

# Outstanding Investor Digest

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

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Volume XII Number 3

December 29, 1997

## OID MAILBAG:

THIRD AVENUE VALUE FUND'S MARTY WHITMAN  
"THE SAFEST, CHEAPEST EQUITIES IN THE WORLD —  
LIKE CLOSED-END FUNDS AT 50-80% OFF, ONLY BETTER."

When Third Avenue Value Fund's Marty Whitman says he's finding bargains, we pay close attention — especially when they involve financial stocks. So when he told us that he was buying some financials that were the equivalent of closed-end funds at 50-80% off, only *better*, and that he'd laid out the story in his latest letter, we figured it was time to share it with you. So without further ado...

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TEMPLETON FUNDS' MARK HOLOWESKO  
"WE'RE MORE A SELLER THAN A BUYER OF U.S. STOCKS.  
GIVEN MORE VALUE IN ASIA, WE'VE BEGUN TO BUY THERE."

Succeeding living legend John Templeton is similar to succeeding Mickey Mantle in center field for the Yankees — a hard act to follow at best. Mark Holowesko, however, continues to pull it off just fine. The trailing 10-year returns of Templeton Growth Fund, which he reportedly began managing in 1987, rank it among the top 1% of funds in its category at the same time its downside volatility has been below that of 85% of its peers. All the while, it's been the

(continued on page 3)

VALUEVEST MANAGEMENT'S  
MARK BAKAR AND JOHN BURBANK  
"LIQUIDATION UNDERWAY IN MORE THAN A FEW NATIONS —  
THE MOST EXTREME UNDERVALUATIONS I'VE EVER SEEN."

Because Mark Bakar founded ValueVest Management only about 2-1/2 years ago, his track record is quite brief by *OID* standards. However, during that short period, he piqued our interest with some unusually intriguing ideas.

Therefore, with some of his favorite hunting grounds, which include the emerging markets, recently savaged, (a casualty of the turmoil in Asia), we thought that it might be

(continued on page 8)

WESCO FINANCIAL'S CHARLIE MUNGER  
WORLDLY WISDOM REVISITED: LESSON #2  
"HOW DO YOU GET WORLDLY WISDOM?  
JUST TAKE THE BEST MODELS FROM ALL DISCIPLINES."

At Berkshire Hathaway's most recent annual meeting, Buffett noted, "Every investor in the world ought to read ... [Charlie Munger's 'Lesson on Elementary Worldly Wisdom'] before they invest. It's a classic."

We agree — in spades. Both we and more than a few of our most thoughtful contributors and subscribers refer to the principles and examples from his original lecture, (which appeared in our May 5th, 1995 edition,) again and again.

For all of those reasons and more, we're very pleased to

(continued on page 24)



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

OUR JAPANESE NON-LIFE INSURERS ARE AMONG  
THE SAFEST, CHEAPEST EQUITIES IN THE WORLD.

It's no wonder these things are bargains...

**Whitman:** [Two ways] bargains [have been] created in [the past] and likely will be created in the future [are by way of bear markets and industry-wide depressions]. In the case of our Japanese non-life insurers, it's a case of both.

The Japanese are in the midst of a severe bear market. Since 1990, the Nikkei's declined from 40,000± to 15,800. Also, Japan's capital short. Among financial institutions, commercial banks in particular seem to be inadequately capitalized. However, the common stocks of all publicly traded Japanese financial institutions have suffered large amounts of unrealized market depreciation — even the non-life insurance companies which appear to be the only financial institutions in Japan with tremendous amounts of surplus capital.

[Another way] bargains have been created historically in industry-wide depressions [where] the Fund has been able to acquire a number of securities of well-financed companies in those industries at prices which from a long-term point of view appear to be bargain prices even though their immediate outlooks were quite poor.... Among those have been our '97 acquisition of Japanese non-life insurance common stocks.

We bought some of the safest, cheapest equities in the world.

**Whitman:** I remain convinced that they're among the safest and cheapest equities available in the industrial world. Consequently, in the fourth quarter of fiscal 1997, TAVF created new positions or added to positions, in Chiyoda, Mitsui, Nissan, Sumitomo and Yasuda. At the end of fiscal 1997, they represented nearly 12% of our equity portfolio.

[These insurers] ... have very high quality assets and ... sell at huge discounts from pre-deferred tax net asset values.

And I can speculate (albeit idly) about the catalyst...

**Whitman:** [However], it seems almost impossible to predict where catalysts will come from which will result in the reflection of these large, underlying asset values in the market prices of the common stocks held by TAVF. Nonetheless, I do speculate (perhaps idly) on what some of these catalysts might be in the years ahead:

The two Japanese non-life issues acquired for the first time ... were Chiyoda and Yasuda. [Approximately] 36.8% of Chiyoda's outstanding common is owned by Toyota Motor Company, whose CEO, president and one other executive are represented in the Chiyoda corporate machinery.

Chiyoda is included in Toyota's consolidated financial statements on an equity basis. If Toyota ever wanted to emulate General Motors or General Electric and have wholly-owned insurance subsidiaries, then Chiyoda — whose common stock sells at more than a 50% discount to adjusted NAV — might be a logical acquisition candidate for Toyota.

Unfortunately, we're not yet experts in this swamp.

**Whitman:** We've done a fair amount of research on that question. Unfortunately, I have not been able, as yet, to develop a good sense of what a fair price ... might be in an acquisition by Toyota. Nor do I have much sense of what

Toyota's legal obligations to pay a fair price might be.

This lack of sense about merger and acquisition considerations in Japan, where the transaction might not be arms-length, contrasts with the knowledge we bring to analyzing a proposed transaction where the target company is incorporated in Delaware....

Come to think of it, nobody's an expert — at least not yet...

**Whitman:** Part of the problem is that, to date, there have been very few acquisitions of public companies in Japan. With the advent of the "Big Bang" though [the planned 1998 deregulation of Japanese financial markets], this dearth of merger and acquisition activity seems about to end, at least for Japanese financial institutions.

The second largest non-life insurer in Japan — Yasuda — seems hell-bent on diversifying into other financial service areas with strong American partners. The two areas where it's expanding with American participants are life insurance and money management.

The P/E ratios may look high, but they're misleading.

**Whitman:** Reported P/E ratios for Japanese non-life insurers are ... well north of 20 times. However, in reporting corporate profits for U.S. or Japanese accounting purposes, they include in net investment income only the dividends received on the common stocks held in their portfolios.

Their P/E ratios would be much more modest were they permitted ... to use "look-through" accounting whereby net investment income would reflect non-life insurers' equities in earnings attributable to the common stocks of portfolio companies.... "Look-through" accounting, [by the way], is the norm when subsidiaries, (even those not wholly-owned), are included in consolidated financial statements.

No flights of fancy for us, even if there's a reason to dream.

**Whitman:** Speculating on the possibilities for catalysts for Chiyoda, Yasuda and other Japanese non-life insurers would be the height of irresponsibility given the state of our knowledge if these stocks' prices actually reflected any sort of premiums over readily ascertainable net asset values. [Fortunately, however,] they don't. TAVF may be speculating on possible future developments. However, the Fund is trying very hard not to pay for the privilege of indulging in Chiyoda-like flights of fancy.

All of the Japanese non-life insurers whose stocks we own have huge portfolios of marketable common stocks — mostly Japanese issues. In contrast, almost no U.S. property and casualty insurers hold anything other than investment grade bonds in their portfolios. U.S. companies lack excess net worths, (i.e., net assets not needed to support insurance operations), and thus are stopped, by regulation and common sense from having common stock portfolios.

A non-Japanese insurer we're happy to pay up for (a little).

**Whitman:** Leucadia National has been a brilliantly managed, resource conversion-type company — buying businesses and assets, building them up, and then selling them. Based on expected closings, Leucadia ought to have an extremely liquid balance sheet and a NAV of about \$30 per share as of early 1998. We acquired our toe-hold position at an all-in cost of \$35.83 per share. It's out of character for us to pay a premium. But ... it seems worth it [here]. In any case, maybe we'll have opportunities to average down.

—OID



TEMPLETON FUNDS'  
MARK HOLOWESKO  
(cont'd from page 1)

model of consistency — outperforming the average fund in its category in every year but one subsequent to Holowesko's rookie year at the helm. (Performance figures and rankings were provided by *Morningstar Mutual Funds*.)

We've learned to pay close attention to Templeton and his former associates. Their views on valuations, economic circumstances and business conditions worldwide have consistently been a source of indispensable perspective.

We're therefore pleased to bring you excerpts from a presentation by Holowesko along with his answers to shareholder questions from this year's annual meeting held July 24th in Toronto — excerpts we believe to be no less relevant today. But, first, we'd like to thank Holowesko and Franklin Templeton for their assistance and for allowing us to share his insights and outlook with you. We hope you find his perspectives as valuable as we do.

LESS IN NORTH AMERICA, MORE IN ASIA.  
AND MORE CASH. HERE'S WHY....

Filling Sir John's shoes hasn't been a one-man job.

**Mark Holowesko:** I'm excited to be able to stand here in front of Sir John 10 years after he asked me to help him run the Templeton Growth Fund and five years after he sold the firm to Franklin and show that, [at least] to a certain extent, we've been able to continue the tradition he set forth originally. But it's taken all of these people behind me to replace the one man to my right. [Applause]

We've had declines in the past — and will in the future.

**Holowesko:** Many of us already know about the potential returns of common stocks. However, not enough is said about risk. Over the 40-odd year history of the Templeton Growth Fund, despite our good performance, in six years the Fund has declined. Hopefully, we can continue that tradition and have [no more than] six years of declines over the *next* 44 years.

We've been active in North America — actively selling.

**Holowesko:** ...In North America, our position continues to shrink. Three years ago, we had roughly 50% of our portfolio in the U.S. market. But that has declined. By May of 1997, it was 28%.... And as we stand here, ... [it's declined to] 22%. We've been very active selling in the North American market...

On an industry basis, there have been some changes in the Fund in the past year — most of them fairly subtle. However, one notable change worth discussing is finance. We've been very successful with our banking investments around the world. And we've taken advantage of that and sold some of them into this very good market.

So we are decreasing our U.S. holdings. But we look at it primarily on a stock-by-stock basis. And our exposure to the U.S. has declined primarily because we're finding more stocks to sell than we are to buy.

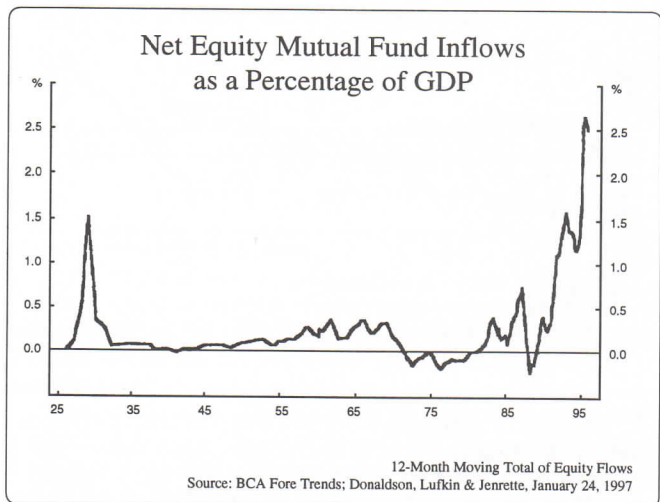
I'd like to give you a sense of why that's occurring,

why our position in Asia may increase, and why the Fund holds cash levels which are slightly higher than normal.

EXCITING AND UNUSUAL TIMES IN NORTH AMERICA  
LEAD TO OBVIOUS VALUATION EXTREMES....

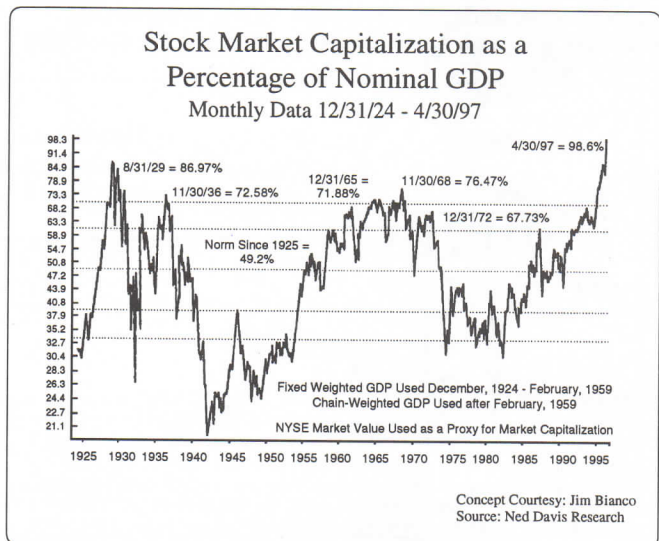
What a difference a decade or so makes....

**Holowesko:** Something very exciting and unusual is happening in America. First, net equity mutual fund inflows as a percentage of GDP — the excitement shown towards mutual funds — is at a record high. As this graph clearly illustrates, when this bull market first began back in the early 1980s, the net inflow into mutual funds — sales less redemptions — was zero. Today, it represents almost 2-1/2% of GDP.



Today, the market is much more expensive and important.

**Holowesko:** That excitement and enthusiasm for mutual funds in the U.S. has led to a rapid rise ... in the importance of the stock market. This graph shows the market capitalization or the size of the stock market in America relative to GDP.



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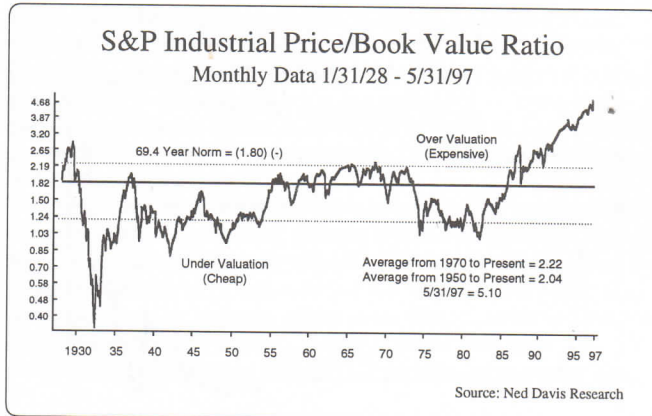


**TEMPLETON FUNDS'  
MARK HOLOWESKO**  
(cont'd from preceding page)

Today, on the far right, on the upper corner, you can see that as of a couple of months ago, the market was 98.6% of GDP — much higher than it's ever been. This chart shows the *size* of the market, how much it's risen and the importance of the market to the economy since so many people have so much invested in the stock market.

Price-to-book multiples 3+ times higher than average...

**Holowesko:** This graph looks at price-to-book value ratios in America. As you can see, we're at an extreme.



Depending on which work you use, the U.S. market is currently trading at 5-1/2 to 6-1/2 times book value. By comparison, over the past 69 years, the U.S. stock market has sold at an average price-to-book multiple of 1.8 times.

Current U.S. valuations are way above historical norms...

**Holowesko:** If the U.S. stock market were to fall back to its 20-year average in terms of P/E, price-to-book, yield and cash flow, it would [decline by] 40%.

That's not to say it's going to *happen*. However, it does show you the extent to which prices have risen in the United States, and why we've been selling many of the securities which on a bottom-up basis look overvalued and

investing some of those profits overseas.

We're at the lowest yield and highest price-to-book ever.

**Holowesko:** This graph [at bottom of page below] also illustrates the risk in the U.S. stock market and why we're moving overseas. The very small dots each represent a year — all the way back to 1925. The vertical axis represents the dividend yield. And the horizontal line is the price-to-book value ratio.

You want low multiples of price-to-book value and high yields on stocks. But, as you see, the small dot on the lower right hand corner shows today's figures. We're at the lowest yield and highest price-to-book value level *ever* in the U.S. market.

We usually leave the party early. But that's OK with us.

**Holowesko:** We have no clue what's going to happen to the U.S. stock market. It could *double* from here. And we certainly have tended to buy too early and sell too early. But the small sun in the bottom right-hand corner shows the valuation of the Japanese stock market at its peak before it lost 50% of its value. We reduced our exposure in Japan several years too early. On the other hand, we missed out on the great decline.

We have no idea what's going to happen in the U.S. And we're not trying to make a market call. The stocks we're selling in the United States are *expensive* based on their fundamentals.

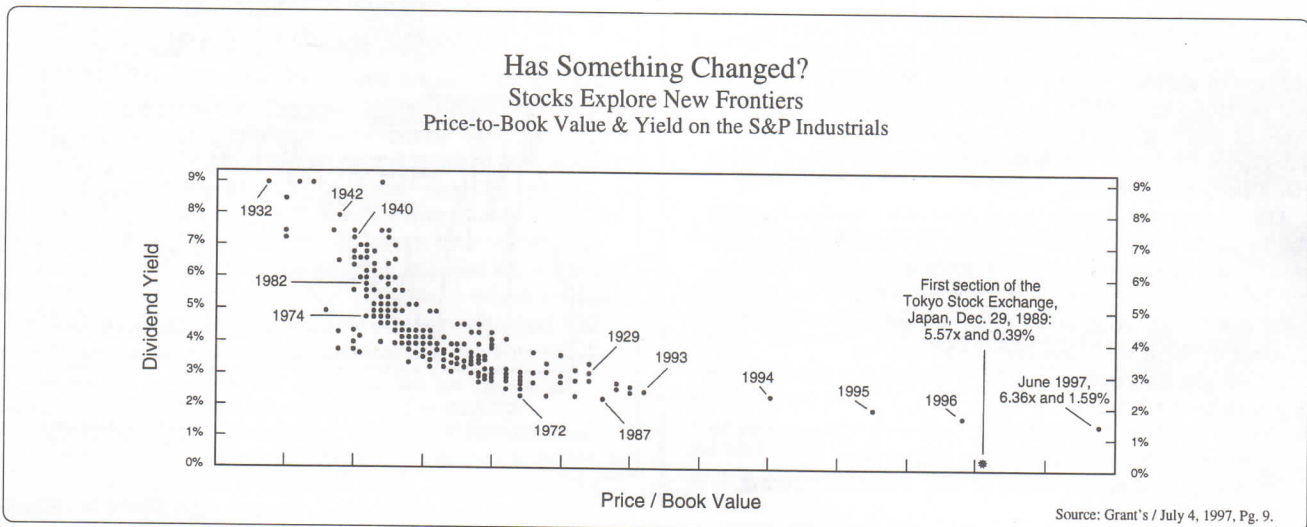
Despite overall selling, we're finding some great *value* in the U.S. For example, one of the cheapest companies in the *world*, we believe, is General Motors — despite the fact that the overall market appears to be very expensive.

U.S. STOCKS ARE GENERALLY OVERVALUED,  
BUT THERE IS MORE VALUE ELSEWHERE.

Based on P/E and dividends, markets are high worldwide.

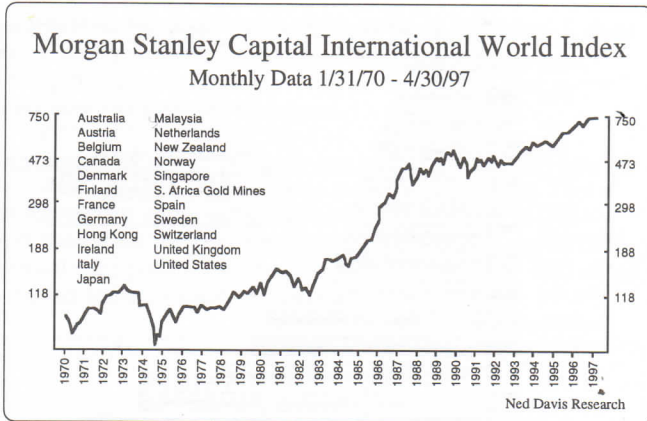
**Holowesko:** Markets worldwide have had good moves. This is the Morgan Stanley Capital International World Index — which is the TSE or S&P of the world. It shows how stock markets in all of the countries listed have performed since the bull market began.

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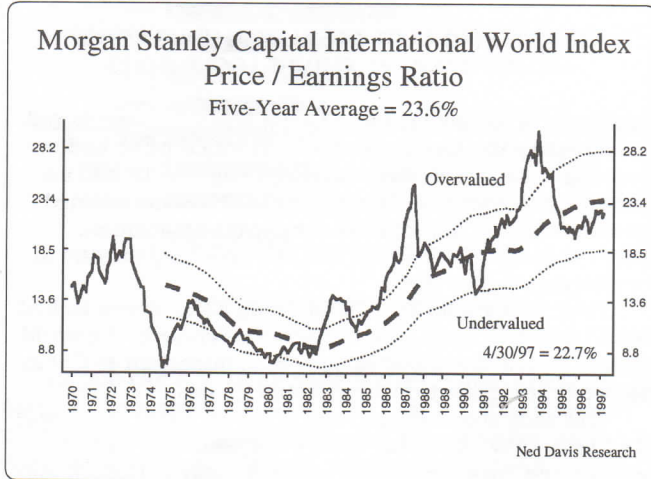




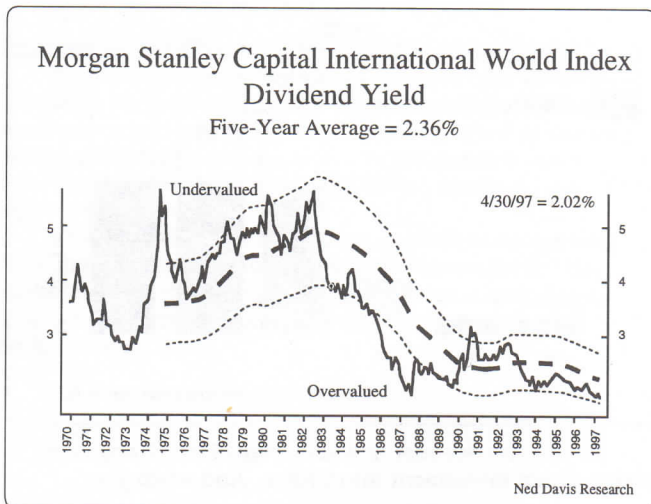
TEMPLETON FUNDS'  
MARK HOLOWESKO  
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And if you look at the valuations of the markets around the world on a P/E ratio basis, they've been rising, and are pretty much in line with the U.S. stock market.



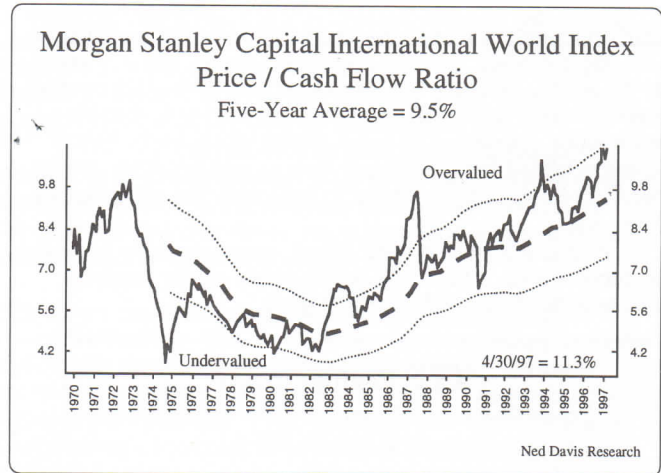
And this is the dividend yield on the MSCI World Index — showing how low it is, as well.



So it's very difficult to find *yield* around the world — including within the United States.

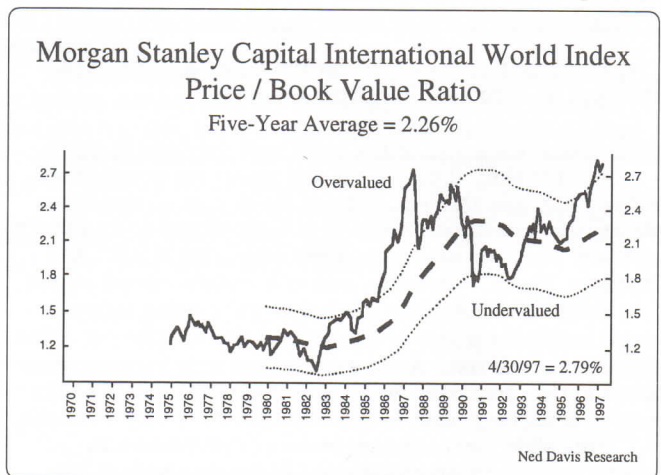
But relative to cash flow & book, other markets are cheaper.

**Holowesko:** But some of the other ratios, this is price-to-cash-flow, for example — [tell a different story].



The Morgan Stanley International World Index may look like it's at an extreme based on price-to-cash-flow. But it includes the United States stock market. If you take the U.S. stock market out of that graph, it falls by about one-third.

Similarly, although the index for markets around the world is high at roughly 2.6 times book, it's roughly half of what it is in America. So we're pushing more of our assets out of North America into some of the overseas markets.



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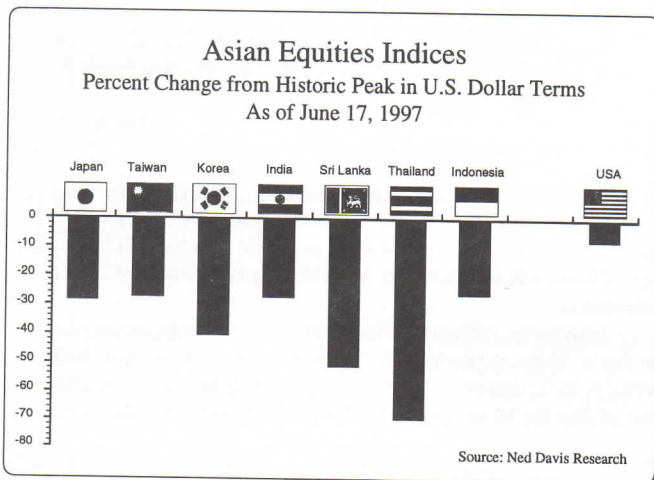
TEMPLETON FUNDS'  
MARK HOLOWESKO  
(cont'd from preceding page)

IF YOU'RE WORRIED ABOUT THE BEAR,  
GO WHERE THE BEAR'S ALREADY BEEN.

Our underweight in Asia has been a good thing — for now.

**Holowesko:** Despite high index levels, there is value in the world. Not only is there value within the U.S. market, [even though] the overall market is overvalued, there is more value appearing in some places where we've been underweighted for quite some time — notably Asia. We've been severely underweighted in Asia with the exception of Hong Kong.

And that's been a good thing. Asian markets have not performed well. This slide shows Asian equity markets, and how far they are from their peak.



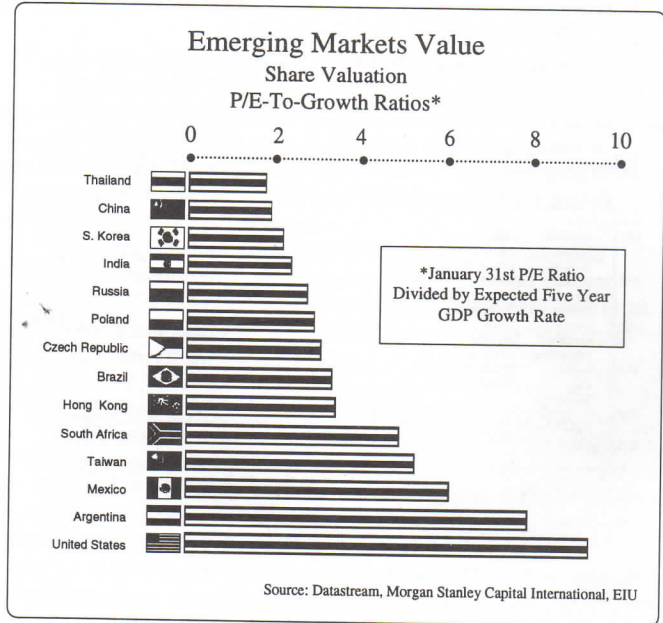
For example, in U.S. dollar terms, as of June 30th, Thailand has dropped 70% from its peak.

We're going where the bear's been (and the price is right).

**Holowesko:** If you're worried about the possibilities of bear markets, the best thing to do is to go to find those places where bear markets have already occurred. And that's certainly been the case with many countries in Asia, like Thailand, Korea, Indonesia, and to a certain extent, Japan.

Based on a lot of the work that we're doing today, I would anticipate that over the next several months our Asian exposure ... will rise. And I say that not only because stock prices in that area have declined, but also because the prices you're paying for growth in those countries are very attractive.

This slide [next column] looks at P/E relative to growth rates in those economies. At the very bottom, you see the U.S. And on top of that, you see a variety of countries — Thailand, China, South Korea and India being amongst the cheapest. And we're basically net buyers of all of those countries, just as we're a net seller of the United States — which, again, is at the bottom...



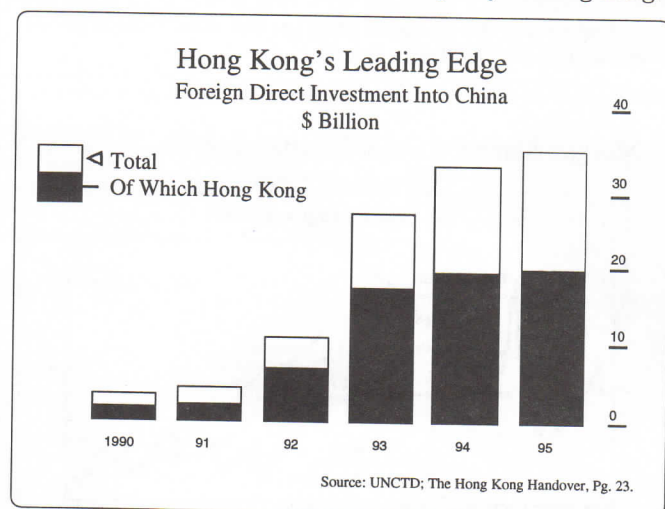
WE'VE FOUND A LOT OF VALUE IN HONG KONG.  
AND WE THINK THE FUTURE LOOKS GOOD.

Hong Kong is too important to China and too cheap to sell.

**Holowesko:** One area of Asia in which we've had an overweight, as I mentioned, is Hong Kong. We've had an interesting transition in Hong Kong. And we maintained our overweight in that market despite that transition. There are many reasons why, but two were fundamental to our decision to stay there:

First, was valuation. To us, Hong Kong stocks looked cheap relative to what was available elsewhere in the world. Second, we felt that Hong Kong was so important to China that we believed the transition would go well.

This slide shows the amount of foreign direct investment into China. The [dark] bar shows the portion of that foreign direct investment that comes by way of Hong Kong.



So you can see just how important Hong Kong is to foreign direct investment into China. And when you

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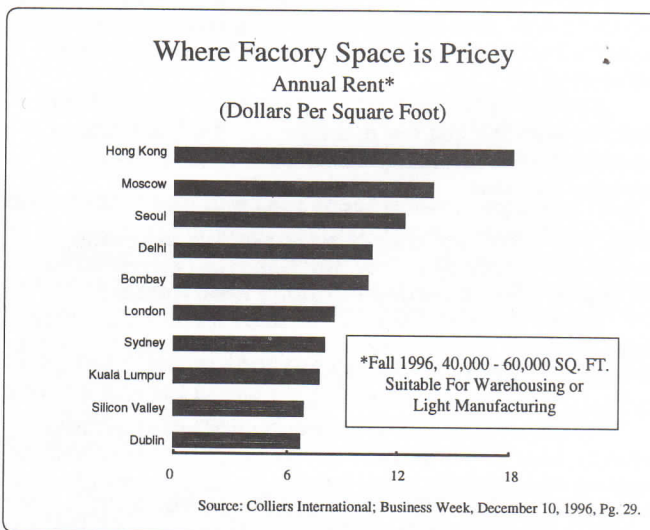


TEMPLETON FUNDS'  
MARK HOLOWESKO  
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understand the importance of Hong Kong to China, it gives you a better sense of comfort. [Therefore, we've been] willing to buy stocks at the very low multiples that we've seen over the past several years.

Our concerns aren't political, but rather real estate-related.

**Holowesko:** There is one area in Hong Kong where we have seen some difficulties and where there is risk — and that is on the real estate side. This graph shows the annual rent paid for factory space in Hong Kong and other selected cities around the world.



As you can see, Hong Kong factory space is now amongst the most expensive in the world.... The annual rents for factory space in Dublin and Silicon Valley, as expensive as they are, are still substantially cheaper than comparable space in Hong Kong. So we have made some reductions in our Hong Kong portfolio over the last year. But it's primarily due to concerns about real estate — not political concerns.

Declining asset prices have hit Japan's economy hard.

**Holowesko:** We maintain an underweight to Japan — which is a very significant non-North American market.... Land values and equity values in Japan peaked in the late 1980s. And there's been a severe reduction in both of those areas since then. It's put a severe strain on the Japanese economy.

We do an awful lot of work on Japan's economy and stock market. And we maintain an underweight in that market despite the dramatic price declines — principally because it's been difficult to find cheap securities on a stock-by-stock basis.

WE'RE NOT TRYING TO MAKE A MARKET CALL.  
WE'RE JUST FINDING MORE TO SELL THAN BUY.

Impact of a severe U.S. correction? That would depend....

**Holowesko:** If the U.S. stock market were to suffer a severe decline, would non-U.S. stock markets do the same? It depends. How fast the U.S. market corrects will largely determine how it impacts other markets. If it *crashes*, then it will have a much greater impact on other markets than if it corrects slowly. But we don't know how or when it will correct, although we do know that it *will*.

However, when we look at the U.S. stock market relative to overseas markets from a valuation standpoint, we see that many other markets have *already* corrected. So even if they come down, we believe that many of them won't come down as *much* as the U.S....

We expect our U.S. exposure to continue declining.

**Holowesko:** But I don't know *what* will happen in the U.S. stock market. *None* of us really knows. Certainly, we're finding more things to sell than buy. As a result, our exposure is declining. And nothing in our work indicates that we won't continue to be more of a seller than a buyer of the U.S. stock markets. So our exposure to the U.S. will probably continue declining — at least over the short term.

We don't try to predict where markets are going. Our cash level is primarily a residual. We're not trying to target any particular cash level. Today, it's roughly 20%. And in the 40+ year history of Templeton Growth Fund, there have been times in the past when our liquid assets have been equally high. So it's not a first for us.

I'd rather defend high cash levels than defend blunders.

**Holowesko:** We would like to see our cash level lower than it is. And I believe it will work itself down over time. But I believe our more conservative stance is going to help us in the long run....

And we're not going to force our cash into stocks that we believe are overvalued. Given our large cash inflows, we'd much rather defend high cash levels than defend why we bought stocks that didn't meet our criteria or defend why we paid up for things just because we had the cash.

It's also a more conservative approach. I believe in Warren Buffett's two rules. Rule #1 is: Don't lose money. And Rule #2 is: Don't forget Rule #1.

—OID

For additional information  
you may contact:

TEMPLETON GROWTH FUND, INC.  
700 CENTRAL AVENUE  
ST. PETERSBURG, FL 33701  
(800) 292-9293  
(813) 823-8712



VALUEVEST MANAGEMENT'S  
MARK BAKAR AND JOHN BURBANK  
(cont'd from page 1)

a particularly interesting time to speak with him and see if he might be willing to share some of his ideas with you. Making us all the more interested, that savaging occurred following three years of anemic returns in emerging markets and with U.S. valuations near all-time highs.

The excerpts which follow were selected from a series of extended conversations with Bakar and one of his associates, John Burbank, beginning December 5th and continuing until very near press time. Again, we'd hoped their bag of bargains wouldn't be empty. Nevertheless, we weren't prepared for the quantity or quality of the ideas they shared with us from which the following were selected and their insights about some of the markets in which they're based. We hope you'll find their ideas as intriguing as we do.

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I'VE NEVER SEEN THIS KIND OF ABSOLUTE HYSTERIA.  
WE'RE FINDING SOME UNBELIEVABLE BARGAINS.

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**OID:** *With apologies in advance for sounding like the proverbial happy undertaker at some terrible tragedy, we understand that there's been absolute carnage in some of your favorite hunting grounds.*

**Mark Bakar:** No apology necessary. We feel the same way. In fact, it's funny that you call now — because, frankly, until recently, we haven't seen very many of the kind of compelling bargains I know you fancy for some time. But now we feel like kids in a candy store. We're finding some of the most unbelievable bargains we've ever seen.

And that's due to a confluence of factors: Things started blowing up around the end of October. And a lot of mutual funds have an October year-end. So there was extreme selling pressure in these markets at that time. And there are still things being sold for reasons that have absolutely nothing to do with fundamentals — to fund redemptions, for tax reasons, etc.

**OID:** *And, no doubt, to eliminate painful reminders — to themselves and their clients.*

**Bakar:** Absolutely. Also, many of the firms who began to invest internationally over the past three to five years have been the biggest mutual fund companies who traditionally had been *domestic* players. And they usually have a lot of capital to invest. So they're limited in what they can buy. And they typically buy the seven or eight largest stocks in each market.

And what happens is that as those markets rise — and these firms see stability, certainty and calm waters — they start venturing into smaller and smaller stocks and bid 'em up.

**OID:** *Good old rear-view-mirror investing.*

**Bakar:** Exactly. And that's great — as long as the market is going *up*. But when it goes the other way and they want to sell those big stakes, they can't. In fact, there's a total *vacuum*. And, therefore, a lot of stocks

around the world are down 60-80% in U.S. dollars — irrespective of quality or fundamentals.

So there's hysteria. There's blood in the streets. And there's a liquidation underway in more than a few places around the world. Therefore, today, we're truly finding the most extreme undervaluations — the best values — that we've ever seen.

In fact, it's the first time in the 2-1/2 years of our firm's existence that I've ever called any of our clients and said, "Give me more money right now." And guess what? They're all giving me more money.

Not all our competitors have that luxury. Therefore, many are selling exactly when they should be buying.

**OID:** *So even if human nature has been repealed in the U.S., it still applies some places.*

**Bakar:** Exactly. But, fortunately, our clients are very sophisticated. And they have very long-term time horizons. So we've had no redemptions. And we have no leverage. We've even got *cash*.

And I've never seen either the value or the hysteria that I've seen the last few months. But we love hysteria — because thanks to that hysteria, we're finding some *amazing* bargains.

**OID:** *You certainly know how to get our attention. But in the words of one of our favorite contributors, do any of these amazing bargains have names?*

**Bakar:** They do. But, if you don't mind, let me bring John Burbank into our conversation before I start trying to provide you with too much detail — because, frankly, he and Oliver Ehrenberg are the brains of our operation.

By the way, aside from Oliver, who's based in London, we're all here in San Francisco. We opened a London office because we believe that you have to be on the ground to do the kind of things we do — because, of course, we're not exactly buying the Nestles and Sonys of the world.

**OID:** *What do you buy?*

**Bakar:** We believe that we combine different elements from several of your contributors. Like John Templeton, we choose to have a global focus because of the generally much greater market inefficiency outside the U.S.

**OID:** *As Templeton and his successors say: you'll thereby find "more bargains and better bargains"...*

**Bakar:** Exactly. And, like Templeton, we're willing to invest in smaller, more obscure companies located in a wide range of countries. We also subscribe to his theory of seeking to invest at the point of maximum pessimism.

But, like Michael Price, we buy securities which aren't always all that straightforward such as convertible debt, arbitrage-type things and the like. Also similar to Price, we're willing to be more than a passive shareholder when the circumstances call for it.

**OID:** *In other words, you're willing to shake the tree.*

**Bakar:** That's right. But, lastly, we also look for easy-to-understand businesses that are growing profitably and earning high returns that don't need much incremental capital to grow. We want them to be operated by capable, honest managers who have equity stakes in those businesses and who are accessible to us. And,

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needless to say, we want to buy 'em right.

**OID: That does sound familiar...**

**Bakar:** So, like Warren Buffett, we're trying to find a few great companies when they're trading at bargain prices.

**OID: Amen. Aren't we all?**

**Bakar:** So, I know you'll be pleased to hear that over the last six months, most of the markets that we're investing in have declined 30% to 75% in U.S. dollar terms. And, as a result, we're finding great companies that are being thrown away across virtually the entire globe.

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WHAT WAS THE "MOTHER OF ALL BARGAINS",  
IS NOW A MOTHER OF ANOTHER COLOR.

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**OID: Still, I imagine that those great companies that are being thrown away include some of your holdings.**

**Bakar:** True. Many of our holdings have taken hits. But we've been lucky. At our high point this year, I believe that we were up about 40%. And we're still up about 20%.

**OID: And I gather that the markets you invest in have done somewhat worse than that?**

**Bakar:** Oh, yeah. In U.S. dollar terms, I believe the IFC Emerging Market Index is down about 19%.

**OID: That would leave you with nearly 50% more capital before fees than someone matching the Index.**

**What accounts for the mammoth difference?**

**Bakar:** The main reason is Asia. We pretty much haven't *been* there. And the reason why we haven't is that, at least until recently, we hadn't found much value there in terms of classic value measures like price-to-book ratio, P/E, etc. Even setting aside price, we hadn't found many companies that met our *qualitative* criteria — for example, that appeared to be well managed.

Plus, there have always been many "value traps" in Asia — situations with structural impediments that could keep shareholders from realizing whatever value there is.

**OID: Structural impediments?**

**Bakar:** Foreign ownership limits, tax issues related to generational transfers and the like. Many things in Asia *look* cheap. And you can spin the most wonderful stories. We've spun 'em ourselves. But all too often, they're *traps*. All of the stock markets in the emerging markets are rigged to one degree or another — as they are in all countries. However, some are worse than others.

For example, Korea's stock market is constrained by virtually *insurmountable* impediments that we could talk about for hours. It's one of the ultimate rigged markets. Insiders are not only protected by foreign ownership limits, but also by all kinds of cozy relationships that determine not only who can buy into what, but even what they *pay*.

**OID: Sounds lovely.**

**Bakar:** And because transfers of shares from one generation to another are taxed based on the share price, they have no incentive for the share price to go up. In fact, quite the *contrary*.

Still, in 1996, we saw what we thought were some wonderful values in Korea and simply couldn't resist buying shares of half-a-dozen or so different companies. But when we visited Korea in January, we left thinking that it was the biggest short we'd ever *seen*.

**John Burbank:** We returned from that trip more negative than we've ever come back from any trip.

**OID: It sounds like it. But negative about what?**

**Bakar:** When we visited Cheil Foods, they told us that in order to shuffle some of their higher cost employees off the payroll of their flour milling operation, they were basically bankrolling them in the bakery business — helping them establish their own *chaebol*.

And at that instant, I began to fully appreciate exactly what a *chaebol* really is. Here's the correct definition:

"A diverse group of poorly managed, unrelated entities with little or no synergies whose primary purpose is the lifetime employment of woefully underutilized employees in the generation of consistently substandard returns."

**OID: I had no idea it was so similar to publishing.**

**Bakar:** Therefore, as soon as we got back, we began to liquidate all our positions except for one small holding. And over several months, we went from being *long* Korea, to having virtually *no* exposure, to being short net.

So although we've found enormous value in selected Korean companies, for most of this year, we've actually been *short*...

**OID: Congratulations.**

**Bakar:** Don't congratulate us too much. In Korea, our shorts were virtually the only thing we did that *worked*.

As I said, we held onto one small holding. And, then, in August, despite being extremely negative about Korea (and even still being short net), we couldn't resist buying this next company. When we put our toe in the water to buy it at KW33,000 [KW = Korean won], we thought that it was truly the "mother of all bargains". But you can buy that stock today for KW11,700.

**OID: So is it now the "grandmother of all bargains", the "mother and father of all bargains" or what?**

**Bakar:** It's a four-letter word beginning with "mother". However, absent the impediments that I alluded to earlier, it's such a no-brainer that someone would definitely buy 51% or more of it *tomorrow* — hopefully *us*. It's really that much of a no-brainer. But I'm getting ahead of myself.

REMEMBER WHENEVER YOU BUY A FOREIGN STOCK,  
YOU'RE MAKING TWO BETS, NOT ONE.

**Bakar:** So we started to buy this company in August at about KW32,400. And within three months, it had dropped all the way down to KW20,000. Needless to say, that caught our attention.

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So we took another look. And when we did, we concluded for several reasons that the Korean currency — the won — was very likely to go into a free fall.

**OID: Can you give us your rationale in a nutshell?**

**Bakar:** Sure. Thailand had started to crumble and devalued its currency. Then, that same phenomenon had begun to spread to Indonesia and other countries in Asia. And if your economy's export driven, as Korea's is, and your neighbors devalue their currencies, then in order to stay competitive, you have to devalue yours, too.

**OID: To offset their "beggar thy neighbor" policy.**

**Bakar:** Exactly. Meanwhile, the Korean currency was one of the few whose value was set by the government rather than being allowed to float. And we concluded that Korea was keeping its currency artificially high — which we confirmed when they finally disclosed their reserves and they turned out to be negligible because they'd used the rest to prop up their currency. So that was our rationale.

And we disliked the currency's prospects so much that we decided to bite the bullet and take our lumps by cashing out of our position at KW20,000 per share.

**OID: Despite thinking it the "mother of all bargains".**

**Bakar:** Exactly. That's the first and only time that I can recall that we've ever done anything like that. In fact, we usually view declines as opportunities to buy *more*. But, in hindsight, at least, we were very fortunate because if we hadn't sold, we'd be down another 65% or so today in U.S. dollar terms — most of it currency-based.

At that time, the won was selling at KW900 to the \$1. And it's declined to about KW1,500. So we'd have been down about 40% based on the currency alone and down over 80% from our original cost in U.S. dollars.

And that reminds us of something we always try to keep in mind — that whenever you invest outside the U.S. you're making *two* bets, not one: 1) the bet on the stock, and (2) the bet on the currency. And if you get *one* of the two wrong, you'll lose money. But if you get *both* wrong, you can be down 80% in the blink of an eye.

**OID: No big deal. We can do that domestically.**

**Bakar:** And that's exactly what's happened in Korea. Since June 19th, the average Korean stock is down more than 79% in U.S. dollar terms.

Incidentally, earlier this year, Jean-Marie Eveillard of SoGen told you about Cheil Foods and its sizeable assets. This one can get you to those same assets even *cheaper*.

**OID: Although I imagine that Cheil Foods can get you to those assets cheaper than it did then, too.**

(continued in next column)

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**Bakar:** Quite a *bit* cheaper. We actually owned Cheil. Needless to say, we sold it earlier this year after our trip. Since you published that feature, it's down about 50% in the local currency and probably about 80% in U.S. dollars.

**OID: It's too bad we don't have room for this segment — because it was starting to sound interesting...**

**Bakar:** Jean-Marie's methodology and his work were 100% right — absolutely dead on. But asset plays are dangerous when a company has horrible management.

[Editor's note: Jean-Marie and Charles de Vaulx stressed that management had destroyed shareholder value in the past and was likely to continue doing so, but that they were, in effect, holding their noses and buying it based on their assessment of its underlying value.]

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USING VERY CONSERVATIVE ASSUMPTIONS,  
SHINSEGAE'S WORTH 6 TIMES TODAY'S PRICE.

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**OID: But changing the subject as quickly as possible, you say this one is cheaper still?**

**Bakar:** It is. In fact, it's so undervalued that we find it *staggering* — truly staggering. It's the ultimate case of the value of the pieces exceeding the price of the whole. This company could very well be selling at 10¢ on the \$1.

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

**Burbank:** Shinsegae Department Stores, like Cheil, is an offshoot of the Samsung group — which is the largest, best managed and least leveraged chaebol in Korea — for whatever that might be worth.

Shinsegae was established and is currently being run by one of the children of the Samsung group's Lee family who wanted to form her own chaebol. That's not unusual, incidentally. In fact, it's a dream of many Koreans.

So when Shinsegae was spun off, it got shares of Samsung-affiliated investments — Samsung Electronics, Samsung Heavy Industries and Samsung Life Insurance, among others. And Shinsegae has its own business which, as you might expect, is department stores and other retail activities.

**OID: That was gonna be my first guess.**

**Burbank:** So Shinsegae's part of the Samsung family. Its primary investment is a 14-1/2% stake in Samsung Life — which is the largest Korean life insurer. And its primary business is retailing — including a department store division and a joint venture with Costco.

**OID: Really!?**

**Burbank:** That joint venture isn't that large as yet. As I recall, there are only two stores in it today. And they're only planning to add about one new store per year. But they also have discount stores called E Marts whose store count they were planning on growing more rapidly — at least until recently.

Shinsegae owns Korea's third largest department store company. And the second largest went bankrupt recently. Even though its retail division isn't what's most important to us, we've been in its department stores. They're very

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high quality — similar to European department stores with food, clothes, etc. And they're downtown in very good locations that aren't easy to reproduce. So there are lots of good things there — including real estate that's worth a lot.

However, Korean companies tend to think in terms of market share and size — in effect, that bigger is better.

**OID: It's not?**

**Burbank:** Not at all costs — which is basically what they were trying to do. For now, it looks like they'll be limited by the amount of money they can raise — which is zero because basically nobody can raise any money today. So they're not going to be able to grow it very fast for now.

Total 1997 retail sales will be about KW1.5 trillion — or about \$1 billion. So its retail segment is decent sized. And it's well run relative to other Korean retailers.

What's a reasonable valuation? I don't want to be aggressive. So I just assume that their market position is going to compensate for their lack of earnings. Therefore, I simply assume that its retail segment's enterprise value is 40% of sales — or about \$400 million. And about half of their 1997 retail sales are from their department stores — which, in the U.S., are valued at closer to 100% of sales. So it's probably worth more, but it's impossible to know.

But Shinsegae has total net debt of \$405± million. Therefore, the value of its retail operations at the very least offsets its net debt. So all I have to do is value the rest of Shinsegae and compare it to its stock price.

**OID: How convenient.**

**Burbank:** And when I multiply its current stock price of KW11,200 by its 11.2 million shares outstanding, I come up with a total market cap for Shinsegae of KW125 billion. That may sound like a lot. But given today's exchange rate of 1,500± Korean won to the \$1, it's only about \$83 million.

**OID: So, in effect, you're paying KW125 billion, or \$83 million, for everything else. And I gather that its other assets are worth more than that.**

**Burbank:** Much more. Most important by far of Shinsegae's assets is its 14-1/2% stake in Samsung Life — which, by the way, is not publicly traded. It owns roughly 2.7 million shares — which I value at KW200,000 each. That's KW543 billion in all for Shinsegae's stake — which is more than four times their total market cap.

**OID: Wow.**

**Burbank:** Then, when I total the values of its pieces including its stakes in the companies I mentioned earlier (among others) and some very well located real estate (which I just include at book value), I come up with estimated net asset value for Shinsegae of about KW70,000 per share — which is nearly six times today's price.

AND THESE AREN'T EXACTLY WILD-EYED NUMBERS.  
ON THE CONTRARY, IT MAY BE WORTH MUCH MORE.

**OID: Isn't myth wonderful?**

**Burbank:** I think that I've been pretty conservative every step of the way. For example, my valuation of Shinsegae's stake in Samsung Life is very low. Some think it may be worth two to three times the price I'm using.

**OID: Aside from brokers and newsletter editors?**

**Burbank:** Yeah. I'm no insurance expert. But we've been told that George Soros actually offered Cheil Foods KW250,000 per share for its stake in Samsung Life.

And we think he was trying to buy it on the cheap. We know someone in the insurance business in the U.S. who tells us he went to Korea, met with Samsung Life's chairman and told him he'd be happy to pay KW650,000 per share — or more than 2-1/2 times what Soros offered.

**Bakar:** And he said, "We don't even want to talk about it at less than KW1 million per share."

**OID: Do either of those guys buy newsletters?**

**Burbank:** It's not clear that they're being irrational. The big problem in valuing Samsung Life is that it's hard to ascertain the nature of the assets. But we know that it's the largest life insurer in Korea by far and, we believe, the largest in Asia ex-Japan. We know it has a market share of roughly 33%. And we know it has premiums of more than KW11 trillion — which even after the decline in the won is still over \$7 billion. So it's just a massive company.

Also, we know who runs it. And its management has a reputation for being sharp. I understand they've made a point of sending their people to work at western companies — like Prudential — to understand how they do it. And Samsung has been very forward thinking generally — which is one reason why it's done so well over time.

**OID: Sounds impressive.**

**Burbank:** But insurance companies play a game in Korea. They don't want to be regulated any more than they already are. And they figure the less earnings they report, the more likely it is the government will stay off their backs and the less they'll pay in taxes. So they all play a game of taking huge reserves and reporting very little in earnings.

And, therefore, the retained earning and book values wind up being very small. For example, as of March 1997, Samsung Life had total assets of roughly KW26.85 trillion — or more than KW1.4 million per share. In contrast, its book value was only about KW489 billion — or only about KW26,000 per share.

So what it's worth is anyone's guess. But through March, it had premiums of KW11.34 trillion — or about \$7.4 billion. And my KW200,000 per share assumes a valuation for Samsung Life of roughly 33% of premiums.

**OID: And you say you think that's conservative.**

**Burbank:** Absolutely. It's hard for us to imagine that it's not worth much more. A similar insurance company in the U.S. would probably sell for 1 times premiums or more, although Samsung Life's premiums are growing faster — from KW7.95 trillion in 1995 to KW10.33 trillion in 1996 and KW11.34 trillion in 1997. In part, of course, that's because Korea's been growing a lot faster — at least in normal times — than most insurers' markets.

**OID: Speaking of fantasies, it sounds like the**

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**KW650,000 figure was just over 1 times premiums?**

**Burbank:** That's right.

**OID:** *At 1 times premiums, wouldn't Samsung Life's shares be worth about KW609,000 each and Shinsegae's itself worth around KW148,000 per share — or roughly 12-1/2 times its current price?*

**Burbank:** I think your math is correct. And we've used very conservative figures for Shinsegae's other assets, too. For example, we just assume Samsung Electronics is worth its current price — which is around KW35,100 per share — despite the fact that it's very depressed.

**OID:** *What makes you think it's depressed?*

**Burbank:** Among other things the fact that it was selling for as much as KW130,000 in 1995.

**OID:** *If I'm reading this chart correctly, it looks like it got all the way up to KW173,000, but who's counting?*

**Burbank:** It's down a lot. And, again, the won was nearly twice as high relative to the U.S. dollar at that time. Therefore, in U.S. dollars, Samsung Electronics was selling at four or five times today's price. So Shinsegae's stake in Samsung Electronics alone was, in effect, selling for more than its entire market cap today. Obviously, that's *crazy*. But that's what it is.

And, then, included among its real estate is the Chosun Westin — which is one of the better hotels in Seoul with a great downtown location. It's a pretty large hotel — with 480 rooms. We've stayed there. It was Korea's first five-star hotel. And it's in a prime, prime location — what's been called the best spot in Seoul.

Again, we carry it at book value — which is only about KW9,400 per share. It's clearly worth *much* more.

**Bakar:** In less stressful times, it was probably worth in the neighborhood of KW25,000 per share — all by *itself*.

**Burbank:** And, again, we're incorporating no value to Shinsegae's retail segment for its growth, market position or anything else. But someone might view those elements as being very valuable indeed.

**OID:** *I'm running out of fingers and toes. But I gather it could be worth a lot more than today's price?*

**Burbank:** You've got it.

**Bakar:** Again, it may be selling at 10¢ on the \$1 — or even *less*.

BUSINESS VALUATION KOREAN STYLE IS QUICK,  
BUT WE'RE HOPING THAT IT'S NOT ACCURATE.

**OID:** *And, yet, you guys aren't backing up the truck.*

**Burbank:** We've recently started to put our toe back into the water. However, the insurance industry in general in Korea is not very well understood — probably because only non-life insurers are public. For example, we heard that Shinsegae wanted to sell its stake in Samsung Life and use the resulting cash to expand its retailing segment.

However, the family that controls the Samsung group didn't want them to sell it to anyone else. So they offered Shinsegae KW50,000 per share for the stake.

**OID:** *A stake that you think may be worth something between KW200,000 and KW600,000.*

**Burbank:** Exactly. But the funniest thing of all was that the Korean analysts then used KW50,000 per share for Samsung Life's value when they did their calculations — not that anyone in Korea ever looks at asset value as a basis for valuing a company anyway.

**OID:** *Of course, who's to say they're wrong?*

**Burbank:** You never know. Also, when you speak with these companies — or even visit with 'em — whether you speak Korean or not, you won't necessarily learn anything. They're not obligated to give you information — whether they're public or not. It's just not in their culture — at least yet — in part because capital up until recently had always been so freely available.

**OID:** *If the available information is truly that limited, how could potential buyers — outside the family, in any case — formulate an offer?*

**Burbank:** Exactly. For Shinsegae to be able to sell its Samsung Life shares, it has to open its books to potential buyers. And they've been unwilling even to do that.

**OID:** *How did Soros and your friend manage to gather enough information to prepare an informed offer?*

**Burbank:** That's a good question. I don't know. Maybe they have resources we don't know about. Maybe they weren't so well informed. And, of course, those stories could be inaccurate. But, again, one thing that we know for sure is Samsung Life's premiums.

**OID:** *Are there any undisclosed liabilities here which may have severely damaged its underlying value?*

**Burbank:** Korean insurance companies tend to invest mostly in fixed-income instruments — although they do own some land and some equities, too. It's not like they're making loans to other companies.

**OID:** *But aren't Korean fixed-income instruments and equities generally down quite a bit in recent years — even more so those in severe distress?*

**Burbank:** That's true. However, we understand that Samsung Life's exposure to equities and bonds is no more than 15% and 10%, respectively, and that close to half of its assets consist of loans to policyholders as a by-product of its long-term savings products.

**OID:** *In other words, loans against policies.*

**Burbank:** Exactly. And aside from cash, that's probably the safest place they could be. So we don't think that Samsung Life is likely to go bankrupt any time soon. At the very least, they'd be among the last to do so.

**OID:** *Although I gather that you wouldn't be shocked were bankruptcies to be pretty darned widespread.*

**Burbank:** Not at all. Quite the contrary. And there is another issue — which is Shinsegae's short-term debt. Shinsegae probably has KW550 billion or so of debt that

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comes due within one year. And it's not really clear how they're going to deal with that. They have enough assets. But in the current environment, unless they come up with some creative solution, they'll either have to roll it over and pay some astronomical interest rate or sell assets into a very depressed market.

THE RISK TODAY IS MORE FROM THE CURRENCY.  
THEREFORE, IT'S A FACTOR YOU MUST CONSIDER.

**Bakar:** Still, we have just begun to put our toe back in the water. What we were waiting for was the currency — because the risk today is more on the currency side. It's hard to imagine the stock price going down much more.

It's not that we're macro investors or market timers. We're bottom-up stock pickers. But when you buy a stock in Korea, it takes two or three days to settle. So you don't even know *what* currency rate you'll get on your purchase until it does.

**OID: Really?!**

**Bakar:** Really. And if the won strengthens in those two or three days, you can find out you paid 20-30% more than you thought in dollar terms — or 20-30% less.

**OID: Talk about a reason for dollar cost averaging...**

**Bakar:** Exactly. It's a *problem*.

**Burbank:** It's *ridiculous*.

**Bakar:** Therefore, as long as the currency's as volatile as it has been — when it's been moving 25% in one day — then it's a factor you have to consider.

**OID: But if it's the only reason you weren't buying, why didn't you just hedge out the currency risk?**

**Bakar:** You *can't* — at least not *economically*. The won is one of those currencies which restrict short selling. If we could have found a way to do it at a reasonable cost, we would have already begun buying Korean stocks.

**OID: You can't go long some stocks and short others?**

**Bakar:** There's no good way to do it that we know of. Everybody's trying to be short all of the things in Korea that you can be short — all of the ADRs, for instance. And, therefore, you can't borrow 'em right now.

**OID: More people wanting to short 'em than supply.**

**Bakar:** Exactly. So we had been waiting for the won to drop to KW2,000 to the \$1. But we've been looking for an entry point into Korea — or, at least, into a couple of Korean companies — ever since the currency hit 2,000.

**OID: Despite the won having strengthened 25% since?**

**Bakar:** I just think it was a psychological level — similar to the Indonesian rupiah going to 6,000.

**OID: A selling climax.**

**Bakar:** Exactly. And it gives us some comfort that the worst may be behind us. At least it gives us enough

comfort to begin to put our toe back in the water in Korea at KW1,500 or even KW1,400 to the \$1 — whether we expect the won to weaken further or not, (which we do).

We expect the U.S. dollar to continue to strengthen against the yen for a variety of reasons — which should put pressure on the Korean won to weaken further, too...

**OID: So Korean products stay competitive...**

**Bakar:** Exactly. Also, if the won and interest rates wind up stabilizing anywhere near today's levels, many highly leveraged Korean companies will be scrambling to pay off dollar-denominated debt. And many of them will ultimately have to declare bankruptcy.

But if our entry price is right, we don't mind if our first purchase is our worst purchase. In fact, we *like* it.

**OID: Then just buy a few shares in my name — although margin and options generally work best...**

**Bakar:** If we like something, we're happy to have it go down and buy more.

AT BEST, IT WON'T BE PRETTY.  
BUT THE PRICE IS RIGHT....

**Bakar:** But a cheap currency alone won't be enough. Korea also has to undertake a variety of reforms.

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

**Bakar:** And because Korea's been forced by the IMF to agree to certain reforms, they're at least *talking* about doing some of the right things — like increasing the percentage of Korean companies that foreigners can own, deregulating their financial system, creating transparency and so forth.

But are the changes far reaching enough? No. And will they ever be implemented? Again, we're *very* skeptical.

Also, the rescue package is designed expressly to bail out the *banks*. But nearly all publicly traded *companies* are highly leveraged, *too* — many of them enormously so. It's not clear to us how the bailout solves *their* problems — especially if, as we expect, a result of IMF-imposed policies is much slower growth.

**OID: What would it take to give you confidence enough to get back into Korea in a serious way?**

**Burbank:** Were they to lift the foreign ownership limit so foreigners could acquire companies, I think we'd be very interested — because, then, asset plays would happen.

**Bakar:** Although, frankly, even then, we find it hard to imagine the Korean authorities standing by and allowing foreigners to buy controlling interests in their companies. When it comes to Korea, we've learned the hard way, unfortunately, to believe it when we see it and not before.

**OID: You and most of the rest of the planet, I gather.**

**Bakar:** However, we were pleasantly surprised by a couple of statements Korea's new president just made. First, he said he hadn't fully understood the magnitude of the problems Korea faces — that they're very big and that Korea has to "take some pain and bite the bullet."

**OID: Refreshing realism. That is encouraging.**

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

**Bakar:** And I was encouraged by something else. Apparently, Korea will allow bank employees to be fired. That's a watershed event, I think, for a couple of reasons: First, it may encourage foreign banks to come in and buy some of Korea's bankrupt banks. And, second, it may represent the bare beginnings of Korea opening up and reforming both its financial system and labor laws.

Korea is totally bust. But they want to do everything they can to avoid defaulting and, therefore, being viewed the way that Latin America's been viewed since the '70s.

**OID:** *And paying far higher interest rates, as a result.*

**Bakar:** Exactly. So the Samsungs of Korea are telling the government not to saddle them with that baggage.

**OID:** *And, hopefully, taxpayers will chime in, too.*

**Bakar:** Absolutely. So perhaps Korea is beginning to understand where the U.S. is coming from and what they're doing and that they're not trying to steal their country. If so, Korea could be close to the bottom.

Still, I'm not putting 20% of my portfolio in Korea today. Again, I expect to see companies going bankrupt every day. And it's hard to imagine that not weighing on their currency and their stock market.

**OID:** *It certainly doesn't sound cheery.*

**Bakar:** But Shinsegae is extremely cheap. And it's probably one helluva buy. That's really the bottom line. And if you do buy it, you'll probably have made an enormous amount of money over the next five years.

But also be prepared to lose 30% in a day.

**Burbank:** If you were able to own 100% of Shinsegae — even if you could buy 51% and the Korean authorities didn't stop you — you could sell off the retailing group, Samsung Electronics and the land, and just hold onto the life insurance piece. And by holding onto it, you'd also avoid a huge capital gains tax.

And I suspect that you might be pretty happy about owning 15% of the largest life insurer in Korea for free.

**OID:** *Or even less — since the value of its other assets may be a multiple of its net debt.*

**Burbank:** Exactly. Again, the level of undervaluation here is staggering — absolutely staggering.

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THIS ONE'S ONLY SELLING AT AN 80% DISCOUNT,  
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**Burbank:** Samsung Fire and Marine is similar to Shinsegae in some ways and different in others. It's similar in that it's another insurance company selling at a very substantial discount to intrinsic value.

But unlike Shinsegae, you're not buying a bundle of unrelated assets that you can sell off and, thereby, own the insurance company for free. It's a relatively pure play.

**OID:** *Darn.*

**Burbank:** That's the negative. The positive is that it's growing much more rapidly and earning higher returns — although you'd never know it from its reported results. It also hides its returns with very conservative reserving.

**Bakar:** Samsung Fire and Marine is a fabulous story. It has premiums of something around \$1.6 billion. And, here again, if it were a U.S. insurance company, I think it would easily be worth 1 times premiums.

And it's growing more rapidly than U.S. companies — and, again, much more rapidly than Samsung Life. Yet, its enterprise value isn't much over \$300 million.

**OID:** *Only an 80% discount? Let's throw it back and wait for it to get cheap.*

**Bakar:** To be able to buy a company of this quality at less than 20% of premiums is unbelievable.

**OID:** *Well, perhaps we shouldn't be quite so rash. Premiums do appear to have been growing very nicely. It looks like they grew 130%+ from 1993 to 1996.*

**Burbank:** Like I said...

**Bakar:** Samsung Fire and Marine sold for as much as KW634,000 per share earlier this year. And foreigners had to pay a hefty premium — 30-40% — on top of that. Tonight, we're buying shares at KW190,000 with no premium at all. So it was selling at 4-5 times today's price.

**OID:** *Even before factoring in the cheaper won.*

**Bakar:** Exactly. And I understand Julian Robertson visited Korea sometime around the middle of this year and was quoted subsequently as saying that one of the very few stocks worth buying was Samsung Fire and Marine.

**OID:** *And you think he might still like it?*

**Bakar:** If he thought it was a bargain at KW400,000 and the currency was much more expensive than it is now, what do you think?

**OID:** *I think 80-90% discounts on those two ideas may be hard to beat — impediments and all.*

**Bakar:** They're amazing values. They really are.

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A GROWTH STORY FEATURING THE EASTER BUNNY  
AND A FUTURE THAT MAY BE MIGHTY SWEET.

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**Bakar:** But having told you about a couple of ideas with structural impediments galore, I should point out that while we are sifting through very cheap securities, we're looking for very good businesses *without* the impediments. And one of the places that we're finding them is Indonesia.

Stocks there have been hit just as hard as they have in Thailand and Korea. And we're finding *lots* of value there — high quality businesses that are just as attractive as anything we're finding elsewhere, if not more so.

Indonesia has *other* things going for it, too. Recently, for example, the World Bank said that five countries would drive the world's economic growth in the 21st century. And, of course, three of them were China, Russia and India.

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VALUEVEST MANAGEMENT'S  
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The other two were Indonesia and Brazil.

But if you walk downstairs and ask 100 people on the street to tell you the fourth largest country in the world, I'll bet you that not *one* would say Indonesia.

**OID: And even if you were to tell them it's Indonesia, I'll bet that very few — erudite financial editors aside, of course — could locate it on a map.**

**Bakar:** Absolutely. Indonesia has 200 million people. But it's virtually unknown in the U.S. And that's part of our thesis: that when unknowledgeable investors panic and sell out of a market that they don't understand, often they throw the baby out with the bathwater.

For example, I could tell you about a company that's run by one of the smartest guys we've ever met that's earning 25% on equity whose sales and earnings are virtually guaranteed to explode in the next 10 years and grow very nicely for decades. We think it has one of the brightest futures of any company we've ever encountered.

**OID: Sounds like it could have a certain charm.**

**Bakar:** And since May 12th, its stock has declined roughly 80% in U.S. dollar terms.

**OID: Sounds promising...**

**Bakar:** And it's selling at 5 times earnings.

**OID: We'll take it, already.**

**Bakar:** Cahaya Kalbar [CEKA/IJ] is selling at around 1,350 rupiah. And its founder and CEO tells us that it should earn about 270 rupiah per share in 1998.

And this guy's been conservative — *very* conservative. We're comfortable with his estimate. We see no reason why they shouldn't earn 270 rupiahs. And if we're right, it's selling at all of 5 times 1998 earnings.

But we're not counting on it. Its earnings could be much lower and it would still be a great bargain — because although it's trading at a value-type price, it's very much a growth story. Cahaya Kalbar is the largest manufacturer of specialty fats in Indonesia, with a 96% share of the market in Indonesia — which, again, is no small country — and a 6% share worldwide.

**OID: Specialty fats?**

**Bakar:** That's right. That's just a fancy way of saying that they make cocoa butter substitutes — which is the primary ingredient in the production of chocolate. And why, you may wonder, would a company that produces cocoa butter substitutes have an exciting future?

**OID: I'll confess that the thought crossed my mind.**

**Bakar:** First, to call a product "chocolate" in Europe, at least 95% of that product must consist of cocoa butter. In other words, to say "chocolate" on the packaging, specialty fats plus any and all other cocoa substitutes can comprise no more than 5% of that product. But those rules don't apply in Asia.

And cocoa substitutes cost a small fraction of what regular cocoa costs. But most people can't tell the difference

between chocolate that's 95% cocoa butter and chocolate that consists primarily of cocoa butter substitutes.

**OID: Really?**

**Bakar:** They can if they taste the two side by side. But, off the shelf, very few people could tell the difference — *very* few. You've probably seen chocolate that's been molded in the shape of an Easter Bunny. Well, when candy companies mold chocolate that way, they tend to use lots of cocoa substitutes in order to extend shelf life. The cocoa substitutes help make the chocolate less sensitive to heat and, therefore, more likely to retain its shape, etc.

And given the high humidity prevalent throughout most of Asia, regular chocolate has a very short shelf life.

**OID: Other contributors with interests in candy — including Robert Friedman and David Winters of Mutual Shares — have told us the same thing.**

**Bakar:** It's an important point. Chocolate made with cocoa substitutes has a far longer shelf life. So that's another reason why cocoa substitutes are the rule rather than the exception throughout most of Asia.

Along those lines, I've seen candy from Cadbury and others being sold in China and elsewhere in Asia using Cahaya's specialty fats with "chocolate" on the wrapper — although, technically, there's very little chocolate in it.

**OID: Similar to "bi-monthly, more or less"?**

**Bakar:** Also, of course, the vast majority of the earth's population — including billions of people in Asia — have incomes a fraction of the average income in Europe.

Let me give you some statistics about average annual per capita consumption of chocolate that we find intriguing: Number one in the world is Switzerland with 9.7 kilograms of chocolate per person per year. For the U.S., the average per capita consumption is 4.9 kilograms. In Russia, the figure is 1.4 kilograms. In Eastern Europe, it's 0.9 kilograms. In Indonesia, it's .125 kilograms. And in China, it's .015 kilograms.

**OID: So that consumption of chocolate in Indonesia and China is less than 1/70th and 1/600th, respectively, of what it is in Switzerland.**

**Bakar:** Exactly. Therefore, you can understand why we like the fact that Cahaya Kalbar's four biggest markets today are China, Eastern Europe, Indonesia and Russia.

**OID: You're not worried about people trading up to cocoa butter as their standard of living rises?**

**Bakar:** Cahaya Kalbar is also in the business of processing cocoa — which it exports to chocolate manufacturers. But that activity accounts for no more than 30% of its sales. And cocoa processing is a much lower return business. So Cahaya is focusing on the specialty fat area.

Consumers in emerging markets will trade up over time. But that's not going to be a factor for decades.

IS IT A COMMODITY BUSINESS? MAYBE.  
BUT, IF SO, IT'S A VERY PROFITABLE ONE.

**OID: Of course, consumption trends can be one thing**

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

**and market share and profitability quite another.  
Do consumers really care whose cocoa substitute  
is in their chocolate? Isn't one as good as another?**

**Bakar:** That's right. It's a commodity product.

**OID: Where's the moat, then — or is there one?**

**Bakar:** Let me answer your question this way. First, Cahaya Kalbar is a family-controlled business that the CEO's family started in 1968. And let me tell you about this guy: He came to see me in San Francisco on his way to New York. And I asked him if he was going to be in Indonesia because I was going to be going there soon. And he told me yes, but he wouldn't be back there right away — because first he was going to be visiting Sweden. So I said, "Why's a guy from Indonesia going to Sweden?"

**OID: If this is one of those kinky stories, let me remind you that we're rated PG...**

**Bakar:** Not at all. He said, "I can't tell you right now. However, when you get to Indonesia in a couple of weeks, I'll be back. And if you ask me then, I can tell you."

So I did. And he told me, "There was a plant that produces the same thing we do in Sweden. And if you're around chocolate five minutes a day, it smells pretty good. But if you're around it 24 hours a day seven days a week, it doesn't smell so good anymore. And this town in Sweden decided that they didn't like the way this plant smelled. There weren't any environmental problems or anything of that sort. They just didn't want the plant there anymore."

So he went to Sweden in order to buy this plant — which he did — for \$1.5 million. Then they disassembled it — machinery and all — and shipped it back to Indonesia and reassembled it for another \$1.5 million. And, so, their all-in cost was \$3 million for a plant which would have cost \$30 million to build from scratch in Indonesia.

That's the kind of manager we want.

**OID: So you believe that it's a first-class management and that they'll somehow achieve first class returns — whether they're in a commodity business or not.**

**Bakar:** That's exactly right. Also, I understand that it's a fairly difficult process to duplicate.

**OID: Why is that?**

(continued in next column)

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**Bakar:** Because it's not a simple production process. Let me put it this way: I was recently in one of their labs. And I didn't understand a word they were saying.

**OID: And they were talking in English?**

**Bakar:** They were talking in English. Obviously, given their profitability, competition is bound to follow. But we're talking about a massive market here.

And, in any case, he says he doesn't see competition on the horizon — at least not just yet. So it would take at least two to three years before anybody could even build a plant that would enable them to enter this business in Indonesia — assuming that they knew *how*.

**OID: So that even if trouble is coming, it probably won't arrive for at least two or three years?**

**Bakar:** That's right. Also, the largest raw material used in the production of specialty fats is palm oil. And Indonesia just happens to be the largest and lowest cost palm oil producer in the world. So Cahaya Kalbar enjoys a cost advantage no one outside Indonesia can match. And they do have a 96% share of the market *within* Indonesia.

**OID: And outside Indonesia?**

**Bakar:** I understand that there are two or three big players in this business — all in Europe — the biggest being a subsidiary of Unilever with about a 20% share.

But we understand that they're focused primarily on Western Europe and doing very little in emerging markets and that Cahaya Kalbar — which, again, has a 6% share of the market worldwide — is the only major player focusing on the emerging markets.

**OID: And Cahaya Kalbar has the largest share there — at least in the markets you named?**

**Bakar:** We think so. We've tried to get hard numbers — even calling the chocolate companies themselves. But those figures are very hard to come by. In any case, that's our understanding.

Also, Cahaya Kalbar is doing some other things which we find interesting. For example, chocolate production apparently has a lot to do with enzymes. And the last time that I visited with them, they told me about opportunities that they were exploring for specialty fats in other areas including pharmaceuticals and cosmetics.

**OID: That's Greek Indonesian to me.**

**Bakar:** I'm no chemistry major either. But we have tremendous confidence in this guy.

A SIMPLE SYNOPSIS: AN AWESOME FUTURE  
AT A RIDICULOUSLY CHEAP PRICE.

**OID: Has this company's brilliant future been reflected in their past results?**

**Bakar:** You tell me. In 1995, Cahaya Kalbar had sales of 24 billion rupiah. In 1996, their sales were about 100 billion rupiah. And their 1997 sales are expected to be about 160 billion rupiah.

**OID: That sounds pretty quick.**

**Bakar:** It's explosive growth. And it's profitable, too.

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They earned 3.5 billion rupiah in '95, 17 billion rupiah in '96, and they'll earn about 23 billion rupiah this year. And we expect them to earn 32-34 billion rupiah or more in 1998.

**OID: And book value?**

**Bakar:** At year-end 1995, it was 51 billion rupiah. At year end 1996, it was 106 billion. And it should be up around 130 billion rupiah as of the end of 1997.

**OID: Which sounds like it may have been juiced some by the issuance of more shares.**

**Bakar:** In a manner of speaking. They came public in 1996.

**OID: But shareholders aren't being diluted by the issuance of too many shares?**

**Bakar:** Not at all. Their 1996 share issue only took their shares outstanding from 92 million originally to today's 119 million.

And here are Cahaya Kalbar's earnings per share figures since 1995: They earned 56 rupiah per share in 1995, 143 rupiah per share in 1996 and they'll earn more than 190 rupiah per share this year. And we expect them to earn about 270 rupiah in 1998.

**OID: Sounds mighty fast, too.**

**Bakar:** Incidentally, Cahaya Kalbar has no net debt at present. But they recently agreed to buy a plant which produces specialty fats that they're funding with a loan from a consortium of European banks. That loan, which they took out in the last few weeks, was in the amount of \$30 million at a rate of only LIBOR + 1-1/2%.

And given the current interest rate environment in Indonesia, to say that that's an attractive interest rate would be more than a mild understatement. I think it tells you a lot about this company — or at least what banks think about 'em.

**OID: Just that banks don't think they need the money. But isn't \$30 million more than Cahaya Kalbar's entire market cap?!**

**Bakar:** It is. But, first of all, probably no more than half of that loan is being used to pay for the plant. And, second, given everything else that this guy has ever done, I'd be very surprised if that purchase doesn't turn out to be a very big positive looking out to 1999 and beyond.

Also, the price of cocoa's skyrocketed of late — which, of course, also gives these guys a tailwind — because as cocoa prices go up, chocolate manufacturers have more and more of an incentive to use substitutes.

Also, Cahaya Kalbar's costs are mostly in rupiahs, whereas its revenues are mostly in dollars — which is the way commodity products are typically priced worldwide. And the rupiah had been trading at 2,300 for most of this year. But it's since declined over 50% against the dollar. So there's another tailwind.

**OID: In which case, earnings are inflated?**

**Bakar:** Not at all. Because of their cocoa processing

activities, higher cocoa prices have thus far been a *drag* on their earnings. And they're likely to remain a drag on their earnings in 1998. However, over time, higher cocoa prices will drive chocolate manufacturers to use more chocolate substitutes.

Also, the benefits of a lower rupiah have just *begun* to come through. They're not factored into the estimate that I mentioned earlier. If the rupiah stays at this level — which neither we nor analysts who follow this company expect — Cahaya Kalbar should earn *more* than our 1998 estimate.

**OID: Unless, of course, competitors who enjoy that same currency tailwind compete those gains away.**

**Bakar:** Not for awhile — because whether your fears about competition over the long term are correct or not, they have virtually none today.

**OID: Any concerns about the currency on this one?**

**Bakar:** The rupiah spent most of the year at 2,300 or thereabouts to the \$1. And when the Asian crisis began, it weakened to 2,700. However, Indonesia had been running a trade surplus. So I don't think anyone would have argued that its currency was overvalued. And, yet, it declined all the way down to 6,000 rupiah to the \$1 — or by more than *half*.

As a friend of mine said, "I don't think it had anything to do with fundamentals. It had to do with hysteria."

**OID: And if Cahaya turns out to have been a mistake, what's the problem likely to have been? Competition?**

**Bakar:** Yep. And not much else that I can think of — geopolitical, big picture factors aside.

**OID: Speaking of the big picture, isn't one of the big fears about Indonesia a recurrence of social unrest?**

**Bakar:** It is. But I don't believe it's warranted at all. Indonesia suffers from the same kind of corruption that most of the world does. But in Indonesia, one man and his family have been in power for 32 years. And that leads to a lot of, let me just say, interesting situations.

But there's no strong anti-capitalism movement — really *no* opposition. There's a strong anti-corruption sentiment and a strong anti-Suharto movement. But I've heard no one saying the country needs to look left. There's no political rhetoric from the left at all. There is no left.

**OID: Today, anyway. But can't that change quickly — especially during prolonged economic downturns?**

**Bakar:** I don't think so. Believe it or not, Indonesia's had annual GDP growth of nearly 7% for the last 32 years. Is that incredible or what?

That's why there is no left. After 32 years of that kind of economic expansion, market economics is going to win out over state-planned economic policy. So if there is social unrest, there is no left for them to turn to. Therefore, if anything, unrest will lead to a democracy more free than it is today — and to more capitalism.

Obviously, Indonesia has its share of problems. But there's a liquidation sale going on. And as value investors, when a market declines 70% in dollar terms, it's probably a place that we want to go fishing — or, at the very least, look and see if there are any fish we might like.

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VALUEVEST MANAGEMENT'S  
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**OID: Or something that smells bad for a good reason.**

**Bakar:** Exactly. And there's a lot of *both* right now. Again, we just think Cahaya Kalbar is ridiculously cheap no matter how you slice it. Our synopsis is very simple: Here's a company we can buy at less than 4 times EBITDA, 5 times earnings and 1.3 times book with earnings growth for the foreseeable future — at least of 30% or more per year and high growth for many, many years thereafter — that's consistently earned 20% or more on its equity and capital. That seems pretty compelling to us.

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THIS BUSINESS IS *GENERALLY* TERRIFIC.  
BUT IN BRAZIL, IT'S *PARTICULARLY* SO.

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**Bakar:** The next one we'd like to tell you about isn't in Asia. But it's a wonderful business with essentially all of the qualities we look for. It generates very high returns, throws off enormous amounts of free cash, and is very, very likely to generate more and more free cash in the future with minimal incremental capital invested.

**OID: That's all well and good. But is it a bargain?**

**Bakar:** It's being thrown away. I believe you'll find it compelling, too. It's a Brazilian elevator company.

**OID: An elevator company is a wonderful business?**

**Bakar:** Absolutely. However, this is John's baby. And I don't want to steal his thunder.

**Burbank:** The company is Elevadores Atlas [ELA3/BZ]. And it earns *extremely* high returns.

**OID: I'll bite. How high?**

**Burbank:** Well, calendar year 1997 is almost over. So we're pretty confident of Elevadores Atlas' estimated return on equity for 1997. And it's expected to earn around 65% on beginning of year equity.

**OID: Why are the returns so high?**

**Burbank:** For several reasons. First, the business doesn't require much capital. Second, most of the money is made on the service side — performing maintenance and repair. It's a complex machine that breaks down a lot.

**Bakar:** And, of course, it's not a discretionary repair. If the elevator in a 30-story building is broken, they *have* to fix it.

**Burbank:** Exactly. As a result, the service side of the business generates very reliable recurring revenue.

**OID: Two of Robert Noel's favorite words.**

**Bakar:** Ours, too. So the companies compete fiercely to win the contract to install their elevator.

**Burbank:** They're happy to break even on installation — it can even be a loss leader — because they're likely to control the servicing since it's their elevator with their parts and they know how it works better than anyone else.

Any elevator company will lose 2-3% of the servicing — perhaps a bit more — to independent service providers who may handle a variety of companies' elevators. But it's unlikely to lose it to another elevator company — in part because they don't *want* to service someone else's elevator. So elevator servicing is very stable and very profitable.

**OID: Makes sense.**

**Burbank:** There's also a third part of the business — which is the modernization of existing elevators. And that's also very profitable, although it's more cyclical, too.

**Bakar:** And Elevadores Atlas isn't just in any market. When you fly into Sao Paolo, you see an endless array of 20-story buildings. Nearly everyone lives in these high-rise apartment buildings.

**Burbank:** The only people who live in single family dwellings are the very, very rich and the very, very poor.

**Bakar:** And one of the reasons why is that the roads and other infrastructure are so poor that it's not a very attractive option to commute.

**Burbank:** It's virtually *impossible*.

**OID: Sounds like Manhattan.**

**Bakar:** Actually, Sao Paolo is *larger* than Manhattan. Population-wise, it's the second largest city in the world with a population of roughly 18 million. It's much larger geographically, too. It's similar to Los Angeles in that it goes on forever. So there's one high rise after another — many of them 20, 30 or 40 years old. So when Brazil gets very hot in the summer and the elevator breaks, there's not a very long debate about whether to get it fixed.

Also, we're talking about a country whose population is up around 160 million people. And this company is no small enterprise — it has a 35-36% market share. So, clearly, Brazil's geography, demographics and the current state of its infrastructure particularly favor this business.

USING TODAY'S EARNINGS, RETURNS ARE SKY HIGH.  
BUT THOSE EARNINGS ARE ACTUALLY *DEPRESSED*.

**OID: It sounds like Elevadores Atlas' returns are very high. But are their returns distorted for some reason — for example, as a result of the very high inflation that Brazil's experienced up until recently?**

**Burbank:** Not at all. In fact, far from being inflated, their earnings are *depressed*.

**Bakar:** That's right. This company doesn't use inflation accounting. And, again, elevator companies typically don't have a lot of assets.

**Burbank:** Therefore, they haven't experienced the inflationary write-up of assets that you would in a utility. Elevadores Atlas' numbers are not inflated at all. In fact, they're based on U.S. GAAP accounting.

**Bakar:** And it's not just Elevadores Atlas that earns such high returns — and it's not just within Brazil. Elevator companies earn very high returns worldwide. Actually, Otis has a number of publicly traded subsidiaries around the world in which we've invested in the past. And they earn similar returns. Aside from software, in fact, the

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elevator business is one of the most, if not *the* most, profitable industries in the world.

**Burbank:** That's right.

**Bakar:** And they don't achieve those returns by utilizing massive leverage. Elevadores Atlas' return on *capital* is 44%±.

**OID: Wow.**

**Bakar:** And even *that* figure is depressed.

**OID: How so?**

**Burbank:** It gets a little complicated. But most elevator companies are part of other companies in the same way that Otis is part of United Technologies. Well, for United Technologies, Otis is a cash cow. It takes money out of the elevator division and puts it in other businesses.

**Bakar:** Into *bad* businesses.

**Burbank:** Generally speaking. Elevadores Atlas was part of a parent company which did that, too. It took the cash flow from the elevator business and invested it into the steel business — which is about as dumb a thing as you can do.

**OID: Don't challenge me. You might be surprised...**

**Burbank:** So Elevadores Atlas got spun off in the second half of last year. And they took with them about R\$85 million worth of amortization of the service portfolios. All that really means is that their parent got R\$85 million from the spin-off which Elevadores Atlas is writing off over five years. So its earnings will remain depressed by that R\$17 million per year of amortization — which, of course, is a non-cash expense — until, I believe, the year 2001.

BASED ON ESTIMATED NORMALIZED EARNINGS,  
ELEVADORES ATLAS IS IN THE BARGAIN BASEMENT.

**OID: Its returns on capital and equity sound great. But what about its valuation?**

**Bakar:** The valuation's going to get you *really* excited.

**Burbank:** Yeah. Elevadores Atlas has approximately 25 million shares outstanding.

**Bakar:** The Brazilian currency is the "real" — the plural of which is "reais". (It's abbreviated "R\$"). And Elevadores Atlas' local price is R\$14.5 — which, incidentally, is off about 20% from its high. That's equivalent to roughly \$13.

**Burbank:** Also, the real has depreciated about 7% against the dollar since the beginning of the year — from 1.04 reais to the \$1 to roughly 1.12 reais today — pretty much in a straight line. Therefore, in dollar terms, Elevadores Atlas has effectively declined about 25%.

But to keep it as simple as possible, let me give you all of these figures in dollars.

**OID: The simpler the better.**

**Burbank:** Actually, I ran these figures when the exchange rate was 1.11 reais to the \$1. But that should

only impact the numbers by about 1%. The effective price in U.S. dollar terms is, therefore, about 1% cheaper.

**OID: Not to worry. We'll add the false precision later.**

**Burbank:** The market cap is roughly \$325 million and its net debt is about \$45 million. So its firm value or enterprise value is about \$370 million.

Elevadores Atlas' book value at the end of this year will probably be about \$54 million.

**OID: So it's not cheap on the basis of price-to-book.**

**Burbank:** Not at all. Sales this year will be a little over \$320 million. Operating profit will be \$69 million. Net income after tax will be about \$32 million. And EBITDA will be around \$94 million.

**OID: So if your figures are correct, the current price is roughly equivalent to 4 times EBITDA?!**

**Burbank:** And 10 times earnings. That's right. And we're probably not too far off since the year is almost over.

But those are *reported* earnings — which, again, are depressed by a little over \$15 million of amortization (which, by the way, is deductible for tax purposes). And these figures assume a tax rate of 33% this year and 37.8% in 1998 and 1999.

Also, they sold their factory which had a book value of about \$29 million for a little over \$25 million. So to normalize earnings, we add back that nearly \$4 million loss.

Before we add back the \$15+ million of amortization, Elevadores Atlas' earnings next year should be up around \$50 million. They won't *report* \$50 million of earnings because they'll have some extraordinary expenses as a result of relocating their plant and some other things. But when we add back that \$15+ million of amortization plus those extraordinary expenses — even assuming no growth — we arrive at normalized earnings of \$61-62 million.

**OID: So using your estimate of normalized earnings, Elevadores Atlas is earning over 100% on equity and is selling at about 5.3 times earnings?**

**Burbank:** Yep. That's why it's our biggest position. Incidentally, another of your contributors — Acorn Funds' Ralph Wanger — owns this one, too.

They sold their factory to move production to another state in Brazil. And that move should give them much lower labor costs and a very large income tax break. But we don't know how much and haven't factored them in yet.

AN AWESOME MARGIN OF SAFETY, (A 10%± YIELD),  
WHILE YOU WAIT FOR A SEEMINGLY GREAT FUTURE.

**Bakar:** Also, we care about margin of safety. And because Elevadores Atlas is such a highly cash generative business, it pays out a very, very high dividend yield. Currently, the dividend yield, believe it or not, is 9.9%.

**OID: Wow, again.**

**Bakar:** So this instrument is like a convertible, only better — because it has high yield without a premium. We're getting paid to wait for very good things to happen with tremendous downside protection over and above the fundamentals of the business.

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VALUEVEST MANAGEMENT'S  
MARK BAKAR AND JOHN BURBANK  
(cont'd from preceding page)

**OID: Not bad.**

**Burbank:** And it gets better. Management has stated that they're going to pay nearly 100% of their earnings as dividends going forward. So the dividend yield is going up. Basically, whatever the P/E ratio is, the inverse is going to be the dividend yield ultimately.

**OID: So that based on its current price, you expect its dividend yield to gravitate up towards 18%!?**

**Burbank:** You've got it. The company simply doesn't need to reinvest much of its earnings to grow.

**OID: Speaking of growth, what kind of earnings and revenue growth do you expect from Elevadores Atlas?**

**Burbank:** Let me answer you this way: There's a huge pent-up demand in Brazil for housing.

**Bakar:** Tremendous pent-up demand.

**Burbank:** Essentially, there is no mortgage financing in Brazil. Therefore, Brazilians who want to buy a house or apartment need to come up with nearly all of the money.

**Bakar:** There basically hasn't been long-term lending for housing because of the legacy of hyperinflation. Understandably, no bank wanted to extend a loan for any longer than five minutes.

**Burbank:** But given that inflation's been strangled in Brazil — and given their screaming need for more housing — as the country gets richer, we expect a very big jump in housing starts and, therefore, elevators. Therefore, in the next year or two, we expect Elevadores Atlas' revenues and earnings to begin to grow at a rate which will attract more growth-oriented investors.

**Bakar:** And, meanwhile, the 10% dividend yield provides us with an additional margin of safety.

COMPARABLE COMPANIES SELL FOR MUCH MORE.  
WE'VE ACTUALLY PAID THOSE HIGHER PRICES.

**Bakar:** That brings up something else interesting — which is the *degree* of undervaluation of this business. Otis has a 50%-owned subsidiary that trades in Spain called Zardoya Otis [ZOT/SM].

Well, Zardoya Otis has roughly 20% higher sales than Elevadores Atlas and the same normalized earnings. However, their market cap is \$1.1 billion versus \$327 million for Elevadores Atlas.

**OID: Quite a few degrees of difference.**

**Bakar:** Zardoya Otis is trading at a multiple of 22 times earnings and 10.8 times enterprise value to EBITDA.

**OID: Much more in line with what you'd expect for a business with the characteristics you've described.**

**Bakar:** Absolutely. You certainly don't expect a business earning 100% on beginning of year equity and all of the other virtues of Elevadores Atlas to sell at less than 5-1/2 times normalized earnings and 4 times EBITDA.

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

**Bakar:** Zardoya Otis is a very attractive business. And we've owned it. But it's not *nearly* as attractive as Elevadores Atlas.

**OID: May we ask what kind of price you paid for it?**

**Burbank:** We paid about 8 times enterprise value, more or less, for Zardoya Otis. And we did well with it. We sold it, as I recall, for 10 or 11 times EBITDA.

**OID: The fact that you'd pay 8 times EBITDA for a similar business suggests that you do think highly of this business — especially since Zardoya Otis probably has far less growth potential than Elevadores Atlas.**

**Burbank:** We do. And learning about Zardoya Otis enabled us to understand the virtues of Elevadores Atlas and, therefore, invest in the IPO in which it was spun off. In fact, we were the first order received by ING Baring.

**Bakar:** And I think the *only* order...

**Burbank:** Judging from how the stock did. It came out at R\$11 per share — and straightaway dropped to R\$9.6. And that was because there's no stand-alone elevator company that's publicly traded in the U.S. So nobody understood it.

**Bakar:** Also, all most international investors want to buy in Brazil is Telebras and the other big stocks. And we own Telebras, too. But Telebras' returns on capital and equity pale beside those of Elevadores Atlas. And it isn't being run nearly as well.

**OID: How does Elevadores Atlas' valuation stack up to those of other Brazilian companies?**

**Bakar:** The Brazilian market is heavily weighted towards public sector giants. But the average company in Brazil is probably selling at 5 or 6 times EBITDA.

**Burbank:** Although most public sector electricity companies trade at a far higher multiple of EBITDA ratio than that of Telebras and most other companies.

**Bakar:** But those figures are low for several reasons: First, Brazilian companies, by and large, have no leverage. Second, they tend to have very, very low return on equity. For example, Telebras' return on equity is no more than 10% — although it's growing rapidly. And that's typical for companies in Brazil.

Price-to-book ratios are relatively meaningless in a country that's experienced hyperinflation. So Brazilian companies have extremely low price-to-book ratios — with the average price-to-book ratio of the unweighted average being probably no more than .6 or .7.

**OID: Interesting. So the average P/E multiple in Brazil is something around 10 times?**

**Burbank:** That's right — 10 or 11.

**OID: In which case Elevadores Atlas is selling at only about half of Brazil's market average P/E multiple — despite earning returns more than 5 times as high?!**

**Bakar:** It's a glaring inefficiency.

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VALUEVEST MANAGEMENT'S  
MARK BAKAR AND JOHN BURBANK  
(cont'd from preceding page)

THEY HAVE THE LEADING BRAND, THE LEADING SHARE,  
AND A MANAGEMENT CAPABLE OF KEEPING BOTH.

**OID:** *Usually there's a reason why something is cheap — sometimes a good one. What's the reason here?*

**Bakar:** We've spent a tremendous amount of time researching this company. There is no reason whatsoever — none — why it should be this cheap.

**OID:** *They're not losing market share?*

**Burbank:** Their market share is actually pretty stable. It's certainly not declining.

**Bakar:** That's right. Otis is the #2 player with a market share of only 19% or 20% — not much more than half that of Elevadores Atlas. And that's rare.

**OID:** *How so?*

**Burbank:** It's unusual to find a market in which both Otis and the other big international players are distant laggards share-wise — especially when they've been there as long as Otis has been in Brazil.

**OID:** *Is that based on unbridled competition? Is Otis free to go after Elevadores Atlas with guns blazing — and have they?*

**Bakar:** Absolutely. It's not a protected market. Elevadores Atlas is winning in wide-open competition.

**OID:** *The global brands aren't likely to prevail sooner or later? Is there no pattern along those lines?*

**Bakar:** Actually, there is a pattern. But, probably, the most common pattern is that Otis tries to buy 'em.

**Burbank:** Yeah. For instance, Otis bought into Zardoya about 25 years ago. And they just bought the shares of their South African subsidiary that they didn't already own for a substantial premium to what it was selling for — although it was a small operation that had been having lots of problems. So I don't think you can draw too many conclusions about the price they paid.

But I think it shows that Otis is trying to increase their ownership of operations around the world.

**OID:** *When the majors haven't bought the locals, they haven't tended to take share the old-fashioned way?*

**Bakar:** Not really. Otis is a formidable competitor and a great company who's basically been everywhere for a fairly long time. For instance, Otis South Africa is a 101-year old company. So these are not new businesses. But there's also Schindler [SHP/SW], a huge Swiss company which also has market share in Brazil. And then there's Kone [KONSB/FH], which is a Finnish company. So there's no shortage of competitors — all formidable.

**Burbank:** And Schindler is one competitor that doesn't concern itself with profitability. They have sales of \$4.1 billion. But its estimated earnings for 1997 are only \$85 million. That's it. And they've been taking share in Brazil. But it's all come from Otis. None of Schindler's share gains have come from Elevadores Atlas.

**OID:** *But shouldn't global players ultimately be able to afford heftier R&D outlays and, therefore, ultimately have superior products — not to mention bigger ad budgets?*

**Bakar:** That's true. And those players do have an advantage when it comes to certain cutting edge products for the biggest projects. But that segment probably accounts for not much more than 1% of the market.

Otis is struggling in Brazil. And for Elevadores Atlas to be able to maintain better share than a great company like Otis says a lot for their management.

**Burbank:** The people are another factor that give us comfort. We talk to managements all over the world. And I've never met a more shareholder-oriented management anywhere outside the U.S. than this one. They do everything you could possibly want — and more.

**OID:** *And management owns a substantial stake?*

**Burbank:** Yes, it does. We understand that following the completion of the spin-off from Industrias Villares [IVI4/BZ], the Villares family will own 15% of Elevadores Atlas. And the CEO's name is Plinio Musetti. However, his middle name is "Villares". He's actually part of the family. And family control can be a problem in some cases, but it's not here. He's U.S. educated. And we're extremely impressed with him — both in terms of his skills and his shareholder orientation.

**Bakar:** But we understand that management, aside from Musetti, owns less than 1%...

**Burbank:** And that might be viewed as a negative by many investors. But, again, I've very rarely encountered a management who's more concerned with shareholder value than these guys. They're very impressive.

**Bakar:** Incidentally, Musetti would like to initiate some kind of plan to incentivize management. And we think that's good news for shareholders, too.

**Burbank:** There really is nothing wrong here.

**Bakar:** In fact, at one meeting with Elevadores Atlas' management, we asked, "Has Otis ever approached you about buying your company?" And their answer was yes.

**Burbank:** And we have a contact at Otis, too. And he's very open with us about how highly he regards Elevadores Atlas. He's told us, for example, that it may be the most profitable elevator company in the world and that they'd love to buy 'em — that it's just a great franchise.

**Bakar:** Elevadores Atlas has a 35-36% share because it has the best brand image. People attribute more value to their apartments if their building has an Atlas elevator. It's a selling point. When you visit a construction site in Brazil — in Sao Paulo, for instance — and they're showing model apartments and drawings of the completed project, you frequently see the Elevadores Atlas sign on the poster. It's a status symbol to have an Elevadores Atlas elevator.

**OID:** *And, therefore, I gather that you're comfortable with Elevadores Atlas' competitive position long term?*

**Burbank:** Absolutely.

**Bakar:** Very.

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VALUEVEST MANAGEMENT'S  
MARK BAKAR AND JOHN BURBANK  
(cont'd from preceding page)

**Burbank:** Again, Elevadores Atlas is *it* in Brazil.

**OID:** *But couldn't someone who's it in other markets drop pricing in Brazil and buy the market?*

**Burbank:** They might. But, again, that's what Schindler is doing. And, so far, it hasn't been able to even put so much as a *dent* in Elevadores Atlas' market share. Actually, Elevadores Atlas could *increase* its market share if they wanted to. They don't *want* more share.

**OID:** *They don't?!*

**Burbank:** Aside from acquisitions, that's right — because they don't want to upset the market balance.

So almost anything's possible. However, to do what you're suggesting — even if it were ultimately successful — would be *enormously* expensive.

**Bakar:** So Elevadores Atlas has a great franchise, great management, dominant market share and enormous distribution muscle. What more could you want?

**OID:** *Long-term financing?*

**Bakar:** Anyone trying to replicate its infrastructure would have to do so at the same time they were fighting a motivated, well managed, deeply entrenched incumbent.

**OID:** *If you put it that way...*

**Burbank:** It would be far cheaper and more rational for anyone who wanted the market to buy Elevadores Atlas — even if they had to pay up some.

THERE ARE RISKS. AND WE KNOW *WHY* IT'S CHEAP,  
BUT WE DON'T THINK *ANYTHING'S* WRONG WITH IT.

**Bakar:** Why, then, is it so cheap? Elevator companies sometimes get grouped in the construction sector — *wrongly* so, we think, for all of the reasons that we've described.

**OID:** *Plus, I gather that Elevadores Atlas' returns have been somewhat hidden within Industrias Villares' and that they usually don't get recognized right away.*

**Bakar:** That's right. And this is virgin territory. Getting information on over-the-counter stocks 20 years ago wasn't nearly as easy as it is today. At that time, they were on the frontier. Where's the frontier today? Investing internationally. And, therefore, we think potential returns — for those willing and able to do the work — are higher.

But there will be occasional panics — as there was recently in Brazil with Telebras.

**Burbank:** The market took Telebras from \$147 on October 21st to \$85 on October 28th — in one *week*.

**OID:** *We accomplish the same thing domestically...*

**Bakar:** We can't control capital flows in and out of the world's capital markets.

**OID:** *Feel free to call anytime.*

**Bakar:** Also, domestic investors rarely have to deal with issues involving the currency — the value of which is

also going to gyrate wildly on occasion. For example, the Korean won's value in U.S. dollars dropped nearly 40% recently in *four days*!

But if the businesses are sound and the numbers are true — and we have 100% conviction that they are in the case of Elevadores Atlas — then those price swings represent opportunities. And in the case of Elevadores Atlas, we think that there's very little in the way of company-level risks. We think that this is a pretty bulletproof industry. Is there a risk of elevators becoming technologically obsolete or that people will stop living in high rises? I don't think so.

**OID:** *What, then, could turn this one into a mistake — aside from the normal risks in emerging markets: nationalization, geopolitics, a competitor marrying into the ruling family, etc.?*

**Bakar:** In terms of the macro risks you hear about, we think some have merit and some don't. But we think the *perceived* risks are far greater than the *actual* risks. On the other hand, if there's a macro meltdown in Brazil, or anywhere else, then *every* company would be effected.

**OID:** *But aside from the company being nationalized, what could cause a permanent loss of value?*

**Burbank:** They'd have to ruin their brand image. Management would have to run the company very poorly. And we think that's highly unlikely.

Actually, there is one risk — although it's hardly one that keeps us up at night. Industry margins on service revenues probably range between 30% and 50%. And Elevadores Atlas' margins are near the top of that range. So it's possible that its margins decline at some point. However, that's not happening today.

**Bakar:** You get an occasional unpleasant surprise in *any* business. But the odds of something really bad happening, we think, is very slim.

Of course, Brazil could always fall apart. And the real is somewhat overvalued. There's no question about that. And you can't hedge the real in the currency market. The only way to do it economically is by shorting stocks — which we have done, albeit very little.

But we're *happy* it's in Brazil. If it were in Sri Lanka or Pakistan, we wouldn't be nearly as excited about it. So we have a big bet there. And we're hedged not because we expect a devaluation, but rather because we want to be in business even if the whole world blows up. But we don't think *anything's* wrong with this one.

**OID:** *Marty Whitman says everything's got something wrong with it.*

**Burbank:** Most people consider this business cyclical and hard to understand. But we see fewer risks in Elevadores Atlas than we see in almost any other business we know of — particularly at anything near its valuation.

**Bakar:** We wish *all* our investments could match up to this one.

AND JUST IN CASE IT'S NOT CHEAP ENOUGH,  
HERE'S A WAY TO BUY IT CHEAPER STILL.

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

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VALUEVEST MANAGEMENT'S  
MARK BAKAR AND JOHN BURBANK  
(cont'd from preceding page)

**Bakar:** We've paid as little as R\$9.6 and as much as R\$13. But I mentioned that Elevadores Atlas is being spun off from Industrias Villares.

**Burbank:** Well, only 26% of Elevadores Atlas is public. Industrias Villares owns the remaining 74%. And that stake accounts for 90% of the assets of Industrias Villares. But Elevadores Atlas was able to convince shareholders of the parent company to spin off all of its remaining shares to Industrias Villares' shareholders.

**Bakar:** Which will make its stock more attractive, too, because the float will be greater. So it'll be more liquid.

And you can actually buy Elevadores Atlas today at an effective discount of about 10% below its current price, which we're doing, by buying Industrias Villares.

**OID: Really?!**

**Bakar:** Really. We bought Elevadores Atlas today at an effective price of R\$13± per share — versus the current price of R\$14-1/2 — by buying Industrias Villares.

**OID: And what does that imply that you were paying for Industrias Villares?**

**Bakar:** We were paying R\$830 per 1,000 shares of Industrias Villares — or R\$.83 per share. And here's how it works: For every 15.6345 shares of Industrias Villares you buy, you receive one share of Elevadores Atlas. So, if you do the math, you'll see that we were buying Elevadores Atlas for R\$12.98 per share.

**OID: And, so, dividing that R\$12.98 by your 1.11 reais per \$1 exchange rate means that you're only paying about \$11.69 per share of Elevadores Atlas — which represents a discount of nearly 11-1/2%?**

**Bakar:** That's right.

**OID: So if you're right about its normalized earnings, you're only paying 4.8 times earnings?!**

**Bakar:** Exactly. And, then, besides its stake in Elevadores Atlas, Industrias Villares also has a little less than R\$100 per share of other assets — including its stake in a publicly traded steel company, an electric generator business and a hodgepodge of other industrial assets. But we simply disregard those.

**Bakar:** We treat the stub like a Christmas present — although we do plan to sell it.

**OID: So your net cost per share is actually even less than the \$11.69 per share you mentioned earlier.**

**Bakar:** That's right.

**OID: Double wow.**

**Bakar:** It's very sweet. I challenge any of your contributors to name one company in the U.S. with a normalized return on equity near 100% and anything approaching the other qualities that Elevadores Atlas has that's selling at less than 5 times earnings.

**OID: I hope they'll take your challenge personally —**

**and give us a call.**

**But if everything you say about it is true, wouldn't they enhance shareholder value more by repurchasing shares rather than paying dividends?**

**Burbank:** They talk about it a lot. And they'd prefer to buy back shares.

**Bakar:** And we'd vastly prefer that they do so.

**Burbank:** But right now, they're hampered in terms of what they can do. In Brazil, you can buy back shares, but you can only do it with retained earnings. And because they were only spun off from Industrias Villares in the fourth quarter of last year and have paid out so much of their earnings in dividends, they don't have sufficient retained earnings to do that.

But they definitely will be buying back shares — particularly after Industrias Villares completes spinning off the remainder of its shares. And that spin-off is supposed to be completed sometime in mid-February.

**OID: It sounds awesome.**

**But some of these ideas sound both so cheap and so attractive that they're almost hard to believe.**

**Bakar:** They're amazing values and incredible stories, but I know they're true.

**OID: Are they particularly attractive or are they representative of the things you're doing generally?**

**Bakar:** I think that they're relatively representative. We could talk about lots of different things today with very similar fundamentals — because, frankly, the kinds of things we like to do have been blowing up left and right. You definitely picked the right time to call.

**OID: You clearly seem to have more intriguing ideas than we have pages — 64-page edition or not.**

**Bakar:** And I'm sure Oliver Ehrenberg could tell you about just as many that you'd like just as much as these. I'm sorry that he couldn't be a part of this feature.

**OID: If you guys don't warn him about the experience, maybe we can correct that omission at some point.**

**Bakar:** Our lips are sealed — although, frankly, I do feel like I'm back in college and I just completed my finals.

**Burbank:** He'll be a better man for it — if he survives. I look forward to spending all my major holidays with you.

**OID: Thanks for sharing some intriguing ideas and eye-opening insights with us.**

**Bakar:** We enjoyed it.

**Burbank:** Our pleasure.

—OID

For additional information  
you may contact:

VALUEVEST MANAGEMENT COMPANY  
CITICORP CENTER  
ONE SANSOME STREET, 39TH FLOOR  
SAN FRANCISCO, CA 94104



WESCO FINANCIAL'S CHARLIE MUNGER  
WORLDLY WISDOM REVISITED  
(cont'd from page 1)

bring you Worldly Wisdom Revisited — excerpts from a lecture and answers to student questions thereafter during a visit last year to a Stanford Law School course he endowed entitled, "Business: What Lawyers Should Know." The course is taught by Professor William Lazier, without whose assistance this feature would not have been possible.

As always, we highly recommend that you give Munger's comments a thorough reading, re-reading, etc. We believe the vein to be enormously rich and very well worth the mining. We hope you find it equally so.

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HOW DO YOU GET WORLDLY WISDOM?  
TAKE THE BEST MODELS FROM ALL DISCIPLINES.

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Without learning, Berkshire wouldn't be what it is today.

**Charlie Munger:** What I'm going to try to do today is to extend the remarks I made two years ago at the U.S.C. Business School.... You were assigned a transcript of my U.S.C. talk. And there's nothing I said then that I wouldn't repeat today. But I want to amplify what I said then....

[It's] perfectly clear ... that if Warren Buffett had never learned anything *new* after graduating from the Columbia Business School, Berkshire would be a pale shadow of its present self. Warren would have gotten *rich* — because what he learned from Ben Graham at Columbia was enough to make anybody rich. But he wouldn't have the kind of enterprise Berkshire Hathaway is if he hadn't kept *learning*.

What do you need? The best models from all disciplines.

**Munger:** How do you *get* worldly wisdom? What system do you use to rise into the tiny top percentage of the world in terms of having sort of an elementary practical wisdom?

I've long believed that a certain system — which almost any intelligent person can learn — works way better than the systems that *most* people use. As I said at the U.S.C. Business School, what you need is a latticework of mental models in your head. And you hang your actual experience and your vicarious experience (that you get from reading and so forth) on this latticework of powerful models. And, with that system, things gradually get to fit together in a way that enhances cognition.

And you need the models — not just from one or two disciplines, but from *all* the important disciplines. You need the best 100 or so models from microeconomics, physiology, psychology particularly, elementary mathematics, hard science and engineering [and so on].

You need not be an expert, but you must learn 'em right.

**Munger:** You don't have to be a huge expert in any of those fields. All you've got to do is take the really *big* ideas and learn them early and well.

You *can't* learn those 100 big ideas you really need the way many students do — where you learn 'em well enough to bang 'em back to the professor and get your grade and then you empty them out as though you were emptying a bathtub so you can take in more water next time. If *that's*

the way you learn the 100 big models you're going to need, [you'll be] an "also ran" in the game of life.

You have to learn the models so that they become part of your ever-used repertoire.

THINK THINGS THROUGH FORWARD *AND* BACKWARD.  
IT WORKS IN ALGEBRA AND IT WORKS IN LIFE.

An incredibly useful trick: thinking things through backwards.

**Munger:** By the way, there's no rule that you can't add another model or two even fairly late in life. In fact, I've clearly done that. I got *most* of the big ones quite *early*. However, once you've gotten these models in your head, what else do you need?

Well, there's one mental trick that's *unbelievably* useful. And that is, as you think through reality using these models, think it through forward and also think it through *backward*. In other words, follow the injunction of the great algebraist, Carl Jacobi, who said, "Invert. *Always* invert."

You're absolutely no good in algebra if you can't turn the problems around and solve them backwards. Indeed, if I ask any of you who plan to get married and have five children, "What are the odds that at least one of them will be a girl?," you can all solve that immediately if you do it backwards. But if you try and do it forward, it's hell on earth. So Jacobi was plainly *right*.

What worked for Jacobi in algebra works in life.

**Munger:** And what worked for Jacobi in algebra works in the *rest* of life. For example, if you were hired by the World Bank to help India, it would be very helpful to determine the three best ways to *increase* man-years of misery in India — and, then, turn around and *avoid* those ways. So think it through backward as well as forward. It's a trick that works in algebra and a trick that works in life.

If you don't, you'll never be a really good thinker. That's just the way [it is]. When it gets complicated, it's very helpful to think it through forward and backward.

Always try to disprove your own assumptions.

**Munger:** And, of course, the mental habit of thinking backward *forces* objectivity — because one of the ways you think a thing through backward is you take your initial assumption and say, "Let's try and *disprove* it."

That is *not* what most people do with their initial assumption. They try and *confirm* it. It's an automatic tendency in psychology — often called "first-conclusion bias." But it's only a tendency. You can train yourself away from the tendency to a substantial degree. You just constantly take your own assumptions and try and disprove them. That's part of the winning game of thinking both forward and backward.

Darwin proved the value of a diligent, objective curiosity.

**Munger:** Darwin is a *great* model in terms of objectivity. And the reason why I especially like Darwin is that his example provides reasonable hope of mental improvement to a great many people. Almost everyone in this room has a higher I.Q. than Darwin. Yet, Darwin's body now lies right next to Newton's in Westminster Abbey.

Part of his secret was *doggedness*. Part of his secret was an immense *objectivity*. And part of his secret, of course,

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WESCO FINANCIAL'S CHARLIE MUNGER  
WORLDLY WISDOM REVISITED: LESSON #2  
(cont'd from preceding page)

was an extreme *curiosity*. And what a diligent, objective curiosity will do for you in this life to elevate you above your intellectual betters — [who have] minds that work faster than yours — is a *lot*. If Darwin could take modest intellectual endowments and end up next to Newton in Westminster Abbey, we can *all* learn something from him.

And one of the great things to learn from Darwin is the value of extreme objectivity. He tried to *disconfirm* his ideas as soon as he got 'em. He quickly put down in his notebook anything that disconfirmed a much-loved idea. He *especially* sought out such things.

Well, if you keep doing that over time, you get to be a perfectly *marvelous* thinker instead of one more klutz repeatedly demonstrating first-conclusion bias.

AND FORCES FROM THESE MODELS COMBINE  
— SOME NEGATIVELY, SOME EXPLOSIVELY.

Big forces from these models combine in more ways than one.

**Munger:** The next great model is the idea that especially big *forces* often come out of these 100 models — when several models *combine*.... You get *lollapalooza* effects when two, three or four forces are all operating in the same direction. And, frequently, you don't get simple addition. It's often like a critical mass in physics where you get a nuclear *explosion* if you get to a certain point of mass — and you don't get anything much worth seeing if you *don't* reach the mass.

Sometimes the forces just add like ordinary quantities and sometimes they combine on a break-point or critical-mass basis. And you've just got to understand....

It's true. Life is just one damn relatedness after another.

**Munger:** More commonly, the forces coming out of these 100 models are *conflicting* to some extent. And you get huge, miserable trade-offs.

But if you can't think in terms of trade-offs and recognize trade-offs in what you're dealing with, you're a horse's *patoot*. You clearly are a *danger* to the rest of the people when serious thinking is being done. You have to recognize how these things combine. And you have to realize the truth of biologist Julian Huxley's idea that, "Life is just one damn relatedness after another." So you [must] have the *models* and you [must] see the *relatedness* and the effects from the relatedness.

You want a lot of autocatalysis in your career & business life.

**Munger:** Another model that I very much like, I've taken from E.O. Wilson, Harvard's great ant specialist biologist — and that's *autocatalysis* in chemistry. If you get a certain kind of process going in chemistry, it *speeds up on its own*.

(continued in next column)

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So you get this marvelous *boost* in what you're trying to do that runs on and on. Now, the laws of physics are such that it doesn't run on *forever*. But it runs on for a goodly while. So you get a huge boost. You accomplish A — and, all of a sudden, you're getting A + B + C for awhile.

Well, you want a *lot* of autocatalysis in your career and your business life, etc. So you *look* for autocatalytic effects.

THE BEST ACADEMIC VALUES REALLY WORK  
AS WELCH, BUFFETT & GRAHAM HAVE SHOWN.

Worldly wisdom is quite academic. Witness Welch & Buffett.

**Munger:** Well, doesn't this sound way too academic for somebody who's coming in from the marts of trade and talking about worldly wisdom? Is practical worldly wisdom as academic as all this sounds? My answer is, "Yeah, it is."

Your assigned reading for today included the latest annual letters from Jack Welch and Warren Buffett relating to *General Electric* and *Berkshire Hathaway*, respectively. Jack Welch has a Ph.D. in engineering. And Warren plainly could have gotten a Ph.D. in any field he wanted to pursue. And both gentlemen are inveterate teachers.

Worldly wisdom is *quite* academic when you get right down to it. Look at what General Electric has achieved — and, for that matter, what Berkshire Hathaway has achieved.

And don't forget Graham....

**Munger:** Of course, *Warren* had a professor/mentor — *Ben Graham* — for whom he had great affection. Graham was so academic that when he graduated from Columbia, three different academic departments invited him into their Ph.D. programs and asked him to start teaching immediately as part of the Ph.D. program: [those three departments being] literature, Greek and Latin classics, and mathematics.

Graham had a *very* academic personality. I knew him. He was a lot like Adam Smith — very preoccupied, very brilliant. He even *looked* like an academic. And he was a good one. And Graham, without ever really *trying* to maximize the gaining of wealth, died rich — even though he was always generous and spent 30 years teaching at Columbia and authored or co-authored the best textbooks in his field.

So I would argue that academia has a *lot* to teach about worldly wisdom and that the best academic values really *work*.

DON'T BE LIKE THE WORLD GENERALLY.  
INSTEAD, BE LIKE THE LITTLE RED HEN.

Be multi-disciplinary — whatever academia & business say.

**Munger:** Of course, when I urge a multi-disciplinary approach — that you've got to have the main models from a broad array of disciplines and you've got to use them *all* — I'm really asking you to ignore jurisdictional boundaries.

And the world isn't organized that way. It *discourages* the jumping of jurisdictional boundaries. Big bureaucratic businesses discourage it. And, of course, academia *itself* discourages it. All I can say there is that, in that respect, academia is horribly wrong and dysfunctional.

And some of the *worst* dysfunctions in businesses come from the fact that they balkanize reality into little individual departments with territoriality and turf protection and so

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WESCO FINANCIAL'S CHARLIE MUNGER  
WORLDLY WISDOM REVISITED: LESSON #2  
(cont'd from preceding page)

forth. So if you want to be a good thinker, you must develop a mind that can *jump* the jurisdictional boundaries.

You don't have to know it all. It's like contract bridge....

**Munger:** You don't have to know it all. Just take in the best, big ideas from all these disciplines. And it's not that hard to do....

I might try and demonstrate that point by [using the analogy of] the card game of contract bridge. Suppose you want to be good at declarer play in contract bridge. Well, you know the contract — you know what you have to achieve. And you can count up the sure winners you have by laying down your high cards and your invincible trumps.

But if you're a trick or two short, how are you going to get the other needed tricks? Well, there are only six or so different, standard methods: You've got long-suit establishment. You've got finesses. You've got throw-in plays. You've got cross-ruffs. You've got squeezes. And you've got various ways of misleading the defense into making errors. So it's a very limited number of models.

But if you only know one or two of those models, then you're going to be a horse's patoot in declarer play.

What works in contract bridge works in life.

**Munger:** Furthermore, these things interact. Therefore, you have to know how the models interact. Otherwise, you can't play the hand right.

Similarly, I've told you to think forward and backward. Well, great declarers in bridge think, "How can I take the necessary winners?" But they think it through *backwards*, [too. They also think,] "What could possibly go wrong that could cause me to have too many *losers*?" And *both* methods of thinking are useful. So [to win in] the game of life, get the needed models into your head and think it through forward and backward. What works in bridge will work in life.

That contract bridge is so out of vogue in your generation is a tragedy. China is way smarter than we are about bridge. They're teaching bridge in *grade* school now. And God knows the Chinese do well enough when introduced to capitalist civilization. If we compete with a bunch of people that really know how to play bridge when our people don't, it'll be just one more disadvantage we don't need.

The world isn't multi-disciplinary. But you can be.

**Munger:** Since your academic structure, by and large, doesn't encourage minds jumping jurisdictional boundaries, you're at a disadvantage because, in that one sense, even though academia's very useful to you, you've been mistaught.

My solution for you is one that I got at a very early age from the nursery: the story of the Little Red Hen. The punch line, of course, is, "Then I'll do it *myself*," said the Little Red Hen."

So if your professors won't give you an appropriate multi-disciplinary approach — if each wants to overuse his own models and underuse the important models in other disciplines — you can correct that folly *yourself*. Just because he's a horse's patoot, you don't have to be one, too. You can reach out and grasp the model that better solves the overall problem. All you have to do is *know* it and

develop the right mental habits.

And it's kind of *fun* to sit there and outthink people who are way smarter than you are because you've trained yourself to be more objective and multi-disciplinary....

Furthermore, there's a *lot* of *money* in it — as I can testify from my own personal experience.

TESTING OUT OUR MULTI-DISCIPLINARY APPROACH  
WITH A (MOSTLY) HYPOTHETICAL EXAMPLE....

Does this stuff really work? Let's find out....

**Munger:** If I'm right in this multi-disciplinary approach which exalts proper academic values, I ought to be able to come up with some exercise that demonstrates its value. So I want you to join me today in a very odd mental construct: Let's go back to 1885 in Atlanta and invent from scratch a new nonalcoholic beverage business out of which we will all get rich. What are we going to do?

Our first decision: Will our beverage be hot or cold?

**Munger:** Well, our first [decision] is [whether we're] going to have a *cold* beverage or a *hot* beverage. By the way, today we're allowed to use all the models that academia has developed — including those developed after 1885. That's the rule of today's game.

Well, to me, it's obvious that we go for a cold beverage. Man has had fire for many eons and hot beverages are widely available. Cold beverages are *hard*. There's no *refrigeration* in 1885. And the general delivery of ice is galloping like crazy, but it's far from having [become ubiquitous]. Furthermore, we know enough physics to see that refrigeration is feasible and will come along in due course. We also know that physiology requires huge ingestion of preferably cold liquid when man is working hard or is hot from climatic effects. So there's a huge *tailwind* to be gained [by creating] a cold beverage that we aren't going to have with a hot beverage.

So just by knowing a few simple models from physics and physiology, we can see it has to be a cold beverage.

FROM ECONOMICS & LAW, TRADEMARK & PROTECTION.  
FROM PSYCHOLOGY, CONDITIONED REFLEXES....

We'll never get very rich without a trademark and a brand.

**Munger:** How do we make a lot of money out of a new cold beverage? Out of twin doctrines from microeconomics and law, obviously it must be a *trademarked* beverage with its own label and trade dress. And we must have legal protection for that trademark and trade dress.

And we have to arrange that people don't order just a generic bottle or glass of our beverage. They must order it by name — our trademarked name. We'll never get very rich from this business except by using a trademark and creating a brand strong enough that people order our new beverage by its trademarked name.

That, again, is obvious based on elementary models taken from the disciplines of law and microeconomics.

If it's repeat behavior we want, we next turn to psychology....

**Munger:** Obviously, we must get a lot of repeat business for our beverage — repeat business that is *triggered* by our trademark.

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WORLDLY WISDOM REVISITED: LESSON #2  
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Well, what model am I talking about whereby people automatically repeat the activity of buying and consuming something in response to a trademark? Well, you look in your psychology book. And, lo and behold, in the most important two segments in every psychology book, you find *conditioned reflexes*. Obviously, if someone is constantly buying a trademarked beverage, they're demonstrating a conditioned reflex — with the trademark, the shape of the bottle, the color of the liquid, etc. being the *stimulus* and their buying it and consuming it being the *response*.

In major part, your business is operant conditioning.

**Munger:** So you read on in the psychology book [looking for] very elementary models. And [under] conditioned reflexes is *operant conditioning* — Skinnerism. The food value and so forth of the beverage is the *reinforcer*. And the trade dress, trade name and look of the beverage is the *stimulant*. So you've got operant conditioning — straight out of B.F. Skinner. That, in major part, is what your business is when you try to establish a beverage sold under a trademark.

MERE ASSOCIATION HAS ENORMOUS POWER  
IN BUSINESS — AT LEAST, AS PROPERLY DEFINED.

"Pavlovian mere-association effects" have enormous power.

**Munger:** Then, you go on to the second kind of conditioned reflex — and that's straight Pavlov, except the textbooks often call it "classical conditioning." That's a terrible name — because it doesn't guide the mind to the full power of the idea.

So, like the Little Red Hen, I don't have to use a silly name just because the psychology professors do. So I'll invent my own name. I call what the textbooks refer to as classical conditioning "Pavlovian mere-association effects" — because mere association has *enormous* power. And your mind is guided to recognition of that when you use a name like "Pavlovian mere-association effects."

Well, how do you *get* Pavlovian mere-association effects? Obviously, you *associate* this beverage and its trademarks with every other good thing that people like generally: exalting events, sex objects, happy times — you name it.

(continued in next column)

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Pavlovian mere association even distorts cognition.

**Munger:** Of course, that's what Coca-Cola's advertising campaign *does*. There's never a big, important, positive-image-type event in the world that Coca-Cola isn't there. They *know* that these Pavlovian mere-association effects [increase the consumption] of their beverage.

In fact, it actually improves the drinker's *experience*. The human mind, under principles of psychology, works in such manner that advertising actually makes you *enjoy* Coke more when you're drinking it. It doesn't just induce you to try it. It actually improves its *effects*. In effect, cognition is *distorted* by Pavlovian mere-association effects.

And, therefore, we're going to use *tons* of Pavlovian mere-association effects. We're also going to make this beverage a maximized reinforcer. And we're going to develop a very clever trade name and trade dress in order to maximize Pavlovian mere-association effects.

Business school professors haven't quite got it yet.

**Munger:** If you ask the average business school professor, "What's the business of the Coca-Cola Company?", he won't give you the right answer. But the right answer was given to me once by Don Keough — the very eminent, recently retired president of Coca-Cola. And what Keough said was, "The business of the Coca-Cola Company is to create and maintain conditioned reflexes."

So Keough and **Munger** have the same idea exactly. And, by the way, we're right. As for the business school professors who talk in a different language — well, maybe they should change.

BY COMBINING AND REINFORCING ELEMENTS,  
WE CAN ACHIEVE LOLLAPALOOZA EFFECTS.

Next, we want as powerful a reinforcing effect as we can get.

**Munger:** In designing our new beverage, we're mindful of *combinatorial* effects. And we're mindful of *autocatalysis* and so forth. Once we get this thing going, we want it to run. We want as powerful a reinforcing effect as we can possibly get. So we together think out what we're going to do to this beverage to make it a powerful reinforcer. And what do we do? We put in *food* value. The reason rats, pigeons and so forth are trained in operant conditioning with food is that food is nearly an automatic reinforcer. So we're going to include some caloric value in our drink.

And why stop with food value? We can include a stimulant.

**Munger:** Another reinforcing trick is a *stimulant* — for instance, caffeine. Why should we hold back? We want fancy combinatorial effects. And once we realize that we get extra-powerful effects — what I call lollapalooza effects — from combining a bunch of things to work in the same direction, we're not going to stop with food value. We're going to have food value *plus* a stimulant: caffeine. It's *obvious*.

Both plainly work. [So there's] no reason not to combine them. We want the double effect. It's better reinforcement.

And we care about the totality of the experience. So flavor.

**Munger:** Flavor is a very important reinforcer. And, here again, we know enough physiology and biology to know that people are genetically programmed to like sweet flavors. So it's going to be some kind of a sweet flavor.

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WESCO FINANCIAL'S CHARLIE MUNGER  
WORLDLY WISDOM REVISITED: LESSON #2  
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Aroma and texture are also very much part of the experience. And, therefore, we're going to care about the totality of the essential experience which people have as they consume our new beverage.

You win big by getting two or three forces working together.

**Munger:** We'll put sugar in because it's a stimulant, too. By making our caloric content sugar, we get food value plus two kinds of stimulants.... Again, I'm trying to get lollapalooza effects by combining. It's perfectly *obvious*. This is the way you win big in the world — by getting two or three forces working together in the same direction.

NEXT, THINKING BACKWARD, WHAT *DON'T* WE WANT?  
AFTERTASTE, COPYCATS, NEGATIVE ASSOCIATIONS....

What *don't* we want? People *discouraged* from drinking it.

**Munger:** But, as I said, you have to think things through forward *and* backward. So, next, we'll think it through backward. It's *dangerous* to just think forward. That way, you miss important points. Let me demonstrate:

What *don't* we want in our new drink? Well, again, we know enough elementary physiology to know that animals are genetically programmed to reject *surfeits* of certain flavors. It's not good for animals just to gorge and gorge on some things. So there are automatic turnoff mechanisms in human physiology.

And we want people to just keep *swilling* our new drink — time after time with no surfeit mechanism discouraging additional consumption. If you try and drink six cream sodas in a row on a hot day, you'll *choke* to death on the aftertaste. It will be a ghastly experience.

So by just thinking backward, we get a huge and useful bit of wisdom. We don't want *any* aftertaste. We want people to be [able to swill] this stuff all day long in hot climates — in cold climates, too, for that matter. We don't want them *discouraged* by their own physiological response to an aftertaste.

So we want to experiment around and get a flavor with virtually no aftertaste. And, incidentally, that's exactly what Coca-Cola has — except they weren't smart enough to do it my way on purpose when they started out. They just stumbled onto the right answer.

And we don't want the huge cost of shipping *water*.

**Munger:** What else don't we want? Well, again, just [using] elementary engineering and mathematics, we know that we don't want to ship a lot of *water* and extra weight and volume of containers all over the world. Obviously, that would cost us a fortune. Therefore, basically, what we're going to sell is *syrup*.

What else don't we want? We don't want it easily copied.

**Munger:** Also, we're trying to add additional lollapalooza effects. So what else can we do? Well, it happens that *carbonation* increases the overall sensual experience — in terms of flavor and so forth.... Besides, we like making it a little more difficult for competitors to copy.

We want it to be reasonably complicated because we want to achieve a big edge that others can't easily copy. Therefore, we carbonate our drink.

So far, so good....

**Munger:** So after we've experimented, ...we're going to use caffeine and sugar as stimulants, have a marvelous flavor with virtually no aftertaste, carbonate our beverage and make it cold. All of this takes care of providing reinforcement to maximize the creation of a conditioned reflex based on operant conditioning....

And we know that we don't want it to look *cheap*.

**Munger:** The next problem is to maximize the obtaining of a conditioned reflex grounded in Pavlovian mere-association effects. But when we finally solve the earlier problems, our liquid is clear — like 7-Up. But if we think in terms of Pavlovian mere-association effects, we realize that our liquid looks cheap and *ordinary* — like water. And we don't want *that*. We want it to look *expensive* and *exotic*. So we stick in burnt caramel or whatever and color the natural flavor of the drink to something vaguely like wine.

We think Pavlovian mere-association effects will be way stronger if our product doesn't look cheap and ordinary. So we stick in this artificial color. And, now, we pretty well have our beverage.

Pavlovian mere-association effects suggest we make it look expensive, exotic and unusual. So we invent a name. And, somehow, we come up with Coca-Cola. We have an exotic script. We make the bottles shaped in a slightly unusual way — and the glasses, too, for that matter. And now we've got trade dress.

So now we're prepared to go out into the world with our new beverage.

MERE-ASSOCIATION EFFECTS DICTATE LOOK & FEEL  
— A SECRET FORMULA, HEAVY ADVERTISING, ETC.

We can't copyright the flavor. So we'll do the next best thing.

**Munger:** And, obviously, we want *protection*. We know enough microeconomics to know that anything that works will get competition.... We think forward and backwards. And thinking backwards, we know that we need *antidotes* to competition.

Well, you can't copyright or trademark a flavor. So we do the next best thing. We're going to keep the formula *secret*.

Flavors can be quite tricky to duplicate — even today.

**Munger:** And this is [way back in] 1885. They don't have mass spectrometers. It's *hard* to duplicate flavors.

One of my favorite business stories comes from *Hershey*. They get their flavor because they make their cocoa butter in old stone grinders that they started with in the 1800s in Pennsylvania. And a little bit of the husk of the cocoa bean winds up in the chocolate. Therefore, they get that odd flavor that people like in Hershey's chocolate.

Hershey knew enough when they wanted to expand into Canada to know they shouldn't change their winning flavor. Therefore, they copied their stone grinders.... Well, it took them five *years* to duplicate their *own* flavor. As you can see, flavors can be *quite* tricky.

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WESCO FINANCIAL'S CHARLIE MUNGER  
WORLDLY WISDOM REVISITED: LESSON #2  
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Flavors are so tricky that permanent royalties are paid.

**Munger:** Even today, there's a company called International Flavors and Fragrances. It's the only company I know that does something on which you can't get a copyright or a patent, but which nevertheless receives a *permanent royalty*. They manage to do that by helping companies develop flavors and aromas in their trademarked products — like shaving cream. The slight aroma of shaving cream is *very* important to consumption. So all of this stuff is terribly important.

At any rate, we're going to keep our formula secret. We'll make a big hoopla over our secrecy. And that will add to our product's *mystique* — which will further enhance its mere-association effects....

Mere-association effects dictate heavy advertising & free signs.

**Munger:** And since we want to play this Pavlovian mere-association game in all of our advertising, we know a heavy percentage of revenues will have to go into advertising.

And we know we have to give free signs to everybody who sells our product because (A) it advertises the product; (B) there's an *informational* advantage (it tells people where they can get the product if they want it); and (C) we don't have to pay for the space; all we have to do is pay for the sign. So we're going to give free signs to all the drug stores, etc.

GETTING THERE FIRST OFFERS HUGE ADVANTAGES:  
E.G., SOCIAL PROOF, ECONOMIES, DISTRIBUTION, ETC.

If we sweep the country fast, we can harness social proof.

**Munger:** And we get the idea early that we're going to sell it both in syrup form to drugstores, etc., and as a complete beverage in containers.

Now we get into problems about how we're going to distribute our product. So we think through autocatalysis again. And we realize that if we can sweep the country *fast* with our product, we harness another doctrine right out of the psychology books: *social proof*. If you see everybody else drinking Coca-Cola, you're likely to drink it. People are *enormously* influenced by what they see other people doing. Indeed, they're *enormously* influenced to *misthink* because they see other people *misthinking* in the same way....

There are just huge advantages to getting there first.

**Munger:** Also, we get a big informational advantage if we can buy all kinds of advertising, sweep the country first and cheaply spread our image over countrywide sales while competitors suffer under poorer advertising economics. So there are *huge* advantages to getting there first.

Competitive factors dictate being ubiquitous, too.

**Munger:** Also, think through operant conditioning — again, going into a reverse mode. How do you *lose* a conditioned reflex that's working for you? Well, the customer tries something else and discovers that *it's* a big reinforcer. So he shifts brands.

We know, in matrimony, that if you're always *available*, the spouse is less likely to shift brands. And people don't

tend to organize marriage to include permanent long separations. Similarly, if you're selling a product and it's always available, people are less likely to shift to some other product and get reinforced by it.

So availability has to be a *religion* in our new business. And, indeed, availability is a religion at Coca-Cola. And, again, it ties right into the psychology books.

It helps distribution as a matter of logistics and so on, too. But it *protects* the *conditioned reflex* business by preventing the other guy's product from getting reinforced because yours is always available.

LIKE COCA-COLA, WE'LL FRANCHISE —  
BUT WE WON'T MAKE THEIR MISTAKES.

The fastest way to sweep the country is to franchise.

**Munger:** All right, now we have Coca-Cola. We have our distribution in mind. We then have to decide *how* we're going to sweep the country fast. Now we get into *relatedness* — trade-offs. The fastest way to do it is to franchise. After all, we're poor and small when we start. And that's the way that Coca-Cola did it.

We won't count on there never again being inflation.

**Munger:** But we have the advantage in today's exercise of playing the game in 1885, but knowing what we know today — of having modern knowledge. And, therefore, very importantly, we won't do what the Coca-Cola Company was so mistaken to do as it started out — which was to give bottling franchises in perpetuity at *fixed* prices for syrup. That was *insane*.

Well, it just so happened that 1885 was right in the middle of a long period of stable-to-declining prices in the English-speaking world — a very remarkable period. However, the Coke people failed to think rationally about what they were doing.

If they'd assimilated a broad, general education, they'd have remembered that the price of wheat in drachmas during the decline of the Roman empire rose by 50,000% and that the failure rate of all great civilizations is 100% — and they wouldn't have assumed there was never going to be any *inflation*.

Again, if you have an appropriate education, you can avoid some mistakes that other people make. Of course, the Coke people should have made a different decision under which they could make bottlers pay for advertising that the whole system, including the bottlers, needed.... And, clearly, you won't guarantee a fixed price for syrup with its expensive ingredients, including sugar. An ever-fixed syrup price can *ruin* you — under inflationary conditions or under conditions requiring more advertising.

And we'll model our distribution more like McDonald's.

**Munger:** And, clearly, we want more control over our franchisees than Coca-Cola originally got. We want to do it more like McDonald's did way later....

Well, you get the general idea. These academic ideas are *enormously* practical. And thinking things through forward and backward has enormous utility. As my life and career tend to demonstrate, you can have many defects, as I do — and this way of thinking will carry you through.

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WESCO FINANCIAL'S CHARLIE MUNGER  
WORLDLY WISDOM REVISITED: LESSON #2  
(cont'd from preceding page)

OUR BRAINS ARE MORE SUITED FOR *MOTION* THAN *MATH*.  
FORTUNATELY, THERE'S A REMEDY — THE *GRAPH*.

There's a reason based in biology why graphs work so well.

**Munger:** Now let's turn to another subject. Suppose that we have a different problem — only this time in real time. This time, it's 1996. And we want to predict the future of the Coca-Cola Company. Will elementary models help us make a good prediction?

I have distributed to the class a *Value Line* graph demonstrating the Coca-Cola Company's recent history and financial results. I was willing to do that without paying a royalty to the Value Line Company because I'm going to tout its product. The *Value Line* graphs, as short-form digests of reality, company by company, are the best things of their kind that America produces. The *Value Line* people have a sensationally good idea — to put the data in exactly the form they put it in and to put it in graph form.

And there's a reason rooted in biology why graphs work so well. If you turn a somersault or juggle milk bottles, your neural apparatus is doing automatic differential equations with huge accuracy. Yet, if you try and think out numbers in ordinary probabilities, you're a considerable *klutz*.

Our brains are more suited to motion than math.

**Munger:** My friend, Dr. Nat Myhrvold, who's the chief technology officer at Microsoft, is *bothered* by this. He's a Ph.D. physicist and knows a lot of math. And it *disturbs* him that biology could create a neural apparatus that could do automatic differential equations at fast speed — and, yet, everywhere he looks, people are total *klutzes* at dealing with ordinary probabilities and ordinary numbers.

By the way, I think Myhrvold's wrong to be amazed by that. The so-called fitness landscape of our ancestors forced them to know how to throw spears, run around, turn corners and what have you long before they had to *think* correctly like Myhrvold. So I don't think he should be so surprised. However, the difference is so *extreme* that I can understand how he finds it incongruous.

A system that actually taps into our primitive neural network.

**Munger:** At any rate, mankind invented a system to cope with the fact that we are so intrinsically lousy at manipulating numbers. It's called the *graph*. Oddly enough, it came out of the Middle Ages. And it's the only intellectual invention of the monks during the Middle Ages I know of that's worth a damn. The graph puts numbers in a form that looks like motion. So it's using some of this primitive neural stuff in your system in a way that helps you *understand* it. So the *Value Line* graphs are very useful.

Value Line graphs and data are just *marvelously* useful.

**Munger:** The graph I've distributed is on *log* paper — which is based on the natural table of logarithms. And that's based on the elementary mathematics of *compound interest* — which is one of the most important models there is on earth. So there's a reason why that graph is in that form.

And if you draw a straight line through data points on a graph on *log* paper, it will tell you the rate at which compound interest is working for you. So these graphs are *marvelously* useful....

I don't use their predictions because our system works better for us than theirs — in fact, a *lot* better. But I can't *imagine* not having their graphs and their data. It's a marvelous, marvelous product....

AND IF YOU'RE TRYING TO LOOK FORWARD,  
BIG, SIMPLE MODELS CAN HELP THERE, TOO.

Will it continue? The answer lies in our models.

**Munger:** So we're trying to figure out if Coca-Cola Company can continue its utterly remarkable performance. Here's a company that earns way more than 50% per annum on book value *after* taxes. And it's growing like crazy.

How are we going to figure out if it's going to continue? It doesn't help just to sit there and mumble its past numbers to yourself mindlessly. What you have to do is reach into your head for two or three of the big, simple models.

We now know that it's a conditioned reflex company that relies on trademarks. What are the chances that they can continue doing it?

Will they continue having legal protection internationally?

**Munger:** Obviously, the first thing we have to decide is whether they're going to continue having legal protection for their trademarks. Otherwise, we shouldn't buy Coca-Cola.

Well, that involves knowing enough microeconomics, knowing enough law and knowing enough about the history of the international arena, (because Coke makes over 80% of its profit outside of North America), so that you can make a *guess* as to whether trademarks are going to continue to be pretty well respected all over the world.

Trademarks create *huge* incentives to make products reliable.

**Munger:** Well, we know that in counterfeiting, in most of the long history of the world, the ordinary remedy has been *death* — because everybody can see that a money exchange system won't work if people can counterfeit the currency.

And it's only a small step from that to realize that if you're talking about a food product — and, after all, it can make you sick, it can kill you, it can do a *lot* of things — if you protect the trademark, you create this *huge* incentive in people to make the product *reliable*.

A fish story (one that got away) about the power of trademarks.

**Munger:** I might tell a little story to illustrate that point. Carnation didn't have the total trademark on the name "Carnation" when it started out. And as it got bigger and bigger, it kept buying up all the little Carnation trademarks that other people had on their products.

But there was this one guy who sold Carnation *Fish*. So help me, God, that was his trade name. Don't ask me why. And every time they'd say, "We'll pay you \$250,000," he'd say, "I want \$400,000." And, then, four years later, they'd say, "We'll give you \$1 million," and he'd say, "I want \$2 million." And they just kept doing that all the way through. And they never *did* buy the trademark — at least, they hadn't bought it the last time I looked.

In the end, Carnation came to him sheep-facedly and

(continued on next page)



WESCO FINANCIAL'S CHARLIE MUNGER  
WORLDLY WISDOM REVISITED: LESSON #2  
(cont'd from preceding page)

said, "We'd like to put *our* quality control inspectors into your fish plants to make sure that your fish are perfect; and we'll pay all the costs," — which he quickly and smirkingly allowed. So he got free quality control in his fish plants — courtesy of the Carnation Company.

So they should be protected, have been and probably will be.

**Munger:** This history shows the enormous *incentive* you create if you give a guy a trademark [he can protect]. And this incentive is very useful to the wider civilization.... As you see, Carnation got so that it was protecting products that it didn't even *own*.

That sort of outcome is *very, very* desirable [for society]. So there are some very fundamental microeconomic reasons why even communist countries should protect trademarks. They don't all do it, but there are very powerful reasons why they *should*. And, by and large, averaged out around the world, trademark protection's been pretty good.

So I think we can bet reasonably that Coca-Cola will enjoy pretty good trademark protection in the future. But we have to be able to make a judgement on that subject before we know enough to buy stock in the Coca-Cola Company. So that's one judgement.

OUR MODELS SUGGEST LOTS OF UPSIDE POTENTIAL  
AND POWERFUL COMPETITIVE ADVANTAGES.

Quantity of liquid consumed is finite, but it's also huge.

**Munger:** Next, we have to figure out how big this market could be. Well, that isn't so hard. We just need ordinary physiology and ordinary arithmetic.

Every human being needs about 64 ounces of liquid every day to stay alive. We have about 6 billion people on Earth. So we just multiply the product of these numbers by the number of days in the year.... And, obviously, we're not going to get more beverage sold per year than that. But that's a *hell* of a lot of beverage.

Coke has room to grow its worldwide volume many-fold.

**Munger:** And, then, we can figure out roughly what share of the world's liquid is currently ingested in the form of Coca-Cola Company products. It's an *awesome* number — particularly in the U.S....

But per capita consumption of Coca-Cola products worldwide averages out much lower than it is in the U.S. And much of the world's population lives in markets where average consumption is still less than 10 8-ounce servings per year. So Coca-Cola still has *miles* to go. Clearly, they have room to multiply their current volume *many-fold*.

[Editor's note: In its 1996 annual report, Coca-Cola estimated U.S. per capita consumption of their products (excluding those distributed by their Minute Maid division) at 363 8-ounce servings per year. By comparison, the comparable figure was 5 servings and 3 servings, respectively, per capita — in effect, 98% and 99% less — for the 2.2 billion people of China and India.

Meanwhile, U.S. consumption of their products has also been growing (about 5% annually).]

And an extra 1-2¢ of profit per serving isn't inconceivable.

**Munger:** What else could impact the profits of the Coca-Cola Company? Well, we've got to figure out how much they're *making* out of each serving of Coca-Cola. And I haven't done that computation recently. But my guess is that it's something within hailing distance of 1¢ per serving. That's all that's sticking to the ribs of the Coca-Cola Company pretax.

Could it go to 2¢ — or even 3¢? That doesn't seem inconceivable for a company so dominant, does it?

So there's no reason Coke's profits couldn't grow 16 times.

**Munger:** Then, of course, there's the possibility of a little inflation. After all, they're selling syrup. You could hardly imagine a better protected position versus inflation.

And when you put all three of these factors together [— higher consumption, higher profits per serving and inflation —] it isn't hard at all for me to imagine the profits of the Coca-Cola Company in due course being 16 times what they are today — even though they're [already] making more than \$3 billion a year after tax.

Now that may strike you as very extreme. But if you go through the arithmetic, it's not inconceivable. So, at least, something very good *could* happen. It may take a long time. But what the hell, you people *have* a long time. I wish I did.

They've competed successfully for years — for good reasons.

**Munger:** We also want to estimate the chances that *competition* will do in Coca-Cola. Remember — think it through forward and think it through in reverse.

Well, they've been competing for a long time. And look how they're winning. Coca-Cola has certain advantages: They can afford to sponsor the Olympics. They can afford *lots* of things. They have a lot of advantages of scale.

And they're available all over the Earth. *That's* an edge that others don't have. And in recent years, their market share has actually been going *up* a little, net — in spite of the fact that they have so much already.

You can quarrel with my conclusion, but not the approach.

**Munger:** So, going through these simple models, you get at least a rational way to look at Coke's future. You may disagree with me when I say something as extreme as I've just said. But I don't think you can quarrel with my basic approach. It's a rational way to examine the outer limit of possibility on the upside. And, as you can see, it's quite *high*.

You don't have to sit there just twiddling your thumbs...

**Munger:** However, if you *don't* have the basic models and the basic mental methods for dealing with the models, then all you can do is to sit there twiddling your thumbs as you look at the *Value Line* graph. But you don't *have* to twiddle your thumbs. You've just got to learn 100 models and a few mental tricks and keep doing it all of your life. It's not that hard.

And the *beauty* of it is that most people *won't* do it — partly because they've been miseducated. And I'm here trying to help you avoid some of the perils which might otherwise result from that miseducation....

—OID



## SETH KLARMAN, BAUPOST GROUP

"Our best investments, that in retrospect seem like free money, seemed not at all that way when we made them. When markets are dropping hard (as they are in Asia) and an investment you think attractive, even compelling, keeps falling, you aren't human if you aren't scared you've made a gigantic mistake. The challenge is to do the fundamental analysis, understand the downside as well as the upside, remain rational when others become emotional and not take advice from Mr. Market, who again and again is a wonderful creator of opportunities, but whose advice should never, ever be followed."

Graham and Dodd Breakfast Lecture — November 13, 1997

Dear Subscriber,

Notwithstanding the possibility our contributors and we may suffer from a severe case of "first-conclusion bias", (see *Worldly Wisdom Revisited* beginning on page 1), and Wally Gaye's admonition about widely known information very rarely being of value, we're struck by the following:

In the late '80s, Cundill Value Fund's Peter Cundill, Baupost Group's Seth Klarman, Jean-Marie Eveillard of SoGen International and John Templeton, among others, warned *OID* subscribers clearly and repeatedly about dangerous overvaluation in the Japanese stock market. All were early and all were proven to be absolutely correct when the Nikkei subsequently declined more than 50% — a decline, we might add, from which it has yet to recover.

More recently, all have made similar comments — only this time about overvalued stocks in the U.S. For example, Peter Cundill was one of the few who *profited* from the Nikkei's decline. Today, Cundill is long Japan and reports finding net-nets there essentially as abundant as they were in the U.S. in the early 1970s. The puts he reports owning today? Among others, S&P puts.

Templeton Growth Fund's Mark Holowesko (page 1) comments on the relative scarcity of value in the U.S. and puts today's valuations in historical perspective. He then explains how, after having been absent from Asia for some time, that they were finding certain Asian markets among the cheapest in the world (even *before* this fall's turmoil).

We believe that Cundill, Templeton, Holowesko et al., as before, may be early, but that they won't be wrong.

We note, too, that Third Avenue's Marty Whitman (see page 1) — whom we'd never known to venture overseas — sounds most excited about the bargains he's finding among the Japanese non-life insurers. Says Whitman, "[I'm] convinced that ... [they're] among the ... safest and cheapest equities ... in the industrial world ... and [that they sell] at huge discounts ... [to] net asset value."

He tells your editor that he views these companies as closed-end funds selling at 50-80% discounts, only better. Why better? Because, Whitman tells us, not incorporated in those discounts is the value of the company's business.

And just as he was right about the bargains in U.S. financial service firms, (see our edition of June 23, 1994), we believe he will be no less right today.

Among the reasons why we think so are that this

year's decline in Asian markets and emerging markets followed three *prior* years of badly lagging performance. Using *Morningstar* data, for example, we estimate that emerging markets funds and Pacific ex-Japan funds were down 9.4% and 7.1%, respectively, for the three years ended December 31, 1996 before falling 16.3% and 32.3% more, respectively, through November 28th of this year.

And, as Valuevest's Mark Bakar and John Burbank observe, some of those markets declined *far* more — up to 70-80% in dollar terms *this year* as a result of their currencies withering vs. the dollar. Furthermore, as they convinced us, those markets appear to offer no shortage of eye-popping bargains. (Feature begins page 1.)

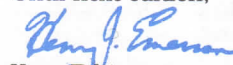
Not in the feature, but also intriguing, was Bakar's observation that the very high returns U.S. companies have earned in recent years have been aided by a cheap dollar — a tailwind a stronger dollar could eliminate or even reverse.

We found his observations more interesting still when we noted (1) that Japan's 1989 crash and subsequent woes had been preceded by the yen rising 100%± vs. the dollar in the prior three years, and (2) that the dollar has already strengthened nearly 66% vs. the yen since its early 1995 low.

On its face, that would not seem to bode well for U.S. corporate profits — particularly if a stronger dollar is as essential to restarting Japan's economy and bailing out certain developing countries in Asia as it seems today.

Lastly, an idea for all seasons from Fairholme Capital's Bruce Berkowitz and Third Avenue's Marty Whitman: After selling Colonial Penn to GE Capital, Leucadia National (LUK) now sells at a tiny premium to a very liquid book. Also, today's environment would seem to be just what the doctor ordered to allow Ian Cumming and Joe Steinberg to put at least a bit of their cash to work. (For more on LUK, see Berkowitz's comments in our November 3, 1994 edition.)

Until next edition,

  
Your Editor

P.S. Whatever else you read this edition, don't even *think* about missing Charlie Munger's *Worldly Wisdom Revisited*.

P.P.S. Thank you for your patience and your support. Happy Holidays to you and yours.

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