in full bloom. And, therefore, you could easily make a case for a much *higher* valuation.

OID: You sure know how to tease a guy...

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG
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Van Den Berg: In fact, looking out four years, we think Wolohan's private market value could be up to $44. And that's just growing these numbers out 6.5% using the same multiples.

And if we do that and then discount that future value back to the present using a 10% rate, that $44 would have a discounted present value of $29.92.

OID: Remarkably close to the estimates you'd arrive at for Wolohan's value today using 1997 estimates.

Van Den Berg: That's right.

OID: All of that — on the surface, at least — would seem to present a very persuasive case valuation-wise.

Van Den Berg: We think so. We really do.

OID: But that's if, and only if, Wolohan is, in fact, comparable to Orchard Supply.

Van Den Berg: Actually, I think it's better, although that's debatable. However, it's certainly comparable.

OID: And you have to like the fact that insiders own more than 20%.

Van Den Berg: Absolutely. Wolohan is a sort of Midwestern family-type of business.

But forget about Orchard. Let's just talk about their *absolute* value. With more than $60 per share in sales, Wolohan's current stock price is less than 20% of sales. And that's not bad at all for a company that until recently, anyway, earned 3-4% net profit margins.

OID: So that if they ever were able to achieve their historic margins, the current price would have been only 5 to 7 times normalized earnings.

Van Den Berg: Exactly. But, again, even if margins turn out to be *2-1/2%*, that would imply earnings of $1.60. If so, today's price would still be below 8 times earnings. Plus, Wolohan's book value is $15.44 per share. So it's also selling at a 17% discount to book.

And, in the past, it's gotten a peak market valuation of 50% of sales, 2-3 times book and 15+ times earnings.

MEDIOCRE MARGINS & GROWTH WOULD BE JUST FINE,
BUT BACK TO THE PAST WOULD BE EVEN BETTER.

Van Den Berg: I'm not fond of buying companies with little or no free cash flow. But this one's being priced as if people don't expect growth of more than 3-4% per year.

OID: Of course, maybe that's being optimistic. One of our contributors says that they make a practice of shorting unfortunates who are in the way of Wal-Mart.

Van Den Berg: I don't doubt it.

OID: And another suggests that closing your stores may be the most sensible competitive response.

Van Den Berg: That may very well be so for many stores. But we don't believe that's the case with Wolohan.

This is a wonderful little company. It's just good people who work hard, do a good job, think things through and who don't do a lot of silly things like some of these other retailers do.

OID: But what makes you think that Home Depot's highly efficient distribution system won't ultimately overwhelm them — however hard-working and otherwise virtuous they may be?

Van Den Berg: I think that's a very fair question — and one that we've definitely been concerned about. The answer lies in how they responded to the challenge. Plus, we don't think that Home Depot is necessarily interested in meeting them in the trenches for two reasons:

First, Wolohan's is serving a very specialized market. Second, Home Depot is set up to do everything nationwide. We don't think Home Depot is going to revamp their stores very much nationwide just to try to beat these 64 stores.

OID: Wolohan's differs in its merchandise mix?

Van Den Berg: Yes. And if Home Depot wanted to compete with them, it would have to become more of a specialized service with specialized stocking, etc. in that region. I think Home Depot has the standard merchandise *everybody* wants.

OID: McHome Improvements.

Van Den Berg: That's right. They vary it a little. But I don't think they're going to revamp their entire approach just to meet the needs of these specialized markets.

OID: How is Wolohan's merchandise different?

Van Den Berg: About 60% of Wolohan's sales are to the professional builder, contractor, remodeler and about 40% are to the serious do-it-yourselfer consumer. A lot of the sales to the professional are value-added services that the competition doesn't provide. Home Depot and the others concentrate on the mass consumer market.

OID: Of course, if they ever did target 'em, might it be a case of it's been nice knowing you, Wolohan's?

Van Den Berg: Yes. But, then, Home Depot would have the increased costs and all of the problems Wolohan is addressing — because they're already providing what amounts to consulting, computer and add-on services that Home Depot — for the time being, at least — hasn't even *begun* to address.

Of course, anything's possible. The question is how much Home Depot would derive from a significant effort and the distraction of revamping their stores in this region.

OID: And I gather the answer is not much.

Van Den Berg: Not enough to make a difference in their sales. Wolohan has only $450 million in sales in *all*.

OID: So it's not worth their distraction.

Van Den Berg: I just can't see Home Depot wanting to meet Wolohan in the marketplace. But I'm not saying they won't. That's *always* a risk in *any* business.

OID: Unless, of course, you're the 900-pound gorilla — or the 900-pound gorilla-killer.

Van Den Berg: Wolohan's been very articulate in

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CENTURY MANAGEMENT'S
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their annual reports and in their communications with shareholders generally. They've set their strategy. They're executing it. Their sales and earnings have started to improve. And, again, a 2-1/2% margin would provide a pretty good return to shareholders — not to mention if they really got going and managed to get it back up to 3-4%.

OID: Why do I find that so hard to imagine?

Van Den Berg: Again, whether it's hard for you to imagine or not, they just reported 6% same store sales growth. And they're planning on increasing sales by *5%* per year by adding new stores. So their projections of their sales growth in the next few years is closer to *10%*.

OID: On the other hand, Robert Noel says you have to be an optimist to be a retailer in the first place.

Van Den Berg: I don't think you need 10% growth to justify the current stock price. In fact, frankly, even if we don't get much more than today's earnings, you could make a case for it having a private market value of $29 or more and a peak market valuation of $24+.

OID: And, according to Value Line, they've actually had double-digit growth in sales, cash flow, earnings, dividends and book value per share for the past decade — despite falling on hard times in the last year or two.

NOT ONLY HAS WOLOHAN *SURVIVED* THE ONSLAUGHT, THEY'VE USED IT TO MAKE THEMSELVES *BETTER*.

OID: Also, it looks like they increased sales per share and book value per share by 7.6% and 8% per year, respectively, for the last five years — which I gather weren't exactly salad days...

Van Den Berg: It hasn't exactly been a picnic. No.

OID: And I see that they achieved that growth despite paying out 20%+ of their earnings as dividends.

Van Den Berg: I think Wolohan is a classic example of a company that's been through the wringer, faced an onslaught of competition, but that's nonetheless been able to survive, avoid losing money, revamp its strategy and make a comeback.

When Philip Fisher was recently interviewed, he was asked what he would change in his book — if anything. And he commented that while he'd put a great deal of emphasis on management, he didn't emphasize it *enough*!

The more I study companies who survive tough times while many of their competitors fall by the wayside, the more I appreciate what a good management can do during bad times. It makes a difference — a *big, big* difference.

And if they survive really well during *bad* times and they do all the right things *then*, you can imagine what's going to happen when they get a *good* market.

OID: Which is exactly what happened following Wolohan's distress from 1980 to 1984. In those years, its average return on beginning of year equity was only 3.7%. But its ROE rebounded thereafter and actually averaged more than 20% from 1986 to 1990.

Van Den Berg: That's the way it works.

OID: Again, to the survivors go the spoils.

Van Den Berg: Exactly.

OID: But even if the industry does rebound, does the growing presence of Home Depot, Lowes, etc. suggest that what's in store for Wolohan is simply worse and worse margins and returns?

Van Den Berg: In the case of Wolohan, you're looking at a really good management in unbelievably bad times. It's like looking at a money manager during a bear market.

OID: Bear market? What's that?

Van Den Berg: Exactly. But a bear market has a way of shaking things out a bit. And if someone does a great job under those conditions, then it tells you something.

If a manager underperforms under those conditions, it doesn't mean they're not doing a good job. But it does tell you what the companies they bought are made of. Although the long term is what's important, it's how they do in *bad* times that ultimately *determines* the long run.

OID: Seeing how they deal with adversity.

Van Den Berg: The thing that impresses me about Wolohan is that not only have they been able to withstand the onslaught, but they've actually also developed some positive programs and used the time to hone their business and make themselves leaner, meaner and better.

They're not real flashy. But they just seem to consistently kind of grind things out.

OID: Three yards and a cloud of dust.

Van Den Berg: That's what they've always done. When all is said and done, they've just made it *happen*. And we believe that they will going forward, too.

MATRIX'S BUSINESS HAS STARTED TO PICK UP. BUT YOU CAN STILL BUY IT AT 90% OFF ITS PEAK.

Van Den Berg: Would you like another bargain?

OID: Is the Pope Polish?

Van Den Berg: You may notice how many of the things we're talking about are in bombed-out industries — like lumber, do-it-yourself contracting and portrait studios.

Well, the next bargain is an oil service company — Matrix Service [MTRX/Nasdaq].

OID: Oil service is bombed out?

Van Den Berg: Matrix is a little different than what you might normally think of when you think of oil service. They service the large storage tanks used in refineries. They build, repair and do maintenance on those tanks. They also service municipal water companies and the storage tanks used in the agriculture and fertilizer areas. But their main business is refinery-related and comes from the major integrated oil companies.

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG
(cont'd from preceding page)

OID: Which explains your earlier reference to investing in bombed-out industries. And I see that Matrix's stock price certainly looks bombed out.

Van Den Berg: Matrix is an excellent example of what Ben Graham said about owning a stock being similar to being in business with a manic-depressive partner. During the mania stage, this thing sold at $30 — which was actually *3* times sales and 5 times book value. Now, during the depressed stage, it's at *30%* of sales and only about 75% of book value. And, actually, we think today's sales are *depressed*.

OID: Very interesting.

Van Den Berg: Let me explain why. Up until a year or two ago, it was terrible times in the refining industry. From 1981 to 1994, refining capacity dropped from a peak of about 18.6 million barrels per day to approximately 15 million barrels. And during that time, utilization dropped from about 85% in 1981 to a low of about 70% in 1983 primarily due to a combination of reduced demand for petroleum products and declining prices.

Utilization is up to 95% today, but they're still not coining money. However, as utilization gets up near 100%, they *will* be able to increase prices.

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

Van Den Berg: And during the lean times, refineries defer their capital expenditures and their maintenance. So as these refineries make more money, they're going to be spending more in those areas. And because environmental restrictions are going to make it very difficult and very expensive to build new refineries, two things are going to happen which benefit Matrix. First, old refineries are going to stay profitable — which means they'll continue to spend more. Second, it's going to put a premium on refurbishing existing refineries.

OID: That sounds very logical.

Van Den Berg: Also, the above ground storage tank (AST) business seems to have about a seven year cycle. After the tanks are built, they need to be serviced for maintenance, have environmental inspections, and have a certain amount of repair work to keep them serviceable.

(continued in next column)

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OID: Gotcha.

Van Den Berg: And we know that the margins in Matrix get as low as 1-2% and as high as 7% or 7-1/2% due to the fact that when they're working near capacity, their margins just naturally go up.

OID: And is it happening yet?

Van Den Berg: That's just beginning to happen. Plus, increased utilization is also causing a greater need for repair and maintenance. A good example of that phenomenon was two refineries that recently had to be temporarily shut down — Tosco's Bayway refinery because of a small fire and Exxon's Baton Rouge refinery after a leak was detected.

And I think we're going to see more of this occurring as the refinery industry catches up on deferred maintenance. And while that's not good news for gasoline prices, it represents future business for companies like Matrix.

OID: And the implications for Matrix?

Van Den Berg: We expect Matrix to have sales of $230 million by 1999-2000 and a net profit margin of *at least* 6.0% to 6-1/2% — which would imply $1.50 of earnings per share. In fact, when industry conditions are right, we think they can earn between $1.50 and $2.00. And bear in mind that this is a $6 stock.

OID: Today, it's at $6. But my Extended Value Line shows Matrix's stock as high as $30± in 1991 and as low as $3 earlier this year.

Van Den Berg: That's right.

OID: And, as you suggest, their after-tax margins at that time peaked at 7.5%. But then they lost money in 1995, albeit only 2¢ per share.

Van Den Berg: You've got it. And I'm not suggesting that you put a big multiple on that $1.50 to $2 of earnings. But it shows you just how leveraged their earnings can be.

IT MAY NOT ALWAYS *PAY* TO BE FLEXIBLE,
BUT IT CERTAINLY DOESN'T COST *AS MUCH*.

Van Den Berg: Plus, in addition to selling at ridiculously low multiples of sales and peak earnings, Matrix's free cash flow is very high relative to earnings. They probably need to spend less than 3% of their sales on capital expenditures vs. 5-6% for the average company.

OID: Because it's a service business.

Van Den Berg: That's right. They can probably get by with only 50¢ to 70¢ per share of capital expenditures and earn $1.50 to $2.00.

OID: And it doesn't look like Matrix is wasting away. According to our Extended Value Line, sales per share have increased by more than 50% since they reported peak earnings in 1992.

Van Den Berg: That's right. What they've been doing is buying out the moms and pops of their industry.

OID: But how are they paying for them? I don't see

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CENTURY MANAGEMENT'S
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any increase in their shares outstanding. And it looks like their long-term debt is only up $2 or $3 million in the last five years.

Van Den Berg: Mostly, they've paid for them using their free cash flow.

OID: Do those acquisitions inflate their book value — assuming they pay a premium to book, of course? And does the resulting goodwill amortization cause them to have understated earnings?

Van Den Berg: They only have about $27 million of goodwill. But they don't have much goodwill amortization.

Incidentally, this is a pretty creative management. And they're doing a number of pretty interesting things. During one conference call, Jim Brilliant, our analyst who follows this company, asked them, "What happens when you have to lay off people?"

We always try to know what it costs to lay off people.

OID: Because, as Charlie Munger points out, it's one of those hidden contingent liabilities that tend to be activated whenever revenues and earnings start to move in the wrong direction.

Van Den Berg: Exactly. And, in our experience, that cost often runs around $20,000 once you figure in all of the associated expenses such as pension costs, retirement costs, etc. And I understand that in Europe, it's as much as *$30,000.*

OID: I thought it was even higher...

Van Den Berg: It *can* be. So when we asked the Matrix executive that question, he said, "All it costs is a phone call. These people are contractors. We take 'em to the job. We have our crews. And we have the people who are the supervisors who are trained people. But you don't need very high-skilled people to do the filling in. So, when business declines, if you have to lay 'em off, you don't have to do too much more than tell 'em."

"Therefore," he said, "there's very little cost involved. And that allows us to manage and navigate the business when it goes through these cycles."

OID: Without incurring huge losses during the contractions.

Van Den Berg: Exactly. That's the way they handle the cyclicality. But to show you how smart these guys are, they also make a point of trying to be adequately staffed in the high-skill positions to be able to handle their growth. So we're pleased to have these guys running this company.

OID: I see in Matrix's proxy that their chairman left the company in November of 1992, when they were still doing very well, and rejoined them in September of 1994. What's that about?

Van Den Berg: Actually, Doyle West resigned as CEO and stayed on as chairman. And they hired a guy from Enron to take over as CEO. But he didn't run the business as well as they thought he could. He built up a backlog of unprofitable business — which, incidentally, isn't an uncommon problem for newcomers in that industry. So West came back.

OID: How much of their downturn do you think was industry-related and how much a function of the manager who they replaced?

Van Den Berg: That's really impossible to know. However, bidding on bad business in bad times always makes a bad situation worse. In fact, it can make a *good* situation *bad.*

I will say this: In 1995, in the worst year of this downturn and the worst year since they went public in 1990, they reported a 2¢ loss. And even given how bad it got, I don't think that they'd have lost money if they hadn't taken on that backlog of unprofitable business. And they wouldn't have taken it on if their CEO would have had experience bidding on repair and maintenance business.

AN INNOVATION IN REFINERY SERVICE CONTRACTS.
LONG-TERM CONTRACTS ARE A WIN/WIN SITUATION.

Van Den Berg: The latest thing that I think is significant is that Matrix just signed a $15 million deal with Chevron — which is a little less than 10% of their sales — that they believe is the prototype for a new way of doing business.

What they're doing is coming up to these companies and saying, "What kind of work do you need in the future?" And the companies tell 'em what they think they'll need.

And Matrix says, "Why don't we hammer out a price that's fair for both of us and agree that if we give you a decent price, you'll give us a long-term contract to do that business. If you do, we won't have to build in anything for the costs of marketing and bidding each job individually — which are quite significant, especially given that very often we go through the whole process and don't wind up with the business."

OID: Interesting.

Van Den Berg: So they tried that deal with Chevron. And they say that Chevron is pretty excited about it because they get a lower price and a reliable supplier. And Matrix is happy with it because it saves them time that they would otherwise have to spend on marketing and continually raising and lowering their service capacity. Plus, it allows them to plan their business a little better.

OID: So it's a win/win approach.

Van Den Berg: Exactly. In effect, they're trying to utilize a strategic partnership model, if you will, with their primary customers so they get long-term relationships and long-term contracts and even out the cycle a bit. Anyway, they anticipate doing *more* of it. They believe that it will represent 20% of their business within a couple of years. And they think that it could eventually represent 40% to 50% of their business.

They have a high renewal rate already — something around 85%. And this alliance strategy, if you will, should make it even higher.

OID: Very interesting. And you have to like the fact that there's so much insider ownership.

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CENTURY MANAGEMENT'S
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Van Den Berg: Yes. These guys have a *big* stake. The officers and directors own 14%. And they're kind of interesting guys. Doyle West and Bill Lee have been together since 1979. They worked for a company that did the same type of thing as Matrix. And that company was sold in January, 1984. So they left in March, 1984 to start their own company because they disagreed with the management. And they subsequently bought their former employer out of bankruptcy.

OID: Don't get mad. Get title.
Van Den Berg: That's what happened.

ACCORDING TO ONE INFORMED INDUSTRY VETERAN, TODAY'S STOCK PRICE IS UNBELIEVABLE (LITERALLY).

Van Den Berg: I'd like to tell you an interesting story — although I can't mention the person's name.

OID: If it's that kind of story, I don't know if...
Van Den Berg: A prospective client came to my office eight or nine months ago. I didn't know what business he was in. However, as he's sitting in my office looking across the stack of annual reports piled up on my desk, he just happens to notice Matrix's annual report. So he asks me, "Do you follow this company?" I say, "As a matter of fact, we do. And we're *buying* it."

He says, "Really? What's it trading for these days?" And, at that time, I think it was $5-1/2 or $6. So I say, "It's around $6." And he says, "*Nahh!*"

So I say, "Do you mind me asking why you find that so hard to believe?"

And he says, "I don't know if you know who I am. But I manage a company in this business." And he tells me the name of the company and goes on to say, "We do environmental work for these same storage tanks. So we follow these guys around all the time. And we know all about them. They're great people. They do a good job. And I'm just shocked that this stock is selling that *cheap.*"

So he said, "Can I borrow their annual report?"

I said, "Well, yeah. If you'd like, I can order you one. This one has soup stains, margin notes and so forth. So I'd like to give you a *clean* copy."

He says, "No, no! I'd really like to take this one home and read it tonight."

So I asked him, "I guess so. But *why*?" And he said, "Oh, my *God.* If this thing is really selling at $6, then I have to see if something's *changed* in this company — because if it hasn't, I want to *buy* some."

OID: Well, it looks like either he didn't or that he doesn't buy in the same mammoth volumes as Buffett and I do — because it's still at the same price.
Van Den Berg: I'm not even sure he bought it. But he was absolutely *shocked.* He said, "I know these guys. I know people on the board. They're all good quality people. And if nothing's changed, then I just think that it's a *tremendous* value."

So, anyway, he was *so* excited about this thing that he couldn't even wait to get the annual report. I mean I thought it was a great value, but I wasn't *that* excited. I could have *waited* a few days for the annual report.

But he validated what we felt — which was that the people were good people and that they do good work.

Then, when he recovered, he said, "Well, if I look at what the price of *my* stock has done in the same period, maybe I *shouldn't* be so surprised."

OID: Which, I suppose, argues that maybe you should take a look at the entire industry.
Van Den Berg: Yes. He said, "Definitely, it's a cycle. And that's just the stage of the cycle we're in right now."

OID: If there was any additional dialogue, perhaps you might consider saving it for our next edition.
Van Den Berg: So I think this is an interesting idea — particularly if you believe that refineries are going to make more money, etc. However, given the current price, you're getting all that upside potential with very little risk — because I think the serious earnings are *ahead* of them. In other words, I don't think we're paying up for that. Actually, I don't think we're paying for *any* of it.

WE'RE NOT *TRYING* TO BUY SMALL CAPS.
WE'RE SIMPLY LOOKING FOR *VALUE.*

OID: And it's being priced that way only because we're in an earnings momentum market and because it has reported losses.
Van Den Berg: Yes. Of course, it has a very small market cap, too. So this one is perfect for your subscribers who believe that small caps outperform big caps.

OID: What's the market cap?
Van Den Berg: I think it's only about $55 million — $6 times 9.3 million shares. So it's a micro-cap.

OID: Isn't that actually still higher than Moore?
Van Den Berg: No. Moore is selling at $19 per share and has about 2.6 million shares.... Actually, you're *right.* Moore *is* lower. I guess that's why people keep referring to us as a small cap manager.

OID: And I thought it was because you printed the name on your brochure in little capital letters...
Van Den Berg: I'm glad we could clear *that* one up. However, we really don't *think* in terms of market cap. When we see businesses like Matrix or Moore selling at the ridiculous multiples they're selling at — with their potential — then I just naturally gravitate to their value.

OID: Yeah. They make my glasses fog up, too.
Van Den Berg: I don't really worry — or even think too much — about the fact that it's a smaller cap situation. I realize that most other money managers don't deal in this kind of company. But we like them just fine.

OID: I can certainly see why.
But what could turn Matrix into a mistake?
Van Den Berg: Here's the good news about Matrix.

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CENTURY MANAGEMENT'S
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If industry conditions continue as bad as they have been...

OID: And it's probably more likely that they're at the beginning of a long up cycle — if there's any justice...

Van Den Berg: Right. But one of the positives about this company is that they have the flexibility to cut back.

WE BELIEVE MATRIX IS WORTH $15 TODAY.
AND, APPARENTLY, THIS MANAGEMENT AGREES.

Van Den Berg: Would you like to know our estimate of Matrix's private market value?

OID: Is this your way of saying that Matrix isn't going to tank?

Van Den Berg: We have Matrix's private market value at $15. And we believe that's a *very* conservative estimate.

OID: One of the finer virtues — at least for a $6 stock.

Van Den Berg: Exactly. But let me quickly tell you how we came up with our estimate. We try to do a real thorough job.

OID: I'd love to hear how you arrived at your $15. But, frankly, if you're right about this business and its management, these numbers speak for themselves.

Van Den Berg: I actually agree with you. And so do sophisticated buyers and sellers in private transactions. For example, we estimate that comparable sales sold at the following multiples: 15 times earnings, 2 times book, 95% of sales, 9 times cash flow and 6-1/2 times EBITDA. And those figures, incidentally, are using our estimates of normalized earnings.

OID: So?

Van Den Berg: Matrix has about $184 million of sales. And they have about 9.6 million shares outstanding. So that's about $19.18 per share of sales.

And we'd expect them to average a net profit margin of just over 5%. If so, that would imply normalized earnings of something around $1. And, therefore, a P/E multiple of 15 would suggest a valuation of about $15.

OID: Gotcha. And, then, 2 times their $7.50± book would come to $15 and 95% of their $19.18 per share of sales would suggest $18.22.

Van Den Berg: That's right. And 9 times cash flow and 6-1/2 times EBITDA would suggest valuations of $16 and $14, respectively. So, as you can see, all of those seem to come in around $15.

And, then, we also project our companies' earnings and free cash flow out five years and then discount them back to a present value. So when we place a value on the company when the industry is very depressed — and then project it out five years when we see things getting better — we have a basis of comparing our evaluations.

OID: In effect, allowing you to refine your estimate...

Van Den Berg: That's right. And let me tell you what the company said. As you know, we try to do a thorough analysis using four or five different approaches. And then we call up company and we tell 'em, "We're shareholders. We're friendly. And we're on your team. We don't have adversarial relationships with any of our companies.

If we do disagree, we generally just pick up the phone and sell our shares rather than write you nasty letters, argue with you, or try to suggest that we know how to run your business."

But we tell them, "We do try to get an understanding of your company. So if there's anything you could share with us with regards to peculiarities in the business and things you think we should know and anything you can teach us, we'd sure appreciate it."

Then we tell them: "Using our own basic approach, we've tried to come up with your private market value — the price at which your company would change hands in a transaction between knowledgeable, sophisticated parties.

And you don't have to comment if you don't want to. But here's the number we've come up with. Could you give us any guidance?"

OID: And that's when you begin to make small talk about golden parachutes and such...

Van Den Berg: Not yet. And a lot of people say, "Well, we don't think about our business in those terms." Other people say, "You might want to look at this company. It's like ours. And it was recently sold." And still others say, "You're high." or "You're low."

When we asked this company what they thought of our $15 number, their comment was that they would not disagree with it — and felt that it was about right.

So we think $15 is a conservative estimate with — for whatever it might be worth — the validation of management.

OID: And you think it's conservative because...

Van Den Berg: For several reasons, actually. However, if for no other reason, we think it's conservative because the industry is itself depressed.

OID: And Matrix's sales along with it.

Van Den Berg: Exactly. Plus, we're not giving them a premium for the kind of management that they have — which is excellent and definitely above the average of the companies that we used as comparable sales. And one of the proofs of how good they are is how quickly they recognized their mistake and replaced their new CEO. Also, the fact that they only lost 2¢ in the worst year of a bad cycle despite being handicapped with a zero margin backlog also tells you how good this management is.

Incidentally, the gentleman I told you about who came into my office also mentioned that these guys have a reputation for being dependable and delivering.

OID: Another fascinating idea.

Van Den Berg: And another $1 bill selling for 50¢.

INVESTORS TODAY ARE FOCUSED ON THE SKY.
THEREFORE, WHAT'S UNDERVALUED IS *DIRT*.

OID: We try not to think about "the market". But,

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CENTURY MANAGEMENT'S
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frankly, some of your statistics are a little scary.

Van Den Berg: Acquisition multiples are one of your best guides as to whether a market is overvalued. As I mentioned before, we're in a peak year valuation-wise — similar to 1968, 1972 and 1987. When average companies growing 6% to 7% per year are being acquired at 22-24 times earnings — that's about as good as it gets. And that's where we are today.

OID: And with companies also currently earning higher returns on equity...

Van Den Berg: They're above the norm, too. They're also at peak *margins*.

OID: The fact that we seem to be at peak margins and peak multiples is not exactly comforting, is it?

Van Den Berg: At the least, it suggests that there's not a lot of room left on the upside — maybe 5-10%. Whenever the S&P 400 gets above 1.10 times sales, then that's stretching it.

OID: What's the longest period that the market has ever stayed overvalued?

Van Den Berg: No more than two or three years — not much longer. That's what it did from 1967 to 1969.

OID: When things get expensive, do you hedge? And are you hedged today?

Van Den Berg: The companies we buy, their managements and the prices we pay are our best hedge. However, by the nature of our investment discipline, we tend to wind up with more cash near peak valuation levels simply because we can find fewer good ideas.

Actually, we're in the process of looking into hedging today — for the first time in my career. However, we don't want to hedge until valuations reach the apex. And, based on historical multiples, stocks could rise 5-10% from here. And, if you hedge with puts and you're wrong, you can lose 100% of your money.

OID: So you'd like the market to go higher...

Van Den Berg: I *always* like the market to go higher. But in accounts that are concerned about it, we put some of their money in Robertson Stephens Contrarian Fund — which has puts, short sales and other hedge instruments including gold stocks — plus a couple of other funds with a similar strategy.

And we bought some South African gold stocks when power was about to be transferred to Mr. Mandela when they were selling at $35 per ounce of gold in the ground. But those have gone up some — to $80 or $90 per ounce. Therefore, we're looking at gold stocks elsewhere.

OID: So you've looked at gold stocks.

Van Den Berg: North American gold stocks are starting to get interesting. We're doing our work on them now. But they're not quite cheap enough for us to buy.

OID: How good a hedge have gold stocks been? Their stock prices appear to have sometimes run counter to those of other stocks. But more often, it looks like they've gone the same way.

Van Den Berg: Currently, the market cap of every North American gold stock combined only totals around $20 billion. By comparison, the U.S. equity market is currently about $7 *trillion*. And we're currently only about one third of the world equity market. So the number of potential dollars that may want to purchase gold stocks could put a bit of upward pressure on their bid prices.

And I'll tell you what will move the demand for gold and gold stocks — and that's inflation and uncertainty. The vast majority of shareholders in mutual funds today came in after the 1990 low.

OID: Really?

Van Den Berg: According to the statistics, 60-65% of the money in mutual funds today came in after the low in 1990 — which means that many mutual fund shareholders have never gone through a bear market.

When someone starts skydiving, their first concern is always whether their parachute will work. But after it works enough times, they become more concerned with the thrill of the drop than they are with their parachute.

First-time parachutists don't have many accidents. They have accidents after they do it enough to get careless. That's just human nature.

And that's the way it is in the stock market today. We're in one of those zones where people are more focused on the upside than the downside — like a skydiver who's more focused on the thrill of the jump and the breathtaking beauty of the clouds above rather than the dirt below.

OID: So one of the things that's undervalued today is parachutes.

Van Den Berg: No, dirt. We just got a new client who wasn't happy with his previous portfolio manager because his stocks weren't moving up fast enough. We told him: "In this environment, it's hard to find a lot of great values. We're finding 'em. But it's not that easy."

He said, "That's what my other money manager said."

What he's really saying is, "Isn't somebody going to tell me what I want to hear?"

OID: And, as you told that client, some of the ones you told us about do indeed sound like great values. Thanks, again, for sharing them with us.

Van Den Berg: My pleasure.

—OID

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ARNOLD VAN DEN BERG, CENTURY MANAGEMENT

"We're in one of those zones where people are more focused on the upside than the downside — like a skydiver who's more focused on the thrill of the jump and the breathtaking beauty of the clouds above rather than the dirt below."

Conversation with *OID* — December 1996

Dear Subscriber,

As we look back at *OID*'s 1996 features, despite a clunker of an idea here and there, we're very pleasantly surprised (shocked may be more accurate) at how well so many of our contributors' ideas have done again this year — even within the context of *this* manic market.

However, after struggling as long and hard as we did to fill this edition with compelling ideas, we conclude that not only is this market unlikely to provide returns similar to those achieved recently looking forward 12-24 months, but that neither are very many of our contributors — either in our pages or in their portfolios.

As more than one of our contributors has observed, their future returns have tended to be inversely correlated to their popularity at cocktail parties and the interest of everyday people — taxi drivers, etc. — in their profession.

We spotlight and celebrate the accomplishments of our contributors and believe they *should* be spotlighted. However, when mainstream financial publications and general interest talk shows agree, we suspect the party's not only gotten out of *hand*, but that it's nearly *over*. And, if so, the hangover probably isn't too far away either.

Corroborating that conclusion: Whenever and wherever graduating MBAs have congregated, busts have generally followed. And if the sound bites we've heard — of business school graduates rationalizing six-figure starting salaries and five-digit signing bonuses as their birthrights because, "after all, we are comparable to sports superstars and deserve to be paid similarly" — even *remotely* resemble reality, (we're not making this stuff up), then the bust moving toward Wall Street could be a *doozy*.

For all of these reasons and more, one of the most undervalued assets in the world today may be the appreciation of risk — be it regarding interest rates, inflation, a bear market, higher oil prices or geopolitics.

And, as more than one wise contributor's observed, the things that people *worry* about almost *never* happen. It's the things they *don't* worry about that *clobber* 'em.

If that's true, (and we believe it is), then one of the biggest risks today may very well be geopolitical risk. Today, the least imaginable — and, therefore, most likely — event may be a geopolitical crisis that strikes fear into the hearts of investors and others worldwide.

If we're right, (and there's a first time for everything, we hope), the best protection may well be (although we still can't believe we're saying it) precious metals or securities that derive their value therefrom. Unlike your editor, someone who *understands* the area — Robertson Stephens' Paul Stephens — seems to concur. Says Stephens, "We believe the next major secular bull market move over the next three to four years is going to be in natural resources and commodity-based securities."

On that cheery note, we're very pleased to tell you that our contributors have (somehow) pulled a few bargains out of their hats yet again. Incredibly, we believe this edition's assortment is right up there with any we've brought you. Our thanks (and yours, we believe, should) go to:

•Franklin Mutual Series' Ray Garea, Larry Sondike and David Winters for an assortment of appetizing ideas.

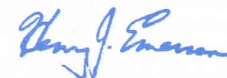
•Century Management's Arnold Van Den Berg for two or three particularly interesting ideas.

We hope you find some of them as intriguing as we do.

However, we also hope you'll structure your affairs, today and always, so you're prepared — as John Templeton recommends — financially and otherwise — for a period as financially painful as recent times have been rewarding. And, as Warren Buffett warns, you shouldn't own anything that you wouldn't be pleased to own were it to decline 50% — because one day, rest assured, it most certainly will.

Luck is on the side of the prepared.

Until next edition,



Your Editor

P.S. As you may know, our web site is actually up, albeit, (we hope) you ain't seen nuthin' yet. We plan to send you passwords to *OID* subscriber-only areas by the end of this month. Among the initial material that we expect online: excerpts from the latest Hoefer and Arnett Conference including several segments from companies featured in our past editions.

Thank you for your patience and your support.

Outstanding Investor Digest is published bimonthly (more or less) by Outstanding Investor Digest, Inc.
Outstanding Investor Digest, 14 East 4th Street, Suite 501, New York, New York 10012 Telephone: (212) 777-3330

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