Outstanding Investor Digest

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

Investors featured in this Edition:

Other Investors in this Edition:

Companies & Investments in this Edition:

Volume XII Numbers 1 & 2 August 8, 1997

OID MAILBAG: BRANDES INVESTMENT PARTNERS, L.P.
QUARTERLY COMMENTARY
"DON'T *FEAR* VOLATILITY.
TAKE *ADVANTAGE* OF IT."

Brandes Investment Partners' Charles Brandes and Glenn Carlson update their clients with their perspectives on the world's markets via their Quarterly Commentaries. The letters are a thumbnail overview of Brandes' outlook on the U.S. and abroad, country-by-country reviews and their rationale for buying specific companies. We're pleased to bring you their latest — dated July 1997:

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
"THE CHIEF LESSONS OF OUR SUCCESS?
THAT A FEW BIG IDEAS REALLY WORK."

Anyone with the good judgement to invest $10,000 in Buffett Partnership in 1956, reinvest the proceeds into shares of Berkshire Hathaway at its termination in 1969 and do absolutely, positively nothing else would have shares of Berkshire at annual meeting time this year worth more than $150 million — *after all taxes, fees and expenses.*

And, believe it or not, even that figure understates the actual returns. Before fees, that $10,000 would have grown to more than $250 million during those 41-odd years.

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SOGEN FUNDS' JEAN-MARIE EVEILLARD
CHARLES DE VAULX, ELIZABETH TOBIN ET AL.
"SOME OF THESE MAY NOT LOOK CHEAP.
BUT APPEARANCES CAN BE DECEIVING...."

With Jean-Marie Eveillard at the helm, shareholders of SoGen International Fund have earned a compound return of 16.7% per year during his 17-year term at the helm — well above the 13.8% return of the MSCI World Index during that same period. Most impressive, he's done it while maintaining cash balances of 15-35% virtually the entire way. And since its inception in late 1993, SoGen Overseas Fund has earned

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WESCO FINANCIAL'S CHARLIE MUNGER
"IF IT WON'T STAND A LITTLE TROUBLE,
THEN IT'S NOT OUR KIND OF BUSINESS."

A highly accomplished investor in his own right prior to assuming the role of vice chairman at Berkshire Hathaway, Charlie Munger is credited by partner Warren Buffett with "giving the best five-second opinions in the world," opening his eyes to the virtues of investing in wonderful businesses and being "interchangeable — what he says nearly always goes for me and vice versa."

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BRANDES INVESTMENT PARTNERS'
CHARLES BRANDES
(cont'd from page 1)

BULL MARKETS AREN'T *ALL* BAD. SOMETIMES THEY CAN EVEN *HELP*.

Not enough U.S. bargains? No problem. We can wait.

In general, markets have been strong world-wide causing a number of stocks to rise above our buy limit. Under these conditions, we prefer to hold cash until we can find stocks at prices low enough to meet our value criteria.

Bull markets aren't *all* bad. Sometimes they even *help*....

U.S. stock prices have risen persistently during 1997. As the U.S. market continued on its blistering pace, it's become more and more challenging to find domestic stocks at bargain prices.

But one benefit of a bull market to a value investor is that previously purchased stocks may reach targeted sell prices more quickly. When a stock reaches its targeted price, it's sold to make room for other undervalued stocks. And several smaller companies in our domestic portfolios were sold during the second quarter after reaching our estimate of their fair value.

And we are finding some things to buy....

But we have identified several new U.S. stocks to add to our portfolios. We've been able to replace sold issues with some we deem to be selling at attractive prices.

Increasingly, utility stocks are being purchased for our portfolios. There is growing activity in this area as companies restructure and plan for increased competition. Certain select companies represent good opportunities for reward for the patient investor. And we believe selected electric utilities, telephone companies and tobacco stocks still offer good value.

THANKFULLY, IT'S A BIG, WIDE WORLD. SOMETHING'S GOING WRONG *SOMEWHERE*.

What goes up must come out....

The second quarter saw increased activity in our portfolios. European markets were particularly lively. And the Spanish market hit record highs. So while the portfolio remains sizably weighted in European markets, strong advances there have led to a subtle shift in distribution among countries.

Two Spanish holdings reached targeted sell prices. After re-evaluating their further potential, we sold them and replaced them with discounted holdings which we believe represent better value at this time.

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And thank goodness for the French....

But we continue to maintain a significant exposure to Continental Europe and find our best values there — France, in particular. The French market dropped in the wake of the May elections and gave us an opportunity to buy some quality businesses at discounted prices. And we were able to add a handful of them to our portfolios.

Electric utilities are bargains outside the U.S., too.

On an industry basis, our best values continue to come from foreign telecommunication stocks and domestic electric utilities. The electric utilities, food and household products and telecommunications are all well represented in your portfolio and are still undervalued. More are being added to portfolios where appropriate.

Thailand's been the worst. So we're on our way.

You may notice a slight shift toward more businesses from Asia and emerging markets. We increased our exposure to Asian and emerging markets countries and continue to find good value in Europe.

On the buy/hold side, we have been buying positions in Thailand, the worst performing emerging market over the past 12 months. In our view, the valuations in Thailand, especially for long-term investors, have become very attractive. We are currently holding some stocks in both India and Korea that are very attractively valued even with the recent appreciation.

Don't *fear* market volatility. Take *advantage* of it.

We continue to find good companies at inexpensive prices. Our outlook for them remains positive. The world continues to move toward free trade and free market economics. These are good times for investors. Don't *fear* inevitable market volatility. Take *advantage* of it.

STOCK FOCUS CONDENSED LOOKS:

Reader's Digest: The right stuff, right track & right price.

Reader's Digest, a leading global publisher of magazines, books, music and video products, operates in 48 countries. Geographically, the bulk of its revenue is obtained from Europe, the U.S. and the Pacific Rim. By product, the company has three main sources of revenue — including *Reader's Digest* magazine, book and home entertainment products, and special interest publications.

Reader's Digest is going through a long-term repositioning which will enhance some products while discontinuing others. Historically, the company has generated strong cash flow and focused on core assets.

It appears to have reasonable and attainable short- and long-term goals which should improve its profitability and return to shareholders. It has strong brand name recognition and low financial risk. Basic fundamentals meet our value criteria and suggest a good opportunity....

UST: Steady growth, lots of free cash & aggressive buybacks

UST is the largest U.S. producer of smokeless tobacco products, including such familiar brand names as Skoal, Skoal Bandits and Copenhagen. It is estimated that UST's

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BRANDES INVESTMENT PARTNERS'
CHARLES BRANDES
(cont'd from preceding page)

smokeless tobacco products account for about 80% of all sold in the U.S. The company also produces and distributes pipe tobacco under the labels Borkum Riff and Don Tomas, and wines under the Chateau Ste. Michelle, Conn Creek, Columbia Crest and Villa Mt. Eden labels.

Through 1996, UST's earnings had increased in each of the past 36 years with the dividend raised in each of the last 26 years. The company generates significant free cash flow which it uses to pay an attractive dividend and aggressively repurchases its own shares.

Attractive assets and lots of free cash at an attractive price.

U.K.-based B.A.T. Industries PLC (BAT) has two lines of business: tobacco and insurance. As the world's second largest tobacco company, one of its most attractive features is its exposure to emerging markets where approximately 75% of their cigarettes are sold. These developing markets are noteworthy in that tobacco use is still growing in absolute terms in those markets while volumes in the U.S. and Western Europe are declining.

Examples of their emerging market exposure include: Latin America, (where BAT has a 56% market share); Eastern Europe/former Soviet Union, (a 9% share); and Africa, (a 6% share). BAT participates in profitable U.S. and Western European markets through the sales of such brands as Kool, Lucky Strike, Kent and Benson & Hedges.

Often overlooked is that BAT is also one of the largest U.K. insurance groups. Operations include: Allied Dunbar, (life insurance and annuities); Eagle Star, (multi-line); and Threadneedle, (asset management). Also, BAT owns Farmers Group, the sixth largest multi-line insurer in the U.S. Collectively, insurance operations account for about 40% of BAT's overall earnings.

BAT trades at attractive multiples of earnings and free cash flow, and the firm pays a large dividend.

Guinness: Strong brands + Merger = Enhanced growth.

Guinness PLC is one of the world's largest alcoholic beverage producers. From the firm's United Distillers sector come Johnnie Walker, Bell's and Dewars Scotch whiskeys, and Gordon's and Tanqueray gins. The company's brewing operations produce Guinness Stout and Harp's beer. Guinness also owns a stake in Moet-Hennessy, one of the leading producers of champagne and cognac.

Attractive attributes include its strong portfolio of well-known brands, the strength of its balance sheet, its free cash flow generation and the fact that the company seeks to repurchase more of its own shares.

Guinness and Grand Metropolitan PLC, another U.K.-based firm with significant alcoholic beverage operations, recently announced plans to merge the two companies. The proposed combination would create the world's sixth largest consumer products company and enhance the growth prospects of the resulting entity.

Unicom does have a problem, but the market overreacted.

Unicom Corp. produces, purchases, transmits, distributes and sells electricity to 3.4 million customers in Chicago and surrounding areas in Northern Illinois and Indiana. From the 1960s through 1988, Unicom invested heavily in nuclear electricity generation. Due to factors beyond the industry's control, this did not develop into the cheap energy source once envisioned.

Today, Unicom's nuclear plants are typical of the "stranded cost" controversy plaguing the industry. This term refers to power-generating plants no longer viable economically in the newly competitive power supply area.

However, the market appears to have overreacted. Despite the stranded cost predicament, Unicom's cheap by all valuation measures: price-to-book, price-to-earnings and price-to-cash flow. We believe that legislation will eventually address the stranded cost problem in a similar manner to what has been accomplished in California and Pennsylvania. Therefore, we believe Unicom will maintain strong cash flow which can be used to retire debt, buy back shares and invest in good businesses.

BTR's cheap today & moving to enhance value tomorrow.

Based in the U.K., BTR PLC is one of Europe's largest diversified industrial holding companies. It operates in five broad business segments: industrial, (power drives and transmissions, conveyor equipment, batteries); control and electrical systems, (valves and meters); transportation, (including sealing systems, anti-vibration systems, railway signals and aerospace); construction, (laminates and wood floorings); and consumer related, (paper machine products and packaging).

BTR's revenues are also geographically diversified, with approximately 80% of revenues derived from countries other than the U.K. Since mid-1996, BTR has been taking significant steps to improve shareholder returns, including disposing of low-margin and non-core businesses.

BTR's shares are trading near a five-year low and appear very attractively priced for long-term investors.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
(cont'd from page 1)

This year, we resolved to use a bare minimum of scarce space to review the no-less-remarkable manner in which those hard-to-believe returns have been achieved. Instead, we'll simply pause to observe that if size, indeed, is the anchor of performance, it's hard to imagine anyone having a greater claim on the title of world's strongest.

We'd like to gratefully acknowledge Mr. Buffett and Mr. Munger for their assistance and cooperation in preparing this feature and allowing us to share it with you. As always, we strongly recommend that you read them (and reread them, etc.).

YOU'LL NEVER GET THE *CERTAINTY* OF DOMINANCE IN FOOD AS YOU DO WITH COKE AND GILLETTE.

You'll never get the same *certainty* of dominance in food....

Shareholder: Do you feel that McDonald's has the ability to dominate in the [same] way that Coca-Cola and Gillette have? Second, do you suggest that I wait until McDonald's stock price comes down a bit or get in now?

Warren Buffett: In this year's annual report, we talked about the base business of Coke and Gillette as being what I called "The Inevitables". But, obviously, that related to the soft drink business in the case of Coke and shaving products in the case of Gillette. It doesn't necessarily extend to *everything* they do. But, fortunately, at Coke and Gillette, each of those is very important.

In the food business, you'll never get the total *certainty* of dominance you could get in products like [those of] Coca-Cola and Gillette. People are more likely to vary where they eat. So they may favor McDonald's, but they'll go to different places at different times.

You'll never get it *again* in soft drinks.

Buffett: In contrast, somebody who starts shaving with a Gillette Sensor Plus is *very* unlikely to go elsewhere. [So] you would never get quite the inevitability in the food business that you would get in the soft drink business with a Coca-Cola.

You'll never get it *again* in soft drinks. It took them 100[+ years] — I guess, they started in 1886, so that would be around 111 years — to get to the point where they are. And their infrastructure is incredible. So I wouldn't put [McDonald's] in the same class in terms of inevitability....

That doesn't mean that McDonald's couldn't be a better investment depending on its price. However, you're not going to get the price from me. And knowing Charlie, I doubt if you'll get it from him.

Gillette's customers are very unlikely to fool around.

Shareholder: Would you comment a little bit further on McDonald's — carrying forward your comments, but more oriented toward how McDonald's would stack up against the Inevitables on the international side?

Buffett: I guess I just would have to stick with my earlier comment: that you won't get the inevitability in food that you will in a single consumer product such as blades. If I'm using a Gillette Sensor blade today, obviously, I'll try the next generation that comes out —which would be the Sensor Excel right now. However, I won't fool around at *all* in-between. A *very* high percentage of people who shave — including women — are happy with the product.

Plus, it's not *expensive*. It's $20-odd a year if you're a typical user. And if you're getting a great result, you're not going to fool around with anything *else*.

You won't get that kind of product loyalty in food generally.

Buffett: By contrast, a great many decisions as to where you eat are simply based on which one you *see*. Convenience is a *huge* factor. So if you're going by a McDonald's or a Burger King or a Wendy's and you happen to be *hungry* at that point or if you're traveling on the road and you see one of those signs, you'll probably stop — you may *very* well stop — at the one you see. So there's a loyalty factor, but it's just not going to be the *same* in *food*.

Also, people want to vary their fare. I'm happy to eat there every day, but most people want to vary where they eat as they go through the week or the month or the year. And they *don't* really have any great desire to vary their soft drink the same way. It's not the same thing.

So it's no knock on McDonald's at all. It's just the nature of the kind of industry they're in. Charlie?

Munger: There've been a lot of failures. It is a *much* tougher business that McDonald's is in.

There's very little financial incentive to switch blades....

Buffett: It's *price*-sensitive, *too* — obviously.

Munger: Part of that's comparative: You can *spend* a lot more money on hamburgers in the course of a year than you can on razor blades. So you can't *save* that much by changing razor blades.

Buffett: Yeah. The average person in the U.S. buys 27 Sensor Excels a year. So that's one every 13-1/2 days. And I don't know the retail price because they give 'em free to us as directors. But if they cost $1 at retail, that's $27. And it makes a lot of difference in your shave.

That's what's *happening*, of course, around the *world* — people are using cheap, double-edged blades or whatever. And they keep moving up the *comfort* scale — the comfort ladder. And, so, Gillette is a direct beneficiary.

If the difference between having great shaves and very so-so shaves, (with lots of nicks and scratches and everything), is $10 a year or $12 a year, that is not going to cause many people to change their habits.

And the market has enlarged in a way we didn't anticipate.

Buffett: Incidentally, Sensor for women has been a *huge* success. I think that they've sold more of those during the same period than during the comparable period following the introduction of the original Sensor for men. And that's been an enlargement of the market that I would not have anticipated. Before its introduction, women just used disposables or their husband's or boyfriend's razor. Thank God they've gotten over *that*.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
(cont'd from preceding page)

IT'S NOT SHARE OF *MARKET* THAT COUNTS. IT'S SHARE OF *MIND* — TODAY AND TOMORROW.

It's what's in the mind of the consumer that counts.

Shareholder: Could you explain a little more about what you call the mind of the consumer and the nature of the product and how you apply it to find companies with growing demand and the best investment potential?

Buffett: When you get into consumer products, you're really interested in finding out, or thinking about, what's in the *mind* of how many *people* throughout the world about a product now — and what's likely to be in their minds five or ten or 20 *years* from now.

Virtually every person on the globe — well, let's cut that down to *75%* of the people on the globe — has some notion in [his or her] mind about Coca-Cola. The word "Coca-Cola" *means* something to them. By comparison, [the word] "RC Cola" doesn't mean *anything* to virtually anyone in the world. It does to the guy who owns RC and his bottler, of course. But virtually everybody in the world has something in mind about Coca-Cola.

And, *overwhelmingly*, it's *favorable*. It's associated with pleasant experiences. And part of that is by *design*. The product is wherever you're *happy* — at Disneyland, Disneyworld and ballparks — *every* place you're likely to have a *smile* on your face, (including the Berkshire Hathaway meeting, I might add).

That position in the mind is pretty firmly established with people in close to 200 countries around the world. And a year from now, it'll be established in *more* minds and have a very, very, very slightly different overall position. And *10* years from now, that positioning could move just a little more. So it's not share of *market*, but share of *mind*, that counts.

Think about what "Disney" means and what that's worth.

Buffett: Disney is the same way. "Disney" means something to billions of people. And if you're a parent with a couple of young children and you've got 50 videos in front of you that you can buy, you're not going to sit down and preview an hour-and-a-half of each of those videos before deciding which one to stick in front of your kids.

You have something in your mind about Disney. And you don't have it about the XYZ Video Company. In fact, you don't have it about Twentieth Century or Paramount....

So that name, to billions of people — including lots of people outside this country — has a *meaning*. And, again, that meaning overwhelmingly is favorable. And it's reinforced by the other activities of the company.

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Just think about how much somebody would *pay* if they could actually *buy* that share of mind of *billions* of people around the world. You can't do it. You can't do it with a $1 billion dollar advertising budget or a *$3* billion advertising budget — or by hiring 20,000 super salesmen. But Disney's got that today.

The question then becomes what does that name stand for five or ten or 20 *years* from now? Well, you know that there'll be more people who've heard of Disney. And you know that there'll *always* be parents interested in having something for their kids to do. And you know that kids will love the same sorts of things....

That's what you're trying to think about....

It's similar with See's Candy. The *associations* are *good*.

Buffett: That's what Charlie and I were thinking about when we bought See's Candy. Here we were, in 1972 — and we know a fair amount about candy; in fact, I know more than when I sat down this morning. (I've eaten about 20 pieces already.)

But does their face light up on Valentine's Day when you hand 'em a box of candy of some nondescript origin and say, "Here, Honey. I took the low bid."?

You've got tens of millions of people, (or, at least, *many* millions of people), who remember that the first time they handed that box of candy to someone, it wasn't long thereafter that they got *kissed* for the first time or something. The *memories* are *good*. The *associations* are *good*.

IF YOU PROTECT YOUR SHARE OF MIND & EXECUTE, THEN NOBODY'S GOING TO CATCH YOU.

It isn't just the product. It's the total shopping *experience*.

Buffett: And it's a total *process*. It isn't just the candy. It's the [customer service] person who takes care of you at Christmas time when they've been on their feet for eight hours with customers yelling at them because they're standing in line with 50 people and, yet, that person is still smiling [and delivering friendly and courteous service]. So it's the customer *service*. It's the *delivery* process. And it's the *shopping* experience.... It's all part of the marketing personality. But it's the position in the *mind* that counts with a consumer product.

And in order to have a very good product — you may need tons of infrastructure. For example, [when we went to China,] I had a case of Cherry Coke awaiting me at the top of the Great Wall. You've got to have what it takes to have the product there when people *want* it.

And that happened.... In World War II, General Eisenhower said to Mr. Woodruff that he wanted a Coca-Cola within an arm's length of every American service man in the *world*. And they built a lot of bottling plants to take care of that.

The world seems to hunger for certain things American.

Buffett: That sort of positioning can be *incredible*. And it seems to work *especially* well for *American* products. People want certain American products — our music, our movies, our soft drinks, our fast food. You can't imagine — at least *I* can't — a French firm or a German firm or a Japanese firm having that same position and selling 47% or 48% of the world's soft drinks. It just doesn't *happen*.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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It's part of something you could broadly call an American *culture*. And the world *hungers* for it.

You don't want to make the mistake that Kodak made.

Buffett: George Fisher is doing a great job with Eastman Kodak. So this goes back to before his watch. But Kodak probably does not have *quite* the same place in people's mind worldwide as it had 20 years ago. I mean, people didn't think of Fuji in those days, say, as being in quite the same place.

And, then, Fuji took the Olympics, as I remember in Los Angeles and they just *pushed* their way through [to achieve] more of a parity with Kodak. You don't want to ever let 'em do that.

And that's why you can see a Coca-Cola or a Disney or companies like that doing things that [leave] you think[ing], "Well, this doesn't make a hell of a lot of *sense*. If they didn't spend this $10 million, wouldn't they still sell as much Coca-Cola?"

But [in my letter to Berkshire shareholders], I quoted from that 1896 report and the promotion [that] they were doing back then that spread the word. You never know *which* dollar is doing it. But you *do* know that virtually everybody in the world that's heard of your product overwhelmingly has a favorable impression of it and that the next generation's going to get it. So that's what you're doing with consumer products.

As long as we execute, people can't catch the real thing.

Buffett: With See's Candy, we are no better than the last person who was served our candy.... But as long as we do the job on *that*, people can't *catch* us. And we can *charge* a little more for it because people are not interested in taking the low bid.

And they're not interested in saving a penny a month on *colas*. Remember that we've talked in these meetings about private labels in the past. Private labels stalled out in the soft drink business. Consumers want the real thing.

I wouldn't have the *faintest* idea of how to displace Coke....

Buffett: More than 900 million servings of Coca-Cola products will be sold today. Just *think* about it — over *900 million*. And that figure will go up next year and the year after....

I don't know how you *displace* companies like that. If you gave me $100 billion — and I encourage any of you thinking about that to step forth — and told me to displace the Coca-Cola Company as the leader in the world in soft drinks, I wouldn't have the *faintest* idea of how to do it.

And that's the kind of business we like. Charlie?

THE NAME OF THE GAME IS *CONTINUING* TO LEARN VALUABLE LESSONS FROM SUCCESS AND FAILURE.

Stepping up for See's Candy was a hard jump for us.

Munger: Yeah. I think the See's Candy example has some interesting lessons for all of us. As Warren said, that was the first time we really stepped up for brand quality. And it was a very hard jump for us who had been used to buying dollar bills for 50¢.

And the interesting thing was that if they'd demanded an extra $100,000 for the See's Candy Company, we wouldn't have bought it. And that was *after* Warren had been trained under the greatest professor in finance, Ben Graham, and had worked with him for 90 hours a week.

Buffett: And eating a lot of *chocolates, too*!

Munger: And, yet, we just didn't have minds well enough trained to make an easy decision *automatically*.

We're proof that the name of the game is *continuing* to learn.

Munger: Fortunately, by *accident*, they *didn't* ask the extra $100,000 for it — and we did buy it. And, as it's succeeded, we kept learning. I think that shows that the name of the game is *continuing* to learn. Even if you're very well trained and have some natural aptitude, you still need to keep learning.

That brings along the somewhat delicate problem people sometimes talk about of "two aging executives", although I don't know what the hell "aging" is supposed to *mean* as an adjective — because I don't know *anybody* who's going in the other direction.

But you people who hold shares are betting — for awhile, at least, to some extent until younger successors come along — on what we will tactfully continue to call "aging executives" continuing to learn.

Thanks in large part to See's, we could recognize Coca-Cola.

Buffett: If we hadn't bought See's and experienced subsequent developments after that (because those developments made us aware of *other* things), we wouldn't have bought Coca-Cola in 1988. So you can give See's a significant part of the credit for the $11+ billion profit that we've got in Coca-Cola today.

Now you could say, "Well, how could you be so dumb as not to be able to recognize a Coca-Cola?" Well, I don't *know*. But...

Munger: We've [only] been drinking about 20 cans a *day*...

Buffett: Yeah! It wasn't like I hadn't been *exposed* to it. It's *amazing*. But it just made us start *thinking* more. We saw how decisions we made in relation to See's played out in the marketplace and that sort of thing. And we saw what *worked* and *didn't* work. And it made us *appreciate* a lot what did work and shy *away* from things that didn't. But it led — it *definitely* led — to Coca-Cola.

And we've had the good luck to buy other businesses in their entirety that taught us a lot.

Another valuable lesson — seeing what *didn't* work.

Buffett: And it's worked in the other direction, too. For example, we were in the windmill business at one time. (*I* was. Charlie stayed out of that business.) [But] I was in the windmill business and pumps.... I just found out how *tough* it was and how it didn't matter. You could apply all kinds of *energy* to 'em, but it didn't do any *good*.

So we learned that it made a great deal of sense to figure out what *pond* to jump into — and that what pond you jumped into was actually probably *more* important than how well you could swim. Charlie?

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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Munger: I don't think it's necessary that people be as *ignorant* as we were as *long* as we were. I think that American education could be better, but not in the hands of many of the people who are now teaching.

Buffett: Is there *any* group we've *forgotten* to offend?

IN SOFT DRINKS, YOU DON'T *HAVE* TO BE #1.
BUT, FRANKLY, YOU'LL DO BETTER IF YOU *ARE*.

Certain people will always prefer a Dr. Pepper....

Shareholder: In the domestic soft drink business, is it winner take all or is there room for three competitors? Honestly, does Dr. Pepper have a future?

Buffett: Yeah. Obviously, Dr. Pepper has a future. Sure, there's room for more than one player in the domestic soft drink market. I think Coke's market share will go up pretty much year after year, but not by any [huge percentage].... We're talking about tenths of a percent in that business. However, tenths of a percent are *important*. The U.S. market is what — about 10 billion cases. So, you know, 1% is 100 million cases....

It's interesting how regional tastes can be. A Dr. Pepper will have a share in Texas *far* greater than in Minnesota.... But there are always going to be people who prefer it.

Some businesses *are* winner take all. But not soft drinks.

Buffett: Interesting, though, is the high percentage of people who prefer cola, (although the percentages are going down a bit). The fastest growing big beverage at Coke today is Sprite. Sprite has had *huge* gains in sales. It does well over a billion cases a year. And it sells very well in a whole bunch of countries.

So you can make *money* with a soft drink company that *doesn't* dominate the business. You'll do a lot better, frankly, with one that *does* dominate it. However, it's not a winner take all type industry. It's not like two newspapers in a town of 100,000 or 200,000. Certain businesses are that way — blue ribbons, but no red ribbons. But the soft drink business isn't one of 'em.

FOR THE *TRULY* WONDERFUL BUSINESS,
REPURCHASES NEARLY *ALWAYS* MAKE SENSE.

Overvalued? We don't *know*. But we're happy owning 'em.

Shareholder: Could you comment on the matter of intrinsic value as it applies to some of "The Inevitables", given that the overpayment risk now is high, and the share repurchases going on at those companies at present?

Buffett: Well, we won't stick a price on 'em. We tell you that they are absolutely *wonderful* businesses run by *sensational* people and that they're selling at prices higher than they've sold at most of the time. But they may well be *worth* it and worth a lot *more* or it may turn out that they're a couple of years ahead of themselves.

We don't *know* the answer to that. But we know that we're very happy *owning* them.

We like wonderful businesses repurchasing shares.

Buffett: Gillette has not repurchased its shares — or hasn't in any significant quantity — for many years. On the other hand, Coke *consistently* repurchases its shares. We generally like a policy of companies that have really wonderful businesses repurchasing their shares. There aren't that *many* super businesses in the world. And the idea of owning more and more of a company like that over time has an appeal to us — and *almost* an appeal regardless of price.

The problem is that most companies that repurchase their shares are so-so businesses. And the repurchases are being done for motivations other than intensifying the interests of the shareholders in a wonderful business.

But when you *know* you have a wonderful business — and we think that most of the ones that we own are anywhere from extremely good to wonderful — we think that it usually makes a lot of sense.

We'd just as soon that Coke *keep* repurchasing shares.

Buffett: It's *hard* to do things that are intelligent with money in this world. And Coke's been *very* intelligent about using their capital — particularly to fortify and improve their bottler network around the world. They've done a *terrific* job that way. That was a neglected area for a long time. And that comes first.

But there's only so far you can *go* with that. And to enhance the ownership of the shareholders in a company like Coca-Cola.... For example, when we bought our first Coca-Cola in '88, we bought about 6.2% of the company. And, at that time, they may have sold 600 million 8-ounce servings — not many more than that — a day. So we had an interest in 36 or 37 million servings. Now we have 8% of their 900+ million servings. So we have an interest in 75 million or so servings a day. And, meanwhile, the profit's gone up a little per serving, too.

So that gets pretty *attractive*. We'd just as soon [that] they *keep* doing that.

AN APPLICATION OF INTELLECTUAL CAPITAL
MADE A *HUGE*, *HUGE* DIFFERENCE TO COKE.

Maybe the smartest purchase in the history of the world....

Buffett: The bottling thing is actually kind of interesting. And a fellow from Omaha, or who used to live in Omaha for a long time, Don Keough, had a lot to do with it — although Roberto had plenty to do with it, too, of course.

But Asa Candler, back in the late 1880s, made a series of transactions. I think some of it is a little fuzzy exactly as to the *timing* of 'em. But he essentially bought the whole Coca-Cola Company for $2,000. And that may be the smartest purchase in the history of the world.

Followed by one of the dumbest contracts in history....

Buffett: And, then, in 1899 I believe, a couple of fellows from Chattanooga came down to visit Mr. Candler. In those days, soft drinks were sold over the counter from fountains to people (in drug stores, primarily). There was a

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BERKSHIRE HATHAWAY'S
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little bottling going on. (There was already somebody bottling in Mississippi, as I recall.) So a couple of fellows came down and said, "Bottling's got a future. You're busy on the fountain side of the business. Why don't you let *us* develop the bottling system?"

Well, Mr. Candler must not have thought very much of bottling because he gave them a contract in *perpetuity* for almost the entire U.S. — for *$1* he sold it to 'em — including the right to buy Coca-Cola syrup at a *fixed price forever*.

Well, the primary ingredient of the syrup was sugar. And sugar went wild during and after World War I in price. But here was a guy who, in effect, had contracted to sell sugar at a fixed price forever. So Asa, who had scored with his $2,000 in a rather big *way*, managed to write what — and it's easy for us to look back at it today — certainly looks like it was one of the *dumbest* contracts in history.

So Coca-Cola was saddled by that contract for *decades*.

Buffett: And in those days, they sold *sub*-rights to bottler contracts. And those were usually the distance that a horse could go in a day and come back. That was sort of the circle that you gave people.

So the Coca-Cola Company was faced over the years with the problem of having the bottling system — which soon became its *dominant* distribution system — being subject to a contract where there was no price flexibility and where the contracts ran in perpetuity.

And, of course, every bottler on his deathbed would call his children and grandchildren around, prop himself up and croak out with his last breath, "Don't let 'em screw with the bottling contract." And then he'd expire.

So the Coca-Cola Company faced this for decades. And there were lawsuits back in the '20s and some things.... But they really couldn't do much about their bottling system.

It was a huge, huge project fixing it. But they got it done.

Buffett: So Roberto and Don Keough and some other people spent 20 or 25 years getting it rationalized. It was a *huge, huge* project. But it made an *enormous* difference over time in the value of the company.

And that's what I mean when I talk about intelligent use of capital — because you *know* [that] you aren't going to get results on that in a day, or a week, or a month, or a year when you set out to get that all rationalized. But they decided that to get the job done; they had to do it.

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It took capital. They used capital to get that job done — and used capital beyond that to repurchase *shares* in a big way. It's been very *smart* and I hope they continue — they're repurchasing shares, probably, as we talk....

Coke offers lesson after lesson, but too many for today.

Munger: Well, I *do* think the Coca-Cola Company is one of the most interesting cases in the history of *business*. And it *ought* to be way more studied than it is. There's just lesson after lesson after lesson in its history. But that's too long a story for today.

WE ALREADY INVEST INTERNATIONALLY — AND IN A WAY THAT'S HARD TO BEAT.

We *already* invest internationally — in fact, very *much* so.

Shareholder: What is your opinion of investing in foreign company's stocks?

Buffett: We have a number of — well, at least several major businesses, (actually at least five or six as I count along) — that derive a *very* significant percentage of their earnings from their international operations:

Coca-Cola earns 80% or more of its profits from its international operations. Gillette will earn two-thirds or more of its profits from its international operations. So, if you look to where our look-through earnings are *coming* from, we get a *lot* from international companies.

We don't discriminate (very much) on the basis of domicile.

Buffett: Those companies don't have to be *domiciled* in the United States. It's a *slight* advantage to us to have them domiciled in the U.S. For example, their dividends are treated better tax-wise if they're based domestically rather than someplace else just because of the way that the U.S. tax laws work.

However, if Coca-Cola were domiciled in Amsterdam or if Gillette were domiciled in London and they had the same basic businesses, we'd be attracted to them to *virtually* the same degree we are with them domiciled in Atlanta and Boston....

And we will *keep* looking. We need to look *everywhere* with the kind of money we have available for investment. Charlie?

Munger: Again, we have a *wonderful* way of playing the rapid development of economies outside the U.S. And, so far, we haven't seen anything that's attracted us as being better. If you can own Coca-Cola, do you really want to get into steel in Malaysia or something?

Some products travel well and some don't....

Buffett: We sold a *substantial* number of Kirby units outside the United States last year. And that business has grown very significantly this year — and, I think, promises to grow. We're always looking for opportunities. But some things travel very well and some don't. Gillette travels, Disney travels, McDonald's travels, Coke travels.

See's Candy *doesn't* travel as well. It might if you

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spent 50 years *working* on it, but it's not an *easy* thing to travel. Actually, candy bars themselves don't travel very well. If you look at the top selling candy bars in France or England or Japan, you don't find the similarity that you find here in the U.S. selling soft drinks or movies or fast food hamburgers or razor blades.

Munger: Except *Snickers*. For some reason, Snickers travels very well.

Buffett: Charlie's got a lot of experience as he goes around the world.... You may want to *invest* where we invest, but you don't want to eat where we eat....

THE BAD NEWS AT ABC: THE DAYTIME RATINGS. THE GOOD NEWS: ESPN. IT'S A *POWERHOUSE*.

I'd love to entice Murph back. They don't *get* any better....

Shareholder: Is Mr. Murphy keeping busy now that ABC's owned by Disney? Also, every week I read about the Nielsen ratings. And it seems that fewer people are watching ABC. Does that matter to Disney's bottom line?

Buffett: If we could hire Mr. Murphy, we would. There is *no* one in this *world* who is a better manager — or a better *human being*, as far as that's concerned.

But I think he's keeping pretty busy. He's responsible for NYU Hospital, (*he* wouldn't say that, but he's been the chairman of it for some years). That's an $800 million a year or thereabouts organization. Charlie runs a hospital. So he knows how busy it can keep you.

But I'd love to find a business I could entice Murph to come back and run because they don't *get* any better than he is. Charlie, do you want to add anything on Murph?

Munger: I'd *like* to because you're absolutely *right*.... [Munger stops. Buffett chuckles. Audience laughs — apparently about Munger's economy with words.]

Certainly, ratings matter. They translate into *money*.

Buffett: What was the other part of the question?

Shareholder: Circa the recent decline in ABC's Nielsen ratings...

Buffett: Yeah. I was hoping you'd *forget*.

Shareholder: ...and [whether those lower] ratings have anything to do with their bottom line.

Buffett: Yeah, it makes a difference. Sure.... It depends on a whole bunch of things. But, overall, you make more money if your ratings are good in news, if they're good in early morning, if they're good in daytime, if they're good in late evening and whatever. Ratings translate into *money*.

They may not translate *immediately* — particularly if you have ... sold upfront too *cheap*. But, over time, the prices you receive for your product relate to your ratings. And, over time, (but over a *longer* period of time), the price that you pay for your product also relates to the rating. But there's a difference in the time cycles.

So it makes a difference to any network's bottom line what their ratings are.

The folks at Disney are very good operators. And it'll show.

Buffett: Disney is conscious of that. They are very good operators, as I think you'll see in a couple of years. But you can't do it *immediately*. Schedule fixes don't work on a week-to-week basis — because people have habits. There's a time lag involved in any change.

Over the last 20 years, you've seen various networks on the top or on the bottom at one time or another. So it moves around. In fact, it moves around a fair amount. Charlie?

We thought daytime was a *lock*. But then *I* appeared....

Munger: Yeah. I think the TV network business is intrinsically a pretty tough business. And Disney did way *better* on ESPN than they might have forecast and they probably did a little *worse* on the network. But these things happen.

Buffett: That was, incidentally, the situation when Cap Cities bought ABC in 1985 and made the deal. I think it closed the first day or two of 1986. I may be wrong on that. But the network's ratings diminished significantly — particularly in *daytime*. We'd always thought that daytime was almost *certain* to produce big earnings. And it had — although prime time is what people pay the most attention to.

But daytime slipped significantly after we bought it. That has no relationship to when I started *appearing* on it. I don't want anybody to make that connection — although it did happen to be at the same time.

ESPN's been *enormously* better for us than we anticipated.

Buffett: The kicker that we got, again, was ESPN. ESPN was losing money when Cap Cities bought ABC. And we never really regarded it as having that much potential. But it's been *huge*. It's been just *enormously* better for us than we ever anticipated.

Leonard Goldenson, who ran ABC, *told* us it was going to be that good. But, of course, we were too smart to pay any attention to it. And I think Disney has been pleasantly surprised by how well ESPN has done, too. It's a *powerhouse*.

WE CAN'T BE AS SURE ABOUT MICROSOFT & INTEL, BUT THAT DOESN'T MEAN THAT *YOU* CAN'T.

A way to earn double Berkshire's historical return....

Shareholder: If someone were to use your investment philosophy of constructing a highly concentrated portfolio of six to eight stocks, and adopted your tax-efficient, buy-and-hold approach, but invested in high octane companies like Intel and Microsoft growing at 30% per year instead of the 15% typical of companies in your portfolio — would they achieve twice the return you've achieved in Berkshire?

Buffett: It will certainly work out to twice the return if Intel and Microsoft do twice as well as Coke and Gillette. It's a question of being able to identify businesses you

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understand and feel very *certain* about. If you understand those businesses, (and many people *do*, but Charlie and I *don't*), you have the opportunity to evaluate them. If you decide they're fairly priced and have marvelous prospects [and you're right], you're going to do very well.

We just find some businesses much harder to understand.

Buffett: But there's a whole group of companies — in fact, a *very* large group of companies — that Charlie and I just don't *know* how to value. And that doesn't *bother* us. We don't know how to figure out what cocoa beans are going to do or the Russian Ruble — there are all *kinds* of financial instruments that we just don't feel like we have the knowledge to evaluate.

It might be a little too much to expect that somebody *would* understand every business in the world. Anyway, we just find some businesses much harder to understand.

By *"understand"*, I mean being able to look *out* 10 years.

Buffett: When I say "*understand*", what I mean is ... that you have a pretty good idea where it's going to *be* 10 years from now. And I just can't *get* that conviction with a *lot* of businesses, whereas I *can* get it with a relative *few*.

Fortunately, as you've pointed out, I only *need* a few — maybe six or eight or something like that.

I can't be as sure about Intel & Microsoft as Coke & Gillette.

Buffett: It would be better for you, (it certainly *would* have been better), if we had insights about what we regard as the somewhat more complicated businesses that you've described — because there was, and may *still* be, the opportunity to make a whole lot more money. Indeed, there *is* if the growth rates you describe are maintained.

I don't think you'll find any better managers than Intel's Andy Grove and Microsoft's Bill Gates. Plus, they certainly seem to have fantastic positions in the businesses they're in. Unfortunately, I don't know enough about those businesses to be as *sure* those positions would be fantastic as I am that Gillette and Coke's businesses are fantastic.

You may understand those businesses better than you understand Coke and Gillette — either because of your background or because of the way your mind is wired. But I *don't*. Therefore, I have to stick with what I think I *can* understand. If there's more money to be made elsewhere, I think the people who make it are *entitled* to it. Charlie?

MAKING MONEY THE INTEL WAY IS VERY TOUGH.
WE'RE NOT LOOKING TO MASTER IT AT THIS POINT.

Seeing clearly into Intel's future is simply too tough for us.

Munger: Well, if you take a business like Intel's — there are limitations under the laws of physics which eventually stop you from putting more transistors on a single chip. And growth of 30% per annum or something like that — I think those limitations are still a good distance away, but they're not an *infinite* distance away.

Thus, Intel must leverage its current leadership into new activities just as IBM leveraged the Hollerith machine into the computer. And predicting whether somebody's going to be able to *do* that is simply too tough for us....

We bought and sold 10% of Intel in its initial funding.

Buffett: Yeah. Bob Noyes, one of the two primary founders of Intel, grew up in Grinnell, Iowa. I think he was the son of a minister in Grinnell, went to Grinnell College and was chairman of the board of trustees at Grinnell when I went on their board back in the late 1960s. And when Noyes left Fairchild to *form* Intel with Gordon Moore, Grinnell bought 10% of the private placement that ... was actually the initial funding for Intel.

And Bob was a *terrific* guy — very easy to talk to — just as Bill Gates is. These fellows explain the businesses to me. They really do. And they're great teachers. They're *very* good at explaining the businesses. But I'm a lousy *student*. Bob was a very down-to-earth Iowa boy who could tell you the risks and the upside. And he was just an *enormous* delight and 100% honest in every way.

So we *did* buy 10% of the original issue [for Grinnell]. But the genius who ran Grinnell's investment committee managed to *sell* those shares a few years later — although I won't give you his *name*. And there's no prize for anybody who calculates the value of those shares today.

It's *very* tough to make money the Intel way....

Buffett: Incidentally, one of the things that Bob was very keen on originally — in fact, it's probably what he was the *keenest* on — was some *watch* that Intel was making. And, according to Bob, it was a *fabulous* watch.

Unfortunately, it had one problem: We sent a guy out from Grinnell who was going to the West Coast to visit Intel. So Bob gave him one of these watches. And when he got back, he wrote up a report about our little investment. And he said, "These watches are *marvelous*. Without *touching* anything, they adapt to the time zones as they change." In other words, it was running very *fast*. And they worked with that watch for five or six years and just fell on their face.

Then, in the mid-'80s, they had to undergo a total transformation when the product on which they relied at that time *also* ran out of gas. Incidentally, Andy Grove has written a terrific book entitled "Only the Paranoid Survive" — which describes Strategic Inflection Points. I recommend every one of you read that book — because it's terrific.

But, anyway, Intel had an Andy Grove there who *made* that transformation — along with some other people. Unfortunately, that doesn't happen every time. Sometimes companies get left *behind*. And we don't want to be *in* businesses where we believe companies can be left behind. Intel could — and almost *did* — go off the tracks.

IBM also owned a big piece of Intel and sold it in the mid-'80s. So here are a bunch of people who should know a lot about that business. Yet, they couldn't see the future *either*. I think it's *very* tough to make money that way.

But *some* people *can* do it — e.g., Walter Scott....

Buffett: I think *some* people can make a *lot* of money understanding those kinds of businesses. There are people with the *insights* — for example, Walter Scott, one of our directors, has done terrifically with a business that started as a gleam in his eye 10 or 12 years ago here in Omaha. And it's become a *huge* business.

Walter explained that business to me on the way

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down to football games. But, again, I was a bad student. So Walter *connected* while I cheered from the stands.

If we couldn't do it when we were younger, why try today?

Buffett: But that really doesn't bother me at *all*. What would bother me is if I *thought* I understood a business and *didn't*. That would bother me. Charlie?

Munger: Well, having *flunked* when we were young and strong at understanding some complex businesses, we're not looking to master what we earlier failed at during our latter years.

Buffett: This may turn out like a *revival* meeting where we all come forward, confess our *sins* and seek absolution.

WE TOOK A PAGE OUT OF MICROSOFT'S BOOK, BUT NOT FROM THE CHAPTER ON ASTRONOMY.

One benefit of choosing World Book....

Shareholder: Before I leave today, I plan to purchase World Book on CD-rom for my 10-year-old daughter. And I'd like a few words from either one of you or both of you about why I'm making the right choice.

Second, does purchasing World Book over a competitor give her a somewhat improved chance of becoming a brilliant, billionaire investor?

Buffett: It practically *guarantees* it.

Shareholder: I'm *buying* it!

The CD version is wonderful, but I prefer the paper one.

Buffett: Charlie, you *love* to talk about World Book.

Munger: I think World Book is clearly the class of the field. They have every word in the English language graded for reading comprehensibility. The articles are cleverly written so that the difficulty of comprehension rises slightly as you go through it. And it's very user-friendly to young people. And since it's something you want to encourage, that user-friendliness is *wonderful*.

I *also* find that with whatever intellect *I* have, it's more user-friendly to *me*.... So it's for both young and old. And for a quick reference system, I don't think that there *is* anything better.

Personally, I like the [paper] version — being an old-fashioned fellow. And I can hardly *imagine* a world where the wise people don't [read the old-fashioned way]. Now maybe we're going to have wise people in the future who spend all of their time in front of screens in the course of getting that wisdom. But I doubt it.

So I think that you're buying a wonderful product. But I would have the other one, too.

We copied their *strategy*, but not their *astronomy*.

Buffett: The product you see there, (the CD Rom version of World Book), was a joint development and was launched in January of this year in conjunction with IBM. IBM has been our partner in that product. I believe it's being bundled into all the IBM PCs now being sold. So they've worked very *well* with us....

Bill Gates did a very good job of developing a product that was bundled with *millions* and *millions* and *millions* of PCs called Encarta. It's actually Funk and Wagnall's.... But Microsoft changed the name to Encarta — which was *smart* of them.

There are a few people in this room who were witness to a demonstration four or five years ago in Bermuda where, in connection with Encarta, it showed the moon and the Earth. And the moon bumped *into* the Earth in this.... I don't know *why* it sticks in my mind, but I thought I ought to mention it today.

But it is doing very well. So, apparently, there are many people who don't care about the fact that the moon and the Earth collide. But in the World Book, the moon and the Earth never bump into each other.

Bill Gates has done *extremely* well with Encarta, incidentally. It was a masterpiece of moving into an area and pushing hard. I tip my hat to him, but now we're...

Munger: Yeah, we've *copied* him.

Buffett: Yeah, we *copied* him. OK, Nancy. Be sure to buy the print version, too, so Charlie will respect you.

WE HAVE CONFIDENCE IN SALOMON'S PEOPLE, BUT NO SUCH CONVICTION ABOUT ITS BUSINESS.

The odds are we'll convert, but we'll decide at that time.

Shareholder: In 1987, when you invested in the Salomon convertible preferred stock, you had an eight-year time frame to convert it into common or take the cash out. In 1995, you took cash out — which wasn't a vote of confidence for Salomon. Any feelings on that for the future?

Buffett: Yeah. We bought it in 1987. And, starting in 1995, every year for five years, we either have to take cash or convert to common 20% of the original issue of $700 million. But we *don't* have to make those decisions *ahead* of time: In 1995, we elected to take cash. In 1996, we elected to take stock.

And we see no reason ever to swing at the ball while it's still in the pitcher's glove. We'd just as soon wait until it gets to the plate to make the decision. So the ball will get to the plate on October 31st, 1997, I believe, for the next 20%. And we'll decide whether to swing at *that* point. But we *don't* need to make that decision today.

The odds are *overwhelming* that we will convert. But we'll wait until that time to make the final decision.

We have confidence in the people, but not in the business.

Buffett: We have *terrific* confidence in the people [who] run Salomon. They've helped us through some incredibly dark days in the past and shown the stuff of which they were made. So we feel very good about that.

But we don't have the same degree of *conviction* about the profitability of investment banking or brokerage as a whole. You don't develop the [same] kind of conviction about *that* business [as you do] a Coca-Cola or something. They have very different economic characteristics. So we'll see how that industry evolves. But we feel *very* good about the management.... Charlie?

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Munger: No more.

INVESTMENT BANKING ISN'T A NATURAL PLACE FOR US — AND OUR SALOMON ISSUE REFLECTED THAT VIEW.

Our Salomon issue was a way of taking our capital out.

Shareholder: Could you just clue us in a little bit more on the $500 million of five-year discount notes that you issued tied to Salomon stock? Was that a way to unload it?

Buffett: That is simply an issue by Berkshire of, as you mentioned, $500 million of a very low coupon note — a very low interest rate note, too — that is convertible or exchangeable into Salomon stock at any time during the next five years. It's a way of taking the capital *out* of that block of stock at a very low interest cost to use elsewhere while we take a limited portion of the upside in the Salomon stock.

We just decided, (whenever it was — six months ago or so), that we might have good opportunities at some point to use that money. And we thought that raising the money at a current cost of a little over 1% and a cost to maturity of 3% — and we think the actual cost is likely to be closer to 1% — made sense.

Investment banking is not a natural place for us to be.

Buffett: We owned convertible preferred issues of Champion, US Airways and Salomon. But I don't think that we've ever owned the common stock of an airline. I don't think we've ever owned the common stock of a paper company. And we've had only a very limited investment in the investment banking business.

Those are industries where we don't feel that we've got the same kind of long-term economic advantage that we do in something like Coke or Gillette. Therefore, those are not natural places for us to be common shareholders. And the issuance of that exchangeable debt reflected that view. Charlie?

Munger: I agree.

GETTING INTO US AIRWAYS WAS A MISTAKE, BUT WOLFE SEEMS CAPABLE OF NULLIFYING IT.

There's no tougher job. And so far, Wolfe's been *terrific*.

Shareholder: Considering the headwinds which face USAir, are you considering redeploying assets? How does the management plan to improve this company?

Buffett: Well, we're just an investor. Incidentally, they now call the company US Airways.... We've owned a preferred stock in it for almost eight years. And the company had some *very* rough going. Charlie and I did not even think its chances for *survival* were very good some years back.

But it's done quite well lately. Stephen Wolfe has done a *terrific* job of running it. So, as of the middle of April, all of our dividends were caught up current. We received, I don't know, $260 or $270 million of dividends in the last eight years. But we have nothing to do with managing the company. In fact, there are some people who might have noted that when Charlie and I left as directors was when the fortunes of the company turned abruptly *upward*.

We feel *very* good about what Stephen Wolfe has done. There's *no* tougher job than running an airline. That is not a job I would wish on *anyone*. He's improved the operating performance dramatically. And the financial performance has improved. Better yet, the preferred dividends have been paid. So we thank him for that — but we have had nothing to do with it.

We actually even have a chance of receiving a *kicker*....

Buffett: By the terms of our preferred issue, in just a little over two years we're due to be paid back our principle amount. It was really a *loan* in equity form with a possible kicker on the upside because of the conversion privilege.

We'd have sold the conversion privilege for *nothing* a few years ago. But it's actually not so far away today. The stock's in the *low* $30s and our conversion's in the *high* $30s. So we actually have some chance of even realizing some conversion value on that. That's been a very pleasant surprise.

I made a mistake by getting *into* it. But Mr. Wolfe seems capable of nullifying my mistake. Charlie?

Munger: Pass.

Buffett: Let's take another look at the mirror here to be sure he's still breathing. Yeah.

ETHICS OF TOBACCO AREN'T BLACK AND WHITE — AND NEITHER WERE THEIR PROSPECTS.

Dearth of tobacco holdings hasn't been due to ethical issues.

Shareholder: Some of the tobacco stocks have been beaten down lately. Does Berkshire own any of them? And have some of them become attractive? In particular, could you tell us your view on a company called UST?

Buffett: People have written me about whether we should [own tobacco stocks]. [But] we own a newspaper in Buffalo, the Buffalo News, that carries tobacco advertising. So we are part of the distribution chain with that 100%-owned subsidiary.... And, so, [our policy has been] that if we felt they were *attractive* as an investment, we would invest in tobacco stocks.

We have owned tobacco stocks in the past. We've never owned a lot of 'em, although that may have been a mistake. We won't comment on what we own now. But, again, we've owned 'em in the past.

So the fact that we have not been significant owners of tobacco stocks has not been because they've been on a *boycott* list. It just means that, overall, we were uncomfortable enough about their *prospects* over time that we did not feel like making a big commitment in them.

We draw the line at being in the business directly.

Buffett: [But] we made a decision some years ago that we didn't want to be in the [business of manufacturing]

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chewing tobacco. We were offered the chance to buy a company that has done *sensationally* well subsequently. And we sat in [the lobby of] a hotel in Memphis, talked about it and finally decided that we didn't want to do it.

Munger: And it *wasn't* because we thought it wouldn't *do* well. We *knew* it was going to do well.

Buffett: We knew it was going to do well. Now, why would we take the ads for those companies or why would we own a supermarket or a Seven Eleven or a convenience store that *sells* 'em or something of the sort and not want to manufacture 'em? I really can't give you the answer to that *precisely*. I just know that one bothers me and the other doesn't. And I'm sure [that] other people would draw the line in a different way.

But exactly where you draw the line is a tough call....

Buffett: Some years back, we owned a lot of bonds of RJR/Nabisco. Should we [be willing to] own the bonds and not the stocks? Should [we] be willing to own the stock, but not ... the *business*? Those are tough calls.

Actually, Charlie's a director of a sensational warehouse chain called Costco, which used to be called Price-Costco, that sells cigarettes. The *biggest* distributor — the biggest seller — of cigarettes in the United States is probably Wal-Mart ... just because they're the biggest seller of *everything*, (Gillette products and almost everything else). They're *huge*.

Do I find that morally reprehensible? I don't. If we owned all of Wal-Mart, we'd be selling cigarettes.... But other people might call it differently — and I wouldn't fault them.

Charlie assumes a *new* responsibility....

Munger: Yeah. I think each company and each individual has to draw their own ethical and moral lines. And personally, I *like* the messy complexity of having to do that. It makes life *interesting*.

Buffett: I hadn't heard *that* before. We'll make him in *charge* of this decision [from now on].

Munger: I don't think we can justify our call particularly.... [But] we have to draw the line *somewhere* — about what we're willing to do and what we're not. And we draw it by our own lights.

THE CHIEF LESSONS OF BERKSHIRE'S SUCCESS
— THAT A FEW BIG IDEAS REALLY WORK.

We really *can* tell you if we're interested in five minutes....

Shareholder: In your letter, you asked anyone with a good company like FlightSafety to please let you know and that you'd be glad to look it over and give an answer within five minutes or less. My wife asked, "How can he *do* that? Where does he get the information to make that decision? And how does he know that the information is valid?"

Buffett: Charlie and I are familiar with virtually every company of any size that would interest us in the country. It's just as though you studied baseball players every day: you get to know all the players after awhile. And that's the way it works if you've been around for 40 or more years looking at businesses.

Then, we have a bunch of *filters* we've developed in our minds over time. We don't say they're *perfect* filters. We don't say that those filters don't occasionally leave things out that should get *through*. But they're efficient. They work just as well as if we spent months, hired experts and did all *kinds* of other things. So we really *can* tell you in five minutes whether we're interested in something.

We'd never owned shares in FlightSafety. But we'd been familiar with the company for at *least* 20 years — wouldn't you say, Charlie?

Munger: Sure. I had a partner who bought a lot of it.

Buffett: Twenty years ago.

Munger: Yeah.

Buffett: And that's true of almost *any* business.... We know — we have a fix on — ones we *don't* understand and we don't care to know any more about 'em particularly, although we'll pick up a little as we go along, maybe. And, then, the ones that we're *capable* of understanding, we've probably gotten about as far as we'll get — *already*. So we *do* know in five minutes.

We really don't do any traditional due diligence.

Buffett: Now when we bought FlightSafety, before the purchase and even for awhile afterwards... They have 40 or so training centers around the world, but I never set foot in *one*. I've never been to its headquarters. We never looked at a lease. We never look at title to the properties.

We don't do *any* of those things. And, to date, that's never cost us a *penny*.

We want to be right about the underlying economics....

Buffett: What costs us money is when we misassess the fundamental economic *characteristics* of the business. But that is something we would not learn by what people generally consider due diligence. We could have lawyers look over all kinds of things. But that isn't what *makes* something a good deal or a bad deal [for us].

And we don't kid ourselves by having lots of studies and reports made. They're going to support whatever they think the guy who pays 'em wants anyway. So they don't *mean* anything. They're *nonsense*.

But we *do* care about being right about the business' economic characteristics. And that's one thing we think we've got: filters that tell us in certain cases that we know enough to assess. Then we make some *mistakes*. Charlie?

Our filters, and ideas for that matter, are oh so simple.

Munger: I've got nothing to add to that except that people *underrate* the importance of a few, simple big ideas. And I think that to the extent Berkshire Hathaway is a didactic enterprise teaching the right systems of thought, the chief lessons are that a few big ideas really *work*. I think these filters of ours have worked pretty well — *because* they're so simple.

Buffett: Yeah, I think most of the people in this room — if they just focused on what made a good business or

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didn't and thought about it a little — could develop a set of filters that would allow them to figure out pretty well what made sense or didn't in five minutes, too.

It's usually easy to quickly tell if the *manager* is right, too.

Buffett: There may be some reason *after* five minutes why we don't get together on a deal. But another thing you can usually tell *very* quickly — at least in extreme cases — is whether you have the kind of *manager* you want. If you have somebody who's batted 400 for their entire life, (and, fortunately, age doesn't change the picture in terms of business performance), and they love what they *do*, it's going to *work*.

If the seller cares a lot about the money, we're probably not going to make a very good deal. If their real interest is what they're going to do with the money, they may fall out of love or have less interest in their business subsequently. We love working with people who are just plain *nuts* about their businesses. It works very well. And you can usually spot it.

Having said that, we'll have a few people figuring out how to fake that attitude and try to sell us some piece of junk. Charlie says we can get conned by some guy with a green eyeshade, a low rent office and all of that. But we *won't* get taken in by the guy with the suede shoes.

INTRINSIC VALUE IS ALL ABOUT FUTURE CASH FLOWS.
THE INVESTOR'S JOB IS TO SEE WHAT THEY'LL BE.

Intrinsic value is simply the present value of future flows.

Shareholder: You write and speak a great deal about intrinsic value and say you give shareholders the information they need to come to their own determination. Would you expand upon that. What do you believe are the most important tools — in your annual report or others you review — in determining intrinsic value?

Second, what rules, principles or standards do you use in applying those tools? Lastly, how does that process — i.e., the use of the tools and application of the standards — relate to what you've previously described as the *filters* you use in determining your valuation of the company?

Buffett: If we could see, in looking at any business its future cash inflows and outflows between the business and its owners over the next, call it, 100 years, or until the business is extinct, and then could discount them back at the appropriate interest rate, (which I'll get to in a second), that would give us a number for intrinsic value.

Businesses have coupons, too. Only they're unknown.

Buffett: It would be like looking at a *bond* with a whole bunch of coupons on it that matured in 100 years. If you can see what those coupons are, you can determine its value by discounting it at an appropriate risk rate. Or you can compare one bond with 5% coupons to another with 7% coupons. Each has a different value because it has different coupons.

Well, *businesses* have coupons that are going to develop in the future, too. The only problem is that they aren't printed on the instrument. Therefore, it's up to the investor to *estimate* what those coupons are going to be.

Intrinsic value is all about future cash flows.

Buffett: As we've said, in high tech businesses or something like that, we don't have the *faintest* idea what those coupons are going to be. But when we find a business we think we can *understand* reasonably well, we're trying to look into the future and see what its coupons are going to be. In effect, we're trying to print its coupons out today. And that's the way that we estimate what businesses are going to be worth in 10 or 20 years.

When we bought See's Candy in 1972, we had to come to a judgement about whether we could figure out the competitive forces that would operate, the strengths and weaknesses of the company and how it would look over a 10- or 20- or 30-year period.

And, if you attempt to assess intrinsic value, it all relates to cash flows. The only reason for putting cash into *any* kind of an investment now is because you expect to take cash *out* — not by selling it to somebody else, (because that's just a game of who beats who), but by what the asset produces. That's true if you're buying a *farm*. It's true if you're buying an *apartment* house. And it's true if you're buying a *business*.

OUR FILTERS ARE DESIGNED TO MAKE SURE
THAT WE'RE IN THE RIGHT BUSINESSES.

Hopefully, our filters make sure we're in the right businesses.

Buffett: You mentioned our filters.... We don't *know* what some businesses will be worth in 10 or 20 years. We can't even make an educated *guess*. Obviously, we don't think we know to two or three decimal places, or anything like that, *precisely* what's going to be produced.

But we can have a high degree of confidence that we're in the *ballpark* with certain kinds of businesses. And our filters are designed to make sure that we're *in* those.

Investors focus on the *asset*. *Speculators* focus on its *price*.

Buffett: We basically use long-term, risk free government bond-type interest rates to think back in terms of what we should discount at. And that's what the game of investment is all *about*. Investment is about putting out money today to get more money back later on from the asset — and not by selling it to somebody else, but by what the asset itself will produce.

If you're an *investor*, you're looking at what the *asset* — in our case businesses — will do. If you're a *speculator*, you're primarily focusing on what the *price* of the asset will do independent of the business. And that's not our game.

So we figure that if we're *right* about the business, we're going to make a lot of money. And if we're *wrong* about the business, we don't have any hopes — we don't *expect* to make money.

We give you the information you need to value Berkshire.

Buffett: And, in looking at Berkshire, we try to tell you as much as we can about our businesses — the *key* factors. The things we put in our report about those businesses are the things that Charlie and I look at ourselves.

So, if Charlie had *nothing* to do with Berkshire, but he

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looked at our report, he'd probably — in my view anyway — come to pretty much the same idea of intrinsic value that he comes to from being around it as long as he has.

The information should be there. We give you the information that, were our positions reversed, we would want to get from you.

And the information is there for Coke and Gillette, too.

Buffett: In companies like Coke or Gillette or Disney — in those kinds of businesses — you will see the information in their reports. You need *some* understanding of what they're doing, but you'll get that kind of knowledge in your everyday activities. You *won't* for some high tech company. But you will with those kinds of companies.

And, then, you sit down and try to print out the *future*.

A VERY INTERESTING QUESTION: IF WE'RE *RIGHT*, WHY ARE SO MANY EMINENT PLACES SO *WRONG*.

Using the filter of opportunity cost leads to better decisions.

Munger: I'd argue that one filter that's useful in investing is the simple idea of *opportunity* cost. If you have one opportunity already available in large quantity and you like it better than 98% of other things you see, you can just screen out the other 98% because you already know something *better*.

So people who have a *lot* of opportunities tend to make better investments than people who *don't*. And people with very *good* opportunities who use the concept of opportunity cost to discriminate between opportunities can make better decisions about what to buy.

With that attitude, you get a concentrated portfolio — which we don't mind.

If we're *right*, why are so many eminent places so *wrong*?

Munger: That practice of ours, which is *so* simple, is not widely copied. I do not know why not. It's copied among Berkshire shareholders. All of *you* have learned it. But it's not the standard in investment management — even at great universities and other intellectual institutions.

And that's a very interesting question: If we're *right*, why are so many eminent places so *wrong*?

Buffett: There are several possible answers to that question. [chuckles]

Munger: Yes.

It's *crazy* not to compare new unknowns to old certainties.

Buffett: The *attitude*, though — I mean, if somebody shows us a business, the first thing that goes through our head is, "Would we rather own this business than more Coca-Cola? Would we rather own it than more Gillette?"

It's *crazy* not to compare it to things that you're very certain of. There are very few businesses that we'll find whose future we're as certain about as we are about Coke's future. And, therefore, we'll want to buy companies where the certainty gets close to that. And, then, we'll want to figure out whether we're better off buying those than just buying more of what we already have.

If every management did that — if before they bought a business being promoted to them in some unrelated field they might not have even heard of, they said, "Is buying this thing better than buying in our *own* stock? Is it better than buying *Coca-Cola* stock?" — there'd be a lot fewer deals done. But, for some reason, they don't seem to do that....

We do. We measure new things against what we regard as being as close to perfection as we can get.

THE GAME *HAS* GOTTEN HARDER, *WAY* HARDER.
BUT 1974-STYLE MARKETS WILL HAPPEN AGAIN.

The old game isn't available. And the new game is *harder*.

Munger: The concept of intrinsic value used to be a lot easier to [implement] because there were all kinds of stocks selling for 50% or less of the amount for which you could have easily liquidated the whole corporation if you owned it. Indeed, in the history of Berkshire Hathaway, we've bought things at 20% of the liquidating value.

And, in the old days, the Ben Graham followers could run their Geiger counters over corporate America and they could ferret out a few things. And you could easily see — if you were at all familiar with the market prices of whole corporations — that you were buying at a huge *discount*. Well, no matter how bad the management, if you're buying at 50% of asset value or even 30%, sometimes you have a lot *going* for you.

But as the world has wised up and stocks have behaved so well for people and have generally gone to higher and higher prices, that game gets much *harder*. *Now* to find something at a discount to intrinsic value, those simple systems ordinarily don't *work*.

You've got to get into Warren's fashion of thinking. And that is a lot *harder*.

You just have to know a few simple things & really *know* 'em.

Munger: I think you can predict the future in a few places best if you understand a few basic ideas that come from a good, general education. That's what I was talking about in that talk I gave at the U.S.C. Business School.

In other words, stripped down and analyzed in terms of a few, simple elemental forces, Coke's a simple company.

You have to understand the human behavior. There are certain fundamental models that do not take the kind of ability that quantum mechanics requires. You just have to know a few simple things — and really *know* them.

Bargains have been widespread before and will be again.

Buffett: When Charlie talks about *liquidating* value, he's not talking about closing up the enterprise, but rather what somebody else will pay for that stream of cash.

Munger: Yeah.

Buffett: And you could have looked at a collection of TV stations owned by a Cap Cities, for example, in 1974, and it would have been worth, let's say, four times what the company was selling for — not because you'd close the stations, but because their stream of income was worth that to somebody else. It's just that the marketplace was very depressed all over. Like I say, on a *negotiated* basis, you could have sold the properties for four times what the company was selling for — and you got a wonderful

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management for free....

Those things *happen* in markets. And they'll happen *again*.

You also must be prepared to walk away if it *doesn't* work.

Buffett: But part of investing and calculating intrinsic value is that if you get the wrong answer when you get through — and the calculation says, "Don't buy." — you can't buy just because somebody else thinks it's going to go up or because your friends made a lot of easy money lately or anything of the sort. You just have to be able to walk away from anything that *doesn't* work.

It *is* harder to invest today — *way* harder.

Buffett: And very *few* things work these days. You also have to be prepared to walk away from anything you don't *understand* — which, in my case, is a big handicap.

Munger: You'd agree with me, Warren, wouldn't you, that it's much harder now?

Buffett: Yeah. But I would also agree that at almost *any* time over the last 40 years that we've been at a podium, we would have said it was much harder to invest, too. But it *is* harder now. It's *way* harder.

Because of our size, our universe of possible ideas is small.

Buffett: Part of it being harder now, too, is the amount of capital we run. If we were running $100,000 and we really needed the money, then our prospects for returns would be *considerably* better than they are running Berkshire. It's very simple. Our universe of possible ideas would expand by a *huge* factor.

We're looking at things today that, by their nature, a *lot* of people are looking at. And there were times in the past when we were looking at things that very few people were looking at.

But there were *other* times in the past when we were looking at things where the whole world was just looking at 'em kind of *crazy*. And that's a decided help.

WE CAN SCREEN OUT 98% OF WHAT WE *LOOK* AT IN THE MIDDLE OF THE SELLER'S FIRST *SENTENCE*.

Two simple filters quickly rule out 98% of what we look at.

Shareholder: Could you elaborate on what filters you use to look at potential investments?

Munger: Well, we've tried to do a good deal of that. [As I mentioned], opportunity cost is a *huge* filter in life. If you've got two suitors who are really eager to have you and one is way the hell better than the other, you do not have to spend much time with the other. [Buffett chuckles] And that's the way we filter out buying opportunities.

Our ideas are so simple that people keep asking us for *mysteries* when all we have are the most *elementary* ideas.

Buffett: The *first* filter we probably use is whether we think — and we know instantly — that it's a business we're going to *understand*. And if it passes through that filter, it's whether a company can have a *sustainable* edge. And those two filters get rid of a *very* significant percentage of the things we look at.

I'm sure many prospective sellers regard me and Charlie as very arbitrary because, very frequently, in the middle of the first sentence, we'll say, "Well, we appreciate the call, but we're not interested."

They think that if they'd just get to explain something, (we get letters about that all the time), we'd see its virtues and want to buy it. But we really *can* tell in the middle of the first sentence, usually, whether those two factors exist. If we can't understand it, obviously, it's not going to happen. We can't *determine* whether it has a sustainable edge. And, if we *can* understand it, we very often conclude that it's *not* the kind of business that has a sustainable edge.

So we can end 98% of the conversations with potential sellers in the middle of somebody's first *sentence* — which, of course, goes over very *big*.... [chuckles]

AND SOMETIMES WE CAN SCREEN THEM OUT BASED ON *WHO* WE'RE DEALING WITH.

And you can see certain things coming....

Buffett: And, then, sometimes, when we're talking about an entire business, we can tell by *who* we're dealing with whether a deal is going to work out or not. If there's an auction going on, we have no interest in talking about it. It just isn't going to work.

If someone is interested in essentially doing that with their business, they're going to want to sit down and renegotiate everything with us all over again after the deal is done anyway. So we're going to have to buy the business two or three times before we get through. And you can just see all these things coming.

On the other hand, we've had a terrific experience, basically, with the people we *have* associated with. So it works a sufficiently high portion of the time....

We don't want to listen to stories all day.... And we don't read brokerage reports or anything of the sort. There are other things we'd like to do with our time. Charlie?

You can avoid enormous misery by avoiding awful people.

Munger: Yeah. Another filter Warren is alluding to is this concept of the quality person. Of course, most people define quality persons as persons very much like *them*.

But there are so many wonderful people out there — and there are so many awful people. And there are *signs* frequently, like *flags* — particularly over the awful people. And, generally speaking, those people are to be avoided.

The amount of *misery* you can avoid by not getting into business with some awful person and the amount of *felicity* you can bring in by making the right associations...

The kind of people we look for: who can be trusted by all.

Munger: All you have to do is look around this room. There are some wonderful people who've created some wonderful businesses. And the customers can trust them, the *employees* can trust them and the *problems* can trust them to be fairly faced and reasonably solved. And that's the kind of people we want to [associate with].

And these people take their promises seriously. I had an experience recently with a company like that. It had its brand on a certain product. And someone invented a

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better product in the same field. Well, they're *removing* their brand from the product — because if it isn't the *best*, they don't want their brand *on* it.

People who think like that frequently do very well in business. And the flags are flying....

On the other hand, if the sign is flashing, "Jerk", pass.

Buffett: It's like a sign on their chest is saying, "Jerk. Jerk. Jerk." And, then, you think you're going to buy their business and they aren't going to be a jerk any more?

ONE OF THE GREAT THINGS ABOUT INVESTING: YOU DON'T HAVE TO START OVER AGAIN EVERY DAY.

One beauty of evaluating *businesses* is that it's *cumulative*.

Shareholder: Many of us get *barraged* with information. Is there an organizational model you use to deal with the plethora of information out there so you can physically and intellectually organize it to have maximum output and retain focus. How do you keep track of it all?

Buffett: Well, we *don't* keep track of everything. But the *beauty*, to some extent, of evaluating *businesses* — and large businesses in particular — is that it's all *cumulative*. If you started doing it 40 or so years ago, you've developed a working knowledge of an *awful* lot of businesses.

And there aren't that many to start with. So you can get a fix on — what are there — maybe 75 or so important industries? And you get to understand how they operate. So you don't have to start *over* again every day. And you don't have to consult a *computer* for it or anything. Therefore, it enjoys the advantage of accumulation of useful information over time.

That's one reason we like businesses that don't change....

Buffett: Then, you just add the incremental *bit* at some point. Why did we decide to buy Coca-Cola in 1988? Well, it may have been just a couple of small, incremental bits of information. But those small bits came into a mass that had been accumulated over *decades*.

It's a great business that way. And that's one reason why we *like* businesses that don't *change* too much — because the past *is* useful to us. Charlie?

Munger: I can't add a *thing* to that one.

MARGIN OF SAFETY IS VERY IMPORTANT, BUT, MOST IMPORTANT, STAY IN YOUR CIRCLE.

How much margin of safety? That depends on the risk....

Shareholder: In your '92 letter, you wrote that you try to deal with the problem of future earnings in two ways: [by sticking to] businesses you understand and by having a margin of safety. You say they are *equally* important. But if you... [loud bang]. But if you cannot have both, which one do you think is *more* important?

Buffett: I think we were told by some higher *authority* which one was more important....

They're bound together. If you understand a business — if you can see its future *perfectly* — then, obviously, you need very *little* in the way of margin of safety. Conversely, the more vulnerable that business is or the greater the possibility of change, (assuming you still want to invest in it), the larger the margin of safety you require.

In the First Edition of *Security Analysis*, as I recall, Graham used the example of J.I. Case and said, "Maybe it's worth somewhere between $30 and $110." He said, "That doesn't sound so great. How much good does that information do you? Well, it may do you some good if it's selling below *$30* or above *$110*."

If you're driving a 9,800 pound truck across a bridge that says it holds 10,000 pounds and the bridge is only about six inches above the ground, then you may feel OK. However, if the bridge is over the Grand Canyon, then you may want a little larger margin of safety. And, therefore, you may only drive a *4,000* pound truck across. So it depends on the nature of the underlying risk.

However, we don't get the margin of safety now that we got in the 1973-74 period, for example.

Most important, understand (and be in the right) business.

Buffett: The *biggest* thing to do is to understand the business. If you understand the business and get into the kind of businesses where, by their nature, surprises are few — and we think we're largely in that type of business....

It's best to learn vicariously. But we haven't always....

Buffett: Regarding learning from your mistakes, the best thing to do is to learn from the *other* guys' mistakes. As Patton used to say, "It's an honor to die for your country, but make sure the *other* guy gets the honor." Our approach is really to try and learn vicariously.

There are many mistakes I've repeated. The *biggest*, probably — or the biggest *category* over time — is being reluctant to pay *up* a little or failing to *continue* buying a business at higher prices when I *knew* it was outstanding. The cost of that mistake has been many, many billions. And I'll probably keep making it.

Missing things outside my circle is one thing. *Inside*....

Buffett: I don't worry at *all* about the kind of mistake I made by not buying Microsoft when I met Bill Gates or anything like that. That's just not my game. But it's another thing altogether when I simply should have known — when there were businesses I *could* understand, that I *knew* were attractive and I didn't do something about it.

You have to step up for no-brainers. It's *crazy* if you don't.

Munger: Yeah. I think that most people get very few what I call *no-brainer* opportunities — where it's just so damned obvious that it's going to work. And because they *are* very few — and because they may be separated by periods of years — I think people have to learn to have the courage and the intelligence to step up in a major kind of way when those rare opportunities come by.

Buffett: Yeah. You've got to be willing to take a really big bite. It's *crazy* if you don't. And it's crazy if you dabble around at the edges so you're not prepared to take

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a big bite when the time comes.

THE RISK-FREE RATE IS SIMPLY A YARDSTICK WE USE AS WE COMPARE ONE OPPORTUNITY TO ANOTHER.

Why they use the risk-free rate to discount cash flows....

Shareholder: When you're projecting cash flows at a company which is a prospective investment, why do you use the current interest rate of risk-free Treasury bills? Why don't you use the sort of opportunity cost discount rate Charlie was referring to — maybe the 12% return on equity you noted corporations have averaged historically, maybe your 15% goal, maybe Coca-Cola's return on equity — as a comparison? As I'm sure you know, doing that would dramatically change the value of the company you're evaluating. Why do you use the risk-free rate?

Buffett: We use the risk-free rate merely to equate one item to another. In other words, we're looking for whatever is *the* most attractive. In order to estimate the present value of anything, we're going to use a number. And, obviously, we can always buy government bonds. Therefore, that becomes the yardstick rate.

It doesn't mean we want to buy government bonds. It doesn't mean we want to buy government bonds if the best thing we can find only has a present value that works out to half a percent a year *better* than the government bond. But it's the appropriate yardstick to use, in our view, to simply compare all *kinds* of investment opportunities across the spectrum: oil wells, farms, whatever it may be.

Now it gets into the degree of certainty, too. But it's the yardstick rate.... It serves as a *constant* throughout the valuation process. Charlie?

The mental process is a cinch....

Munger: Yeah. If you look at a corporate stock, it's obvious you can buy any maturity of government bond you want. So one opportunity cost of buying a stock is to compare it to the bond. But you may find that in the case of half of the stocks in America, you either know so little about them or you're so fearful or think so poorly of them that you'd rather have the government bond. So, on an opportunity cost basis, they're taken out [by that] filter.

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Now you start finding corporations where you *like* the stocks way better than government bonds. So you've got to compare them one against the other. And when you find the one that you regard as the *best* opportunity — that you can *understand* is the best opportunity — now you've got one to buy. It's a very simple idea. It uses nothing but the most elementary ideas of economics and game theory. And it's *child's* play as a mental process.

Granted, it's hard to make these business appraisals. But the mental process is a cinch.

We might actually prefer the bond over 80%+ of stocks.

Buffett: If Charlie and I were told that we had a choice of buying Stock A, B, C or D among all ... stocks currently listed on the New York Stock Exchange or a 10-year government bond — and we had to hold whichever one we bought for 10 years — probably, in at least 80% of the cases, we would take the 10-year government bond. In many cases, it would be because we didn't understand the business well enough. In other cases, it might be because we understood it and *still* preferred the 10-year government. But we would measure everything that way.

Where would you come out — 80% or what, Charlie — if you had to own 'em for 10 years? You get to fondle a stock certificate or a government bond. Which one are you gonna choose?

Munger: Life is a whole series of opportunity costs. You've got to marry the best person who is convenient to find that will have you. And investment is much the same sort of process.

Buffett: I *knew* we'd get in trouble after lunch. Zone 2!

How do we adjust for risk? By getting a big discount.

Shareholder: Following up on that other question — if you don't adjust for risk by using higher discount rates, how *do* you adjust for risk — or *do* you?

Buffett: Well, we adjust by simply trying to buy it at a big discount from the present value calculated using the risk-free interest rate. So if interest rates are 7% and we discount it back at 7%, (which Charlie says I never do anyway — and he's correct), then we'd require a substantial discount from that present value figure in order to warrant buying it.

WE SEEK TO MINIMIZE BUSINESS RISK AS WELL AS ENTERPRISE RISK.

We focus on businesses and, therefore, business risk.

Shareholder: Given recent stock market volatility, could you give us your definition of stock market risk? And how does your definition differ from the standard one?

Buffett: We think first in terms of *business* risk. The key to Ben Graham's approach to investing is not thinking of stocks as pieces of paper or as part of the stock market. Stocks are pieces of *businesses*. The people in this room own a *piece* of a business. And if that business does well, they're going to do all right, too — as long as they didn't pay way too much to buy into it. So we're thinking about

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
(cont'd from preceding page)

business risk.

Risk can come from leverage or be inherent in a business.

Buffett: But business risk can arrive in various ways: For example, it can arise from the capital structure when somebody sinks a ton of debt into some business — so that if there's a hiccup in the business, the lenders foreclose.

It can come about just by the *nature* of the business. Certain businesses are just inherently very risky. Back when there were more commercial aircraft manufacturers, Charlie and I would think of developing a big airliner as a bet-your-company risk because you would have to first shove hundreds and hundreds of millions of dollars out into the pot before you really had customers. Then, if you had a problem with the plane, the company could go. So certain businesses inherently — because of long lead times and heavy capital investment — have a lot of risk.

The low-cost producer *makes* commodity businesses risky.

Buffett: Commodity businesses have risk unless you're the low-cost producer because the low-cost producer can put you *out* of business. Our textile business *wasn't* the low-cost producer. We had a fine management. And everybody worked hard. We had cooperative unions — all kinds of things. But we weren't the low-cost producer. So it was a risky business. The guy who could sell it *cheaper* than we could *made* it risky for us.

We seek to minimize business risk and enterprise risk.

Buffett: So there are *many* ways that businesses can be risky. And we tend to go into businesses that are inherently low risk and that are capitalized in such a way that the low risk of the *business* is also transformed into low risk for the *enterprise.*

IF YOU CAN MANAGE THE RISK BETWEEN YOUR EARS, THEN VOLATILITY TRULY BECOMES YOUR FRIEND.

Other risks — including the risk of you yourself....

Buffett: But the risk *beyond* that is that even though you buy such businesses, you pay too much for them. That risk is usually one of *time* rather than loss of *principal* — unless you get into a really extravagant situation.

Then the risk becomes the risk of you *yourself* — of whether you're able to retain your belief in the real fundamentals of the business and not get too concerned about the stock market. After all, the stock market is there to *serve* you, not to *instruct* you. And that's a *key* to owning a good business and getting rid of the risk that would otherwise exist in the market.

Real investors *love* volatility — in fact, the more, the better.

Buffett: You mentioned volatility. Well, it doesn't make any *difference* to us whether stock market volatility averages a half a percent a day or a quarter percent a day or 5% a day. In fact, we'd make a lot more money if it were *higher* — because it would create more *mistakes.* So volatility is a huge *plus* to the *real* investor.

Ben Graham used the example of Mr. Market — and we've used it, (I've copied it), in the annual report; (I copy from *all* of the good writers). He said to just imagine that when you buy a stock, you've bought into a business where you have this obliging partner who comes around every day and offers you a price at which he'll either buy or sell. And the price is virtually identical.

No one ever gets that in a *private* business — no one gets a buy/sell offer every day. But in the *stock* market, you get it. Well, that's a *huge* advantage.

And it's a *bigger* advantage if this partner of yours is a heavy drinking manic depressive. In fact, the crazier he is, the more money you're going to *make.* So, as an investor, you should *love* volatility — not if you're on *margin.* But if you're an investor, you *aren't* on margin. And if you're an investor, you love the idea of wild swings because it means more things are going to get mispriced.

Volatility is down. That's bad — because so is *opportunity*.

Buffett: Actually, volatility in recent years has dampened from what it used to be. It *looks* bigger because people think in terms of Dow points. So they see these big numbers — like plus 50 or minus 50 or something. But volatility was much higher many years ago than it is now. The amplitude of the swings then was *really* wild. And, so, that gave you more *opportunity.* Charlie?

WHATEVER FINANCE COURSES MAY TEACH, THERE'S NO WAY THAT CHEAPER IS RISKIER.

Finance professors got risk mixed up with foolish math.

Munger: Well, it got to be the occasion in corporate finance departments at universities where they developed the notion of risk-adjusted returns. And my best advice to all of you would be to totally *ignore* this development.

Risk had a very good colloquial meaning — namely, the chance that something would go horribly wrong. But finance professors sort of got [risk] mixed up with a lot of foolish mathematics. To me what they do is *less* rational than what we do. And I don't think we're going to change.

Whatever may be taught in finance, cheaper isn't riskier.

Buffett: Yeah. Finance departments teach that *volatility* equals risk. Now, they want to measure risk. And they don't know any *other* way — they don't know how to do it, basically. So they say that volatility measures risk.

I've often used the example of the Washington Post stock when we first bought it: In 1973, it had gone down almost 50% — from a valuation of the whole company of close to say $180 or $175 million down to maybe $80 million or $90 million. And because it happened very *fast,* the *beta* of the stock had actually *increased.* A professor would have told you that the stock of the company was more risky if you bought it for *$80* million than if you bought it for *$170* million — which is something that I've thought about ever since they told me that 25 years ago. And I *still* haven't figured it out.

At least *one* university course will be doing it right....

Buffett: And incidentally, I should make an announcement on that because I've made a certain amount of fun of finance departments over the years. But a fellow

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
(cont'd from preceding page)

named Mason Hawkins of Southeastern Asset Management just gave a $1 million gift to the University of Florida. And the state of Florida is matching that with $750,000. So this $1.75 million will be used to establish several courses in what essentially is the Graham approach to investing, I think, starting very soon.

So there will be at least one — and there are [probably] *more* than this, but there will be at least one — finance department specifically devoted to teaching the Graham approach. And I think they're even going to pick up on my suggestion that I stuck in the annual report about having a course on how to value a business and what your attitude toward the stock market should be.

So thanks to Mason — who's done very well managing money — there'll be at least *one* university course tackling what *I* think are the important questions in investing.

[Editor's note: Of course, we're proud to count Mason among our valued, long-time contributors.]

IF TODAY'S RATES & RETURNS ARE SUSTAINABLE, THEN ONE CAN JUSTIFY TODAY'S VALUATIONS.

If today's interest rates & ROEs persist, valuations are fine.

Shareholder: At current interest rates, inflation and current earnings growth, what does your valuation model suggest is the fair value of these companies?

Buffett: Well, that's a *good* question, but a *tough* one. If you believe that American business in aggregate can earn the kind of returns on equity that it has in the last couple of years and you foresee no change in interest rates, you could justify 7,000 on the Dow and 800 on the S&P.

Now there are a couple of *ifs* I threw in there. If interest rates go higher, valuations go down automatically. *More* importantly, if the returns on equity of American industry — which are at historic highs and which classical economics would suggest would be hard to maintain — go down on average, *that* would pull it down.

But if you're willing to accept the current level of returns on equity as being typical of future [returns] for American business, and you're willing to assume interest rates [at present levels] or lower, then you can justify today's valuation on the Dow and the S&P.

What years this century saw the greatest gain in the Dow?

Buffett: And it's interesting — because I got all that commentary after I wrote that line in the annual report.... But let me give you a little trivia quiz:

What two years in this century has the Dow had the greatest overall gain? The two years in the 1900s are 1933 — which most of you don't think of as a banner year — and 1954. In both of those years, the Dow was up over 50% counting dividends.

Bear in mind that the Dow's high in 1929 was 381 and that it was 25 years before that high was surpassed. But, in 1954, the Dow went from around 280 up to 404 or thereabouts — or up just a little over 50%. Therefore, in March of 1955, because the Dow had gone up, what did they do? They decided to have Congressional hearings about it. So in March of 1955, they had hearings in the Senate Banking and Currency Committee under Chairman Fulbright.

And my boss, Ben Graham, was called down to testify. And it's fascinating reading. Bernard Baruch was there — as were all kinds of people. I've got [a transcript of] the hearings at home. And Ben's opening comments about the market at that time were that the market *looks* high and it *is* high, but it's not as high as it *looks*.

The market looks high, but there have been *huge* changes.

Buffett: Well, that's about the *present* situation, too. I mean, it looks *very* high just by comparing 7,000, certainly, to the 404 at the end of 1954 when Ben was testifying. But there have been *huge* changes in earnings and return on equity of American business in general — and you've had this big move in interest rates.

Now, those are underlying fundamentals that have powered a huge bull market. But after awhile, as I mentioned earlier, people get captivated simply by the notion of rising prices without going back to the underlying rationale. And that's when you get very dangerous conditions in terms of possible bubbles.

People losing their heads is good for those who keep theirs.

Buffett: I have no *idea* where markets will go. But we have the kind of conditions that could cause real excesses — just like there were excesses in 1973 and 1974 when you could buy things at 20¢ on the $1 and you had excesses in the *other* direction. The country didn't *disappear* or anything. It's just that people behave in extreme ways in markets. And over time, that's very good for people who keep their heads. Charlie?

Munger: I've got nothing to add.

WE UNDERSTAND HOW WE GOT HERE, EVEN IF WE DIDN'T PREDICT IT.

I've been wrong so far, but 22% ROEs seem unsustainable.

Shareholder: Right now, the S&P 500, in aggregate, has a return on equity of about 22%. Corporate America, over the decades, has averaged 12-13%. How did we get to this point of extraordinary profitability? And how likely are we over the next 10 or 15 years to revert back to the mean?

Buffett: Well, I never thought that it would happen. So I start out with the fact that if you had listened to me, you'd have been dead wrong in terms of what the return on equity in 1995, 1996 or 1997 would be.

But it doesn't seem to me that 22% returns on equity are *sustainable* in a world where the long-term interest rate is 7% and where the capability of saving large amounts in the economy are quite dramatic. You'd just think that there'd be some sort of leveling effect between 7% and the 22% figure that you named — that as savings got directed within the economy and as the competitive forces operate that we were taught will operate over time, that those leveling forces would come into play.

But, again, I've been wrong on that subject so far.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
(cont'd from preceding page)

Today's returns justify today's prices and infinitely more.

Buffett: And that's why I say these stock price levels are justified if those returns can be sustained. Let's just say that you were valuing a 22% perpetual bond. And let's say that roughly a third of that coupon, or about 7%, will be paid out as dividends and the other 15% will be reinvested in *more* 22% bonds with similar characteristics. [Well, that would imply earnings growth of 15% per year — versus an historical average of more like 6.7%.]

What's that bond worth on a present value basis? Well, it's going to be worth a *lot* of *money*. In fact, it's going to be worth *so* much money that it creates a mathematical *fallacy* at some point — because when the compound rate of earnings growth gets higher than the discount rate, you get into infinite numbers. And while that's a concept we like to *think* about around Berkshire, we haven't figured out how to *attain* it.

There's an article called "The Petersburg Paradox and the Growth Stock Fallacy" — I think that's the name of it — that was written by a fellow named, I believe, David Durand. It was written about 25 years ago. And it gets into this bit where the growth rate is higher than the discount rate. And it can't work for an extended period of time. But it's sure fun while it's going on. Charlie?

We understand, (in hindsight anyway), why ROEs soared.

Munger: Yeah. I think a couple of things contributed to this phenomenon which we so carefully mispredicted: Number one, it became very fashionable for corporations to buy in shares. I think we helped in a very small way to bring on that enlightenment. And I think that was a *plus* in terms of rational corporate decision-making.

The other thing that happened was that the antitrust administration got way more lenient in allowing people to buy competitors. And I think those two factors helped raise returns on capital in the United States.

[Editor's note: As you may recall from past editions, Buffett and Munger have also pointed to other factors. One of them was the changing composition of the indices from capital intensive, manufacturing-oriented companies to service-oriented firms with lower capital requirements and, historically, higher returns. Another was the recognition of health and pension liabilities by GAAP, (Generally Accepted Accounting Principles), and the resulting decline of book value, (which, of course, is the denominator in the calculation of return on equity).]

BUT THE LAWS OF MATHEMATICS WEREN'T REPEALED,
WHATEVER YOUR BROKER OR ADVISOR MIGHT SAY.

But something has to *give*. Trees *can't* grow to the sky.

Munger: But that can't — you wouldn't think that could go on *forever*. What 15% per annum compounded will do is grow way faster than the economy can grow, way faster than corporate profits can grow over the long pull. So, sooner or later, something has to happen. I don't think we've reached a new order of things where the laws of mathematics have somehow been *repealed*.

Buffett: If real output — real GDP — in this country grows at, say, 3% a year, and the capitalized value of industry grows at *10%* a year, at some point, you get into mathematical *absurdities* in a low inflation environment. You just can't have it....

We have an economy that's $7 or $8 trillion in GDP and equity markets totaling $7 or $8 trillion in equity value — which may or may not make sense. But if you get to a GDP of *$15* trillion and equity valuations of *$75* trillion, you just get to things that *can't* make sense. These differential rates of growth among items with some relationship, however *tenuous*, don't work after awhile. And, so nobody wants to *think* about it — just like they don't want to think about their own death. But it doesn't go away just because they don't want to think about it.

We haven't gotten to any point like that yet. However, you can project out the numbers — and it's obvious that they just won't make any *sense* after awhile.

Munger: Yeah. Corporate profits can't be 200% of GDP.

Buffett: Yeah.

Munger: They can't be *50%* of GDP. So these high rates of compounding just go off automatically into absurdity.

Buffett: Yeah, they really can't be *20%* of GDP...

Munger: No....

But don't expect to hear this from your advisor or broker.

Munger: And all you people should be aware of this because all of the people who are professional sellers of investment advice — brokerage services, etc. — have an *immense* vested interest in believing that things that *can't* be true *are* true.

Buffett: Yeah.

Munger: Not only that, but they've been selected in a Darwinian process to have formidable *sales* skills in large part. This is *dangerous* to the rest of us.

Buffett: [And] *you've* been selected to be the *recipients* of their advice....

NO MARKET CALL INTENDED. I WAS JUST
TRYING TO AVOID ANY *MORE* EXUBERANCE.

There's probably not much reason to talk to Greenspan....

Shareholder: Recently, Mr. Greenspan made his comments about exuberance. And it wasn't long thereafter that you came out in the annual report and made your comments that you felt the market was fully valued or something of that nature. Did you have or have you had any communication with Mr. Greenspan regarding the valuation of the stock market?

Buffett: No. I can't remember precisely the last time I saw Alan Greenspan, but it was a long time ago. We had one conversation the day of the Salomon crisis. And he was on the board of Cap Cities/ABC before he took his job with the Fed. So I knew him then.

[But] it's very hard to understand what Alan says sometimes. So there's not much sense [in] talking to him [anyway] — I mean he's very careful about what he says.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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My comments were intended to spotlight stock price risk.

Buffett: But I'm glad you brought up the report — because in this year's report, I talk about Coke and Gillette as being "The Inevitables" and [about] what wonderful businesses they are. They're absolutely wonderful companies run by outstanding managers.

But you can *pay* too much — at least in the *short* run — for businesses like that. There is always a risk that you pay a price where it will take a few years for the business to catch up with the stock. So I thought it appropriate — particularly because the report goes to a lot of people — that they not take those comments as an unqualified buy recommendation about those companies. So I pointed out that a *stock* can get ahead of a *business* — no matter how wonderful it may be.

And I don't know where that point is with those companies or any other companies. But I did say that I thought the risks were fairly high that that situation existed with most securities in the market — including companies such as "The Inevitables". [So my comments were] designed to be sure people did not take the remarks that I made about those companies and just take [them] as an unqualified buy recommendation regardless of price.

We have *no* intention of selling those two stocks. We wouldn't sell 'em if they were selling at prices considerably higher than they are now. But I didn't want [people] — particularly relatively unsophisticated people — to see those names there and think this guy is touting these [things] as some wonderful buy.

But it's better to be sure about the *business* than the price.

Buffett: Generally speaking, it's *more* important to be certain about a *business* being wonderful than it is to be certain the price isn't 5% or 10% too high....

That's a philosophy that I came slowly to originally. I used to be *incredibly* price conscious. We used to have prayer meetings around the office before we would raise our bid an eighth. But that was a mistake — in some cases, a *huge* mistake. We missed things because of that.

ONE THING WE CAN CONFIDENTLY GUARANTEE: LOWER LONG-TERM RETURNS FROM STOCKS.

It's *hard* to find wonderful businesses cheap today.

Buffett: So what I said in the [annual] report was not a market prediction in any sense. We never try to predict the stock market. We *do* try to price *businesses*.... And we find it hard to find wonderful, good, average [or] substandard businesses that look to us like they're cheap today. But, of course, you don't always get a chance to *buy* things cheap.

One thing we can guarantee: lower future returns.

Munger: Well, I certainly agree with that.... The one thing we can confidently guarantee is that real, inflation-adjusted returns from investing in a standard collection of stocks will be lower in the long-term future than they've been in the last 15 years or so. This has been an unprecedented period. And there will be some regression toward the mean in the average returns from investing in the stock market.

Stocks have gone up for good reasons....

Buffett: American business has done *extraordinarily* well in the last decade plus. That's a huge plus for *securities* since they represent pieces of those businesses.

Interest rates over the last 15 years have fallen. *That's* a big plus for stocks. Any time interest rates go down, the value of every financial asset goes up — in a rational calculation. Both of those factors have combined in recent years to produce conditions that enhanced the true value of American business.

But you can get into more trouble with a *good* premise....

Buffett: But those are pretty widely recognized now. And after awhile ... Ben Graham always used to say [that] you could get in more trouble in investment with a good premise than with a bad premise because the bad premise would shout out to you immediately as being fallacious, whereas a *good* premise will *work* for awhile.

Businesses are worth more money if interest rates fall and returns on equity rise. But, eventually, the market action of the securities themselves creates its own rationale for a large crop of buyers. And people forget about the reasons and the mathematical limitations that were applicable and what got 'em excited in the first place. And, after awhile, the rising prices themselves alone will keep people excited and cause more people to enter the game.

Therefore, the good premise after awhile is forgotten — except for the fact that it produced these rising prices. And the prices themselves take over.

People tend to forget about the importance of price.

Buffett: [Graham] wrote about that in connection with the 1920s. Edgar Lawrence Smith wrote a fine book [in 1924] on why stocks do better than bonds. And that was sort of the bible of the bull market of the 1920s. And it made some sense — *if* you paid attention to a couple of the caveats which were in Edgar Lawrence Smith's little book that related to *price*.

But people tend to *forget* about the importance of the price that they pay as the experience of a bull market just sort of dulls the senses.

IF IT DOESN'T *MATTER* OR WE CAN'T *KNOW* IT, (LIKE WHAT THE MARKET WILL DO), WE *IGNORE* IT.

If we can't know it or it can't make a difference, we ignore it.

Shareholder: In the first edition of *Security Analysis* — the 1934 edition — Ben Graham talked about the development of the New Era Theory and its consequences on the securities business. We see a lot of the same words and phrases being repeated by analysts on Wall Street today. With historical returns on common stocks dating back to the 1800s coming in at about 7% paired together with the concept of regression to the mean in statistics, do you not think that we're in a very dangerous period?

Buffett: Well, the answer is that we never *know* — at least in terms of what the *markets* will do. I don't think

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(cont'd from preceding page)

that the Coca-Cola Company is in a dangerous position or a dangerous era — or Gillette or McDonald's or Wells Fargo or whatever (or See's Candy or the other businesses that we own in their entirety...).

Whether valuations are too high gets back to the question that we talked about earlier: If businesses in aggregate keep earning very high returns on equity and interest rates stay where they are, we're *not* in an overvalued period. If it turns out that these returns are *not* sustainable or interest rates go *higher*, we'll look back and say that it was a high point — at least for awhile.

But we have no *notion* on that. We really don't *think* about it — because we don't *know*. Our job really is to focus on things that we *can* know that make a *difference*. If something *can't* make a difference or if we can't *know* it, then we write it off.

A 4%/year return for a decade wouldn't surprise us at *all*.

Munger: Warren, you *would* expect *average* returns from stock market index-type investing to regress somewhat down from what they've been the last few years.

Buffett: I don't think you'll get the *investment* result from owning the S&P over the next 10 years that you've gotten over the *past* 10 years. If someone wanted to put some real money on that, they would find a taker with me. That's *very* unlikely to happen.

Munger: And that's not predicting a crash.

Buffett: *No.*

Munger: It's just saying that the result from the next 10 years is almost certain to be less.

Buffett: It wouldn't surprise me in the *least* — and in no way is this a prediction — if stocks averaged a total return of *4%* a year for the next 10 years. That doesn't mean it will. And we don't know the number. But that would *not* be a surprising outcome. And it wouldn't *bother* us particularly either.

ALL THOSE MACRO FACTORS PEOPLE WRITE ABOUT HAVE ABSOLUTELY *NOTHING* TO DO WITH WHAT *WE* DO.

We pay *no* attention to capital flows. All we're interested in....

Shareholder: Are analysts taking into consideration the fact that people from around the world can bypass their own stock markets and come here and buy instead?

Isn't it similar to the situation when the Japanese started to buy real estate in America and forced us to pay a *premium* price? And if so, won't we, as Americans, be likely to see stock prices continue going up?

Buffett: We pay *very* little attention, (actually, we don't pay *any* attention), to capital flows. In other words, we don't really care who's buying or selling any security. Somebody is buying or selling each *one*. So, obviously, you could focus on the buyers, you could focus on the sellers or you could say that now that there's $20 billion a month or whatever it is going into equity funds and all of that.... But [none of that makes] any *difference* to us.

All we're interested in is what the business is worth.

Whatever happened to M-2 (and other unsolved mysteries).

Buffett: And whatever it is people pay attention to — whether it's market signals, whether it's what the Fed's going to do — it'll *change*. Do you remember how 10 years ago everybody, no matter what day of the week it was, would ask, "What's M-2 doing?"

I've always thought of writing a mystery about, "Whatever happened to M-2?"

There's always *something* that people are talking about. There's so much time to fill with chatter and pages to fill that they write about all these things that to *us* don't make much *difference* — because we don't care if the market *closes* for the next five years.

All those macro factors have *nothing* to do with what we do.

Buffett: What we care about is how much Coca-Cola is sold five years from now, what percentage of the world market they have, what they're charging, how many shares they have outstanding and that sort of thing. However, we don't care who's buying it or selling it in the *least* — except we like it when the *company's* buying it.

It's the same with Gillette: What we care about is whether people are trading up in their shaving experience. Capital flows and all those macro factors that people like to write about have absolutely *nothing* to do with what we do. We're buying *businesses*.

And I really think that it isn't a bad mindset, whenever you buy any stock, to always ask yourself, "Would I be happy owning this stock if the market were to *close* for five years?" — because if you say yes to that, then you're buying a *business*. If you *don't*, then you may not be focusing on the proper thing.

In economics and everywhere, always ask, "And *then* what?".

Buffett: By its nature, the U.S. is running a substantial merchandise trade deficit. If you buy more from the rest of the world than you're selling them — which is what happens by definition when you're running a trade deficit — you have to balance the books.

They have to get something — some capital asset — in exchange: They may get a government bond. They may get a piece of a U.S. business. But they have to get *something*.

The *key* thing in economics, whenever someone makes an assertion to you, is to always ask, "And *then* what?" Actually, it's not such a bad idea to ask it about *everything*. But you should always ask, "And then what?"

So when you read that the merchandise trade deficit is $9 billion, what *else* does that mean? It means that somehow we must have also traded $9 billion of capital assets — [future] claims on *our* production — and given them to somebody else in the world. So they *have* to invest. They don't have any choice.

And when somebody says, "Won't it be terrible if the Japanese sell all of their government bonds?" Well, they *can't* without getting *another* American asset in exchange. There's simply no other way to *do* it. They could sell it to the French, but then the French have the same problem.

So trace *through* the transactions on the circle whenever you talk about any specific action in economics.

—OID

SOGEN FUNDS'
JEAN-MARIE EVEILLARD ET AL.
(cont'd from page 1)

a compound return of 13.4% per year — handily outpacing the MSCI EAFE Index's return of 8.0% per year despite also carrying significant cash. (All figures were provided by Societe Generale Asset Management and Morgan Stanley.)

Year	SoGen Intl Fd Annual Return	MSCI World Total Return
1979	+24.1%	+11.0%
1980	+31.7	+25.7
1981	+ 8.0	- 4.8
1982	+31.6	+ 9.7
1983	+24.0	+21.9
1984	+ 2.9	+ 4.7
1985	+32.7	+40.6
1986	+25.0	+41.9
1987	+13.8	+16.2
1988	+14.2	+23.3
1989	+17.2	+16.6
1990	- 1.3	-17.0
1991	+17.9	+18.3
1992	+ 8.4	- 5.2
1993	+26.2	+22.5
1994	+ 2.5	+ 5.1
1995	+15.2	+20.7
1996	+13.6	+13.5
1979-96	+16.7%	+13.8%
1987-96	+12.5%	+10.6%
1992-96	+12.9%	+10.8%
1994-96	+10.3%	+12.9%

Having moved to the U.S. during his 20s, Eveillard retains a distinctive French accent and attributes some of his traits and perspectives to that heritage. For example, he confesses a preference for "original, obscure, oddball, out-of-the-way situations" and remains the only manager to have referenced the Panic of 1893 during an interview.

He seems to gain a certain satisfaction from being uncategorizable. Flagship SoGen International Fund, despite its name, has until recently usually had more of its assets inside the U.S. than outside it. Categorized by *Morningstar* as a "hybrid international fund," others have categorized it as a growth or capital appreciation fund.

In past interviews, Eveillard has told *OID* subscribers about some truly classic bargains. Among them have been leading national newspapers Oriental Press and Telegraaf at 6-8 times earnings, Sabeton at less than 60% of net cash, Huffman Koos at 1-1/2 times trailing peak earnings, JSB Financial at 50% of book and RJR PIKs at an amazing 54% per year yield-to-maturity.

This time, understated and humble as ever, he first warned us that he'd been assisted considerably in his bargain-hunting endeavors in past interviews by valuations much lower than today's. Then, he (and several associates) promptly began to tell us about some of the most intriguing ideas we've heard about in *any* environment.

For all of those reasons and more, we're very pleased to bring you excerpts from a series of conversations with Eveillard and associates Charles de Vaulx, Elizabeth Tobin and Charles-Edward de Lardemelle. We hope that you find their insights about the current financial scene in the U.S. and elsewhere and about a handful of what seem to be particularly fascinating ideas nearly as intriguing as we do:

WE'VE BEEN TOO CONSERVATIVE. AND WE SHOULD'VE KNOWN BETTER.

OID: Historically, you've achieved excellent returns despite hauling around lots of cash.

Jean-Marie Eveillard: I think our cash equivalents have probably fluctuated between 15% and 35%. I suspect it's averaged something like 20%.

Some people believe it doesn't matter how one gets from point A to point B — whether it's via a straight line or with tremendous ups and downs along the way. However, many individuals are simply uncomfortable with lots of ups and downs. It's not that they don't understand the math — because many *do.* They're simply uncomfortable with lots of volatility.

OID: So that too much volatility in their fund would make them, in the colorful words of Roger Engemann, more likely to get off the train.

Eveillard: That's right. I've come to realize that most of our shareholders tend to be of the fearful variety. Our appeal to them, if you will, (for as long as it lasts anyway), has been, "We'll get *some* returns with him, but he'll protect our capital along the way."

So we appeal on the basis of having delivered what you might call decent returns with modest fluctuations, where people know that when things have gotten difficult, we've held up very well.

OID: Although some would consider near top quartile returns despite maintaining 20-25% cash levels plus other hedges something better than decent.

Eveillard: Thanks. But if equity markets continue to be so strong — particularly *domestic* equity markets — I worry that caution will no longer be a virtue, but a vice.

OID: But, at least, we'll all be rich....

Eveillard: Yes. And, at least so far, my clients haven't had a heart attack with me.

OID: And your percentage of cash today?

Eveillard: Approximately 20%.

OID: Besides cash, how much of your portfolio would you consider to be in the hedge category?

Eveillard: A little less than 5% of our portfolio is in gold-related securities. And that's the alternative asset. Presumably, it provides protection if financial asset prices go down. So between cash-equivalents and gold-related securities, we have roughly 25% of our portfolio in what you might call hedges.

Then, we have roughly another 14% in a variety of

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fixed-income securities including some Brady Bonds, some high-yield U.S. corporates, and a few medium-term bonds — governments mostly denominated in Canadian and New Zealand dollars — plus a few 4 or 5-year U.S. treasuries.

OID: Besides those, do you own anything else which might fit in the hedge category loosely defined — natural resource-type things, etc.?

Eveillard: Not really. We own a smattering of commodity-related securities based on industrial and agricultural-related commodities throughout the world. For instance, we own Carter Holt in New Zealand which is a forest products and paper company.

OID: Which, as I recall, we've spoken about before.

Eveillard: Yes. But I don't look at it as a hedge.

OID: Because the security price might fluctuate more with financial markets than commodity prices?

Eveillard: That's right. Plus, I think there's a cyclical case to be made for commodities, in that, perhaps, in 1997, European and Japanese economies will be growing and, therefore, the world economy will be in gear.

Plus, there is the secular or quasi-secular case associated with the tremendous demand from the developing world. Mainland China, for example, has already turned from an exporter of oil to an importer. And as the standard of living in developing countries rises, the first desire won't be for services (such as a fancy haircut), but rather for goods you and I take for granted such as a bar of chocolate or a bicycle with gears.

OID: The pause that refreshes, if you will.

Eveillard: Exactly. And those goods will require commodity inputs.

OID: As Robertson Stephens' Paul Stephens and Templeton Funds' Mark Holowesko point out.

Eveillard: Yes. So, on that basis, we own a few commodity-related securities around the world. But I don't view them so much as hedges. I view them more as beneficiaries of any cyclical demand that might start in '97 or '98 if Europe and Japan get their act together plus demand over the next few years from developing countries.

OID: Is your posture today more defensive than usual — because, frankly, it looks similar to what it's been for the last decade or more....

Eveillard: I'm afraid it *is*.

OID: You're afraid?

Eveillard: Because it's been a *mistake*.

(continued in next column)

OID: Isn't hindsight wonderful?

Eveillard: No hindsight should have been necessary. As value investors, we should be driven by valuations. And in 1986 and 1987, we cut down on American equities on the basis of their valuations. Then, in 1988, we cut down on Japanese stocks on the basis of their valuations. And our timing in both instances was not very good. But, eventually, in both of those cases, we were proven right.

But valuations of American stocks in 1990 *weren't* excessive. My big mistake was that I got scared by what I saw happening in the American banking system. I wrongly thought that its difficulties would either spell real trouble for the economy or in order to avoid that, the Fed would try to bail everybody out which would lead to more inflation.

However, Greenspan managed to keep banking difficulties from degenerating into any Great Depression and managed to do so without resuscitating inflation.

So over the past seven years, we've been too defensive. And that hasn't helped our returns.

OID: Despite your laments, Morningstar says that your returns put you in the top 26% of all managers for the past five years. So the returns you've earned on the invested portion must have been pretty nifty — something around 20% compounded I gather.

Eveillard: We've done well. But as my wife asks, "Why did you have the cash?" And, of course, she's right. If I'd been smart, I'd have had *no* cash.

IF IT'S A MAJOR DISCOUNT YOU'RE AFTER,
CONSIDER FRENCH HOLDING COMPANIES.

OID: And I know that you've told us about some truly classic ideas in the past — most of which, I gather, have done quite well, too.

Eveillard: I was able to do that in the past because we got some help from financial asset prices generally. Today, it's another *story*. The advance in equity prices since 1990 in the U.S. and since 1992 in Europe has been so tremendous that it's much *harder* today.

We keep at it. However, as I mentioned earlier, in SoGen International Fund, we're about 60% in equities. We are finding some things. But I'm not sure how good they'll prove to be.

OID: Could you give us a few examples?

Eveillard: Immobiliere Marseillaise by definition is a $1 bill selling for 50¢ or less — there's no doubt about it — because it sells at a discount to net asset value of 64%. And it's not like this management has been a laggard at compounding net asset value. Quite the contrary.

Even though the prices of French stocks generally have risen over the last year or so, most of the French holding companies continue to sell at major discounts. So if you want to buy $1 bills for 50¢...

OID: Always.

Eveillard: Then the French holding companies are an excellent place to look. And in the past 12 to 18 months,

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we've acquired some of them. Some have moved up because we're not the only Americans to have developed an interest in them. For example, I understand that the Baupost Group's Seth Klarman has personally visited with some of them in Paris.

OID: And, as I recall, Peter Cundill and Tim McElvaine told us about EuraFrance and Paribas.

Eveillard: And Peter talked with *us* about Paribas. In fact, we even looked at it. But we decided that there was more uncertainty in their real estate loans than we wanted to face. But Peter was right and we were wrong — and the stock's moved up.

[Editor's note: See the August 8th, 1996 edition for our feature with Peter Cundill and Tim McElvaine.]

Eveillard: These holding companies generally have a variety of stakes in other companies and, occasionally, some miscellaneous real estate holdings. And, therefore, we're not thinking in terms of P/Es, but rather discounts to net asset value.

Plus, almost all of their stakes are in companies that are *themselves* publicly traded. So calculating net asset value isn't very complicated.

OID: You just look up the price in the newspaper — assuming you get a French newspaper.

Eveillard: Exactly. Sometimes they have other assets like real estate — the value of which you have to estimate. However, in essence, we're buying what amounts to a portfolio of publicly traded companies.

It's not a *diversified* portfolio because they're often major stakes. Sometimes one stake can represent 30% or more of the total net asset value. But what you do have is a portfolio composed of a few stakes which you can buy at a huge discount.

OID: I don't want to look a gift horse in the mouth, especially one selling at a huge discount. But doesn't the question then become a huge discount to what?

Eveillard: Generally not — unless you're worried that the stock prices of those various stakes are way overvalued or you see that their management has been unable to grow net asset value.

And something else gives us comfort: There are a lot of these holding companies in France. And in some cases, their net asset value has increased 15% or more a year for 5, 10 or even 15 years.

OID: You're pulling my leg.

Eveillard: Not at all. And, as I recall, that included periods during which the French stock market didn't do that well. So the heads of a few holding companies have done a pretty good job. And those are generally the ones that we own.

OID: Certainly 15% or more per year growth at the kind of discounts you're describing sounds like a mighty hard combination to beat. But I presume that they don't usually sell for a huge discount?

Eveillard: They haven't always sold for that kind of discount historically. For example, in 1987, in what was admittedly a very strong market for equities, (at least for a portion of the year), these holding companies were selling at discounts of only 5% or 10%.

OID: So at least in an extremely overvalued market, these holding companies haven't sold at big discounts.

Eveillard: You laugh. But that's right. And, in fact, that's often what happens. If you look at closed-end funds, they often sell at a premium when the country itself is hot and a discount when the country is cold.

And that's *bizarre*. It should be the other way around.

OID: Based on logic, but not the wiring of our brains.

Eveillard: Exactly. You're buying a *depressed* asset at a *discount* — which is not very logical to expect — just as it's not very logical to expect an overvalued asset to sell at a premium. But logical or not, that's how it usually works.

A SUCCESSION OF HOLDING COMPANIES CAN CREATE A DISCOUNT TO A DISCOUNT.

Eveillard: Similarly, sometimes there is a *succession* of these holding companies. In other words, one owns a stake in another which owns a stake in a third, etc. And, often, the closer you get to the *top* holding company, the larger the discount.

OID: Because you get a discount to a discount.

Eveillard: Exactly. So Immobiliere Marseillaise has a stake in EuraFrance — which is also a holding company. And EuraFrance, itself, has a stake in Gaz et Eaux.

OID: And for the sake of fitting this feature into the available pages, I hope that Gaz et Eaux is not a holding company, too.

Eveillard: Gaz et Eaux *is* a holding company. And, actually, I didn't mention Rue Imperiale de Lyon — the *top* holding company — because the market for it is very thin.

Of the four, Eurafrance trades most easily. But Immobiliere Marseillaise sells at a bigger discount. So, although it also trades more thinly than EuraFrance, other things being equal, I'd rather go with it.

Incidentally, we value those sub-holding companies using their adjusted net asset value — not their stock price.

OID: Sounds reasonable.

Eveillard: I think so. And, therefore, the discount is often narrowest for the holding companies at the bottom of the chain and biggest for the ones at the top. And that's so for Gaz et Eaux, Eurafrance and Immobiliere Marseillaise.

Therefore, starting at the bottom of the chain, let's first look at Gaz et Eaux. Its assets break down roughly as follows: 26% cash, 25% Pearson (the British media company), 12% Sidel (a manufacturer of machinery that produce PET bottles [biodegradable plastic bottles]), 19% Danone (the big food company), and the remaining 15% in unlisted companies including a stake in Lazard Partners.

OID: And the estimated discount?

Eveillard: Because Gaz et Eaux is, in effect, the first

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level holding company, we estimate that the discount is only about 38% to its adjusted net asset value [NAV].

OID: But it gets better.

Eveillard: Yes, indeed. Looking next at EuraFrance, about 35% of its adjusted NAV is accounted for by its stake in Gaz et Eaux, another 35% or so by its holdings in publicly traded insurance businesses in Europe, 20% or so by cash and 10% by a variety of unlisted companies.

And thanks in part to the fact that Gaz et Eaux itself sells at a discount to its NAV, at its current price of FF2,500 per share, EuraFrance is selling at a discount of a little more than 46%.

OID: You're starting to get warm...

Eveillard: And continuing up the chain, the next holding company is Immobiliere Marseillaise. There, about 75% of its asset value is accounted for by its stake in EuraFrance, 21% or thereabouts by real estate in Marseille, and the remaining 4% or so by net cash.

OID: May I ask you how you value their real estate?

Eveillard: Elizabeth Tobin did that calculation. And I don't recall how. But knowing her, she probably used a conservative value. Let me get her to tell you.

OID: You don't have a more aggressive analyst — perhaps an ex-broker or ex-newsletter editor?

Elizabeth Tobin: They own 260,000 square meters of apartment properties. And we valued it at FF4,000 per square meter, based on conversations with people who I believe are knowledgeable about that market.

OID: For the metrically challenged among us, what would that be equivalent to in dollars per square foot?

Tobin: A meter is 39.37 inches. So one meter is equivalent to just under 3.3 feet. Therefore, one square meter would be just over 10-3/4 square feet. And at current exchange rates, FF4,000 would be roughly equal to $645. So in U.S. dollar terms, we've valued their real estate at about $60 per square foot.

OID: That sounds reasonable.

Tobin: We think so.

Eveillard: And, again, it's comforting to us, at least, that real estate in France — including Marseille — has been depressed for six or seven years. It's done terribly. So we're not exactly talking about overheated real estate.

And when we add up the value of its stakes, Immobiliere Marseillaise's current stock price of FF7,900 represents a discount of about 67% from adjusted NAV.

OID: Super. But are those figures before or after tax?

Eveillard: They're *before* tax. However, the tax rate in France on long-term capital gains is only about 20% currently. And so, after-tax, Immobiliere Marseillaise is still selling at a discount of more than 60%.

OID: Excellent.

Tobin: They're talking about increasing the rate on capital gains taxes in France — temporarily, they say.

OID: Famous last words. Wasn't that what they said when they started the U.S. income tax?

Tobin: Exactly. And the same thing happened in Germany when they imposed a "temporary" tax to help pay for reunification. But we understand that the new tax law shouldn't impact the after-tax value by more than about 1% for these companies.

More troublesome is that the French government is also talking about increasing the tax rate on corporate income by about 15%.

OID: And you said Rue Imperiale de Lyon is at the top of the holding company chain?

Eveillard: Yes. But we estimate its current stock price of FF5,650 represents a discount of about 50% from its adjusted NAV.

OID: Less than Immobiliere Marselleise's discount.

Eveillard: That's right. So the top holding company is not always cheapest. And, again, it's very thinly traded.

OID: You say that the real estate market in France has been depressed for a long time. But what can you tell us about the valuations of their other assets? I believe Peter Cundill told us about one whose holdings sounded a bit pricy. Does packaging come to mind?

Eveillard: That was probably Marine-Wendel and CGIP. The top holding is Marine-Wendel and the sub-holding is CGIP — which owns a stake in Crown, Cork & Seal among others.

And the P/E on Crown, Cork & Seal looks high. But it just went though a merger. And I think some of the cost savings have already shown up, but not all. So it may look expensive on the basis of their 1996 earnings, but it may be much less high on the basis of '97 or '98.

OID: That's what Peter Cundill said.

Eveillard: Going up the holding chain, we estimate that the discounts on CGIP and Marine-Wendel are about 44% and 48%, respectively. Incidentally, those two are controlled by the Wendel family — who, we believe, has also done an excellent job of overseeing their portfolios, building value and so forth.

And, so, we think a 50% discount to adjusted NAV on a well managed portfolio of fairly valued securities is still attractive. It's even better, of course, if it's a 50% discount to a portfolio of *undervalued* securities. But as long as they aren't overvalued...

OID: Which I gather they aren't in the case of the ones you've told us about?

Eveillard: I believe the insurance company stocks that EuraFrance owns are fairly valued. We're talking about stocks that have gone up with the markets in Europe. And Pearson has gone up with the market in England. So neither the insurance stocks nor Pearson strike us as overvalued *or* undervalued. The only one that might be undervalued is Danone — the French food company.

But at a discount of 50-60% or more...

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AND THESE AREN'T SOME PASSIVE PORTFOLIOS.
UNDERLYING VALUE HAS COMPOUNDED VERY NICELY.

OID: And you said that these holding companies have actually compounded their underlying values nicely?

Eveillard: Yes. They're not just sitting on a portfolio that doesn't change over time. They invest and disinvest. They don't trade those securities actively, of course — because oftentimes these are very substantial stakes. Still, every now and then, they manage to sell one and buy another major stake. So that's how they've added value.

The major shareholder of Rue Imperiale de Lyon, incidentally, is Lazard Freres — the Paris-based investment banking firm.

OID: And I gather that you expect the future returns of these holding companies under their watch to continue being above average, if not spectacular.

Eveillard: Well, they have their own money at stake, they're very shrewd and they've done very well in the past. So, at the very least, we think it's a big positive.

We believe they have the ability to sell stakes from time to time at a premium and redeploy the capital into stakes which they can buy at more attractive prices. And sometimes they get involved with the various managements — at least in terms of strategy.

OID: And you're not aware of any problems involving excessive compensation or anything else detrimental to other shareholders?

Eveillard: No, I'm not.

OID: So it's not like buying something mediocre at a discount and praying that the discount will close so you can sell it and have the privilege of paying taxes.

Eveillard: Exactly. It's a successful, well managed operation which can be bought at a substantial discount.

OID: Why, then, are they selling at those discounts?

Eveillard: The only answer I can give is that it's one of the inefficiencies of the French stock market. French investors traditionally have disliked buying into the stocks of holding companies that own a variety of stakes. And the French have always insisted that the stocks of their holding companies *should* sell at a discount to their net asset value. Maybe there isn't enough simplicity to it. Maybe there's a taint in people's minds about them being conglomerates.

OID: Which sounds like it could be a good reason — given the lack of focus, etc., which often results.

Eveillard: But they *aren't*. Each of them has their own independent or relatively independent management. And EuraFrance's management gets involved in them only when they feel that they need to get involved.

OID: I gather, then, that the underlying companies are reasonably well run.

Eveillard: I think the answer is yes. If they weren't, EuraFrance's management would do something about it — either prod current management, try to replace managements which leave something to be desired or try to get rid of their stakes in those companies.

Again, they're attentive — possibly because it's their own money that's at stake.

THINGS ARE GETTING BETTER IN EUROPE
— BELIEVE IT OR NOT, EVEN IN FRANCE.

OID: In a recent letter to Sequoia Fund shareholders, Bill Ruane, Bob Goldfarb, Carly Cunniff et al. detailed what sounded like absurd demands being made by unions in France. And others tell us that the situation in France is...

Eveillard: Some call it pre-revolutionary — in other words, that there is a budding social crisis that may erupt into something much worse.

OID: The words "anti-business" and "anti-shareholder" are the ones we hear most frequently.

Eveillard: Yes. However, if anything, I'm seeing a modest improvement in the attitudes of managements. They're becoming more shareholder friendly. And it's not a phenomenon peculiar to France, but rather one which pretty much applies to the rest of Continental Europe, too.

OID: At the risk of being overly negative about France to a man named Jean-Marie, what about its society?

Eveillard: I suspect the French vaguely understand that the way of life they have been used to cannot endure. But they hate change so much that they resist it. However, I think I see the beginnings of understanding. And that's what makes me less pessimistic than others about France. But we'll see if I'm right or not.

OID: And however challenging the setting may be, these managements have apparently thrived anyway.

Eveillard: Exactly.

OID: Can companies buy back their shares in France?

Eveillard: Not very easily — because there are all sorts of legal and tax-related difficulties. But I understand — and this is an indication that Europe is indeed changing for the better — that Germany is reviewing the tax penalties it imposes on share buybacks. And so is Sweden. So things are changing for the better throughout much of Europe.

EUROPEAN & AMERICAN EARNINGS?
THEY'RE GENERALLY APPLES & ORANGES.

Eveillard: Also, Americans are sometimes surprised to hear this — and I don't want to cast aspersions on American accounting...

OID: There's no need for you to do it. Buffett, Munger and Ruane handle that task just fine.

Eveillard: However, Americans tend to believe that they have the best accounting in the world.

OID: They don't?

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Eveillard: They don't. They have the best *disclosure.* They have the greatest transparency in their accounting, but that doesn't mean it's either conservative or liberal.

And better disclosure doesn't speak to that difference. The difficulty — although it's not an exact science, as David Winters of the Mutual Series Fund acknowledged in your December 31st edition — is that while European accounting tends to be more *conservative*, it also tends to be less *transparent*. And, therefore, one's task of making adjustments is much more difficult.

OID: Because it forces you to become something of a sleuth to deduce the reality behind the curtain.

Eveillard: Exactly. So Winters makes the same kind of adjustments we do. I liked how he laid it out because he's one of the very few who make all of those adjustments. As he says, most investors — including local institutions in the Netherlands — don't. They stick to appearances — which are deceiving. But the true reality of the business lies elsewhere. So some work has to be done. And he does it.

OID: One more comment like that and we'll probably lose him as a contributor — either for ego reasons or because Michael Price won't let him speak with us given what it might mean for his compensation....

Eveillard: That's the way to approach foreign equities. In Europe and Asia, you must make certain adjustments. But the local institutions and the local research firms are so mesmerized by the American approach — which is based on price-to-earnings and earnings-per-share growth — that they apply it to their own local securities without bothering to first ask themselves whether the accounting is the same or not.

OID: And based on your comments and those of other contributors, I gather you think it's generally not.

Eveillard: That's right. For example, companies in Europe and Japan tend to depreciate their fixed assets much faster on average than comparable companies in the U.S. and the U.K.

OID: That's what we keep hearing.

Eveillard: And that's one reason why we think it's so important to also consider price-to-cash-flow, (cash flow meaning after-tax earnings plus depreciation), rather than only price to after-tax earnings. That way, you eliminate the differences from one country to another and one company to another in accounting for depreciation.

OID: Gotcha.

Eveillard: However, even price-to-cash-flow ignores whether a company has lots of net cash or net debt on its balance sheet.

OID: It doesn't factor in the leverage or lack thereof.

Eveillard: Exactly. And that's why it's so important to go one step further and use enterprise value to EBITDA [earnings before interest, taxes, depreciation and amortization] as Winters did with Telegraaf. That way, because you add back interest paid or deduct interest received and adjust the company's enterprise value to reflect its net cash or net debt, you account for balance sheet differences from one company to another.

OID: Which has the added benefit, perhaps, of being the way that a potential acquiree might view it.

Eveillard: That's right. Enterprise value to EBITDA is by no means the be-all and end-all. But it is particularly helpful in evaluating a company with a lot of debt or a lot of net cash.

A BARGAIN WHEN WE LAST SPOKE
THAT'S ONCE AGAIN A BARGAIN TODAY.

Eveillard: For example, Emin Leydier, the French paper company that I told you about before, for reporting purposes depreciates its equipment over only eight years. By comparison, its most conservative American counterpart — Georgia Pacific — depreciates its equipment over *16* years.

OID: A mighty dramatic difference.

Eveillard: Absolutely. And, therefore, if you look at Emin Leydier purely on the basis of its earnings per share, you might think it's very expensive — because it's trading at nearly 70 times 1996 earnings.

But because EBITDA is earnings *before* interest, depreciation, taxes and amortization, it eliminates that distortion. So, instead of selling at a very high P/E, Emin Leydier, according to our calculations, is actually selling at something like 5-1/2 times extremely depressed EBITDA.

OID And when you told us about it before, you said it was selling at only 2-1/2 times after-tax cash flow.

Eveillard: Yes. And it's not that much higher today.

OID: When we talked about it in 1992, Emin Leydier was selling at FF255. What is it selling for today?

Eveillard: Around FF420. But it went up to nearly *FF650* in 1995 when the price of paper moved up. But then they moved down dramatically in 1996.

Emin Leydier has a state-of-the-art operation though. Over a full cycle, we think they should make good money. It's just that it's inherently a cyclical business.

And assessing Emin Leydier's normalized earnings is somewhat subjective. It depends to a very large degree what assumptions you make about the paper cycle. You have to look out to mid-cycle. And, as you like to say, you have to "normalize" it. And there's a lot of subjectivity involved when you do that.

OID: There's no need to get personal.

Eveillard: But it's probably selling at 7 or 8 times mid-cycle earnings and 3-1/2 times mid-cycle cash flow.

OID: Not that different than when you told us about it in 1992.

Eveillard: I think that's right. And Emin Leydier's book value is about FF280 as of year-end 1996. So it's selling at 1-1/2 times book.

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I thought we were at the bottom of the cycle when we spoke then. And I think we're at the bottom of the cycle again today. But it looks like they're still making money — albeit much less than they made in 1995 because the price of paper has come down so much.

However, we're still quite positive on Emin Leydier. So we've been buying more.

LOW COST POSITION + FIRST RATE, MOTIVATED MGM'T = UNUSUALLY HIGH RETURNS IN A SO-SO BUSINESS.

OID: Although Emin Leydier is a paper company, you mentioned last time that it's a high return business — over the full paper cycle anyway.

Eveillard: Correct. Emin Leydier's return on equity can be 30% or more in good years and the low single-digits in bad ones. But I would think that its return on equity might average 18% to 20% over most cycles.

OID: But how can they earn such high returns in what sounds like such a commodity business?

Eveillard: First, they're a low-cost competitor — which is what you want in a commodity business.

OID: More "need" than "want", I think. Otherwise, investing in them might be hazardous to your wealth.

Eveillard: That's true. One of my associates was talking with the management of a much larger Swedish paper company and Emin Leydier came up. And the management of that company said, "Oh, we've approached them. We'd love to take them over."

However, management controls Emin Leydier. So they can't be taken over against their will. And they have no interest whatsoever in being taken over — at least currently. Also, Emin Leydier's business is not completely the worst kind of commodity paper business.

OID: Talk about faint praise...

Eveillard: That's because they're in two businesses: (1) paper for corrugated board and (2) the corrugated board itself.

That's good for a couple of reasons. First, their corrugated board is used to produce corrugated containers used mostly in food packaging. And those sales, at least, are relatively stable; although it's also used to package other consumer products — including toys. Also good is the fact that to a great extent it's a local business because corrugated board's bulk is such that you don't transport it 500 miles.

OID: Similar to the virtues of rock quarries — as we've been told before by Semper Vic's Tom Russo and the folks at Tweedy, Browne. They're quasi-monopolies within their locales because of high shipping costs.

Eveillard: That's right. It's generally not cost effective for anyone to transport the product any great distance.

OID: But, if that's so, why don't paper businesses generally earn high returns?

Eveillard: For a variety of reasons, I believe that the paper industry, in general, will earn higher returns in the future than it has historically. But Emin Leydier is the low-cost competitor, too.

OID: Assuming for the moment that they can earn the returns you describe, can they reinvest those earnings at high returns, too?

Eveillard: Yes. In normal times, they generate lots of excess cash flow. And they can reinvest it — either by installing new equipment or making small acquisitions.

Because the paper business is not a stable business and earnings vary so much from one year to the next, the price acquirers pay does, too. In fact, it varies *tremendously*.

OID: Because the price of paper varies so much.

Eveillard: Right. Therefore, the smart people make acquisitions of good, small paper companies at the bottom of the cycle when the managements of paper companies and their shareholders are sort of discouraged — particularly when there is some financial distress.

OID: And I gather you would include Emin Leydier's management among those smart people rather than among those who'll be selling out in distress.

Eveillard: Exactly.

OID: Their FF500 million of debt doesn't make you worry about them one day being a distressed seller themselves? After all, that's over FF300 per share.

Eveillard: That debt would make me uncomfortable — indeed I would be uncomfortable even if they had *no* debt — did they not meet several key criteria: First, that they not be in the worst kind of commodity business. Second, that they be the industry's low-cost competitor. And, third, that management be skilled, motivated and honest. If a business passes muster on each of those criteria, debt or no debt and commodity business or not, then I think it can have lots of value.

OID: And since you mentioned management, I gather it's no coincidence that the top two officers are named Emin and Leydier.

Eveillard: That's right. It's a business that the two families have developed.

OID: Which suggests that perhaps the enterprise may have their attention.

Eveillard: It has their attention because their money is at stake. The families, which include more than just the two top officers, control the company.

But that may be both a plus and a minus. It's a plus for the reason you suggest — they have their own money and pride at stake. However, it may also be a minus in that, as I mentioned earlier, they can't be taken over against their will. The reason I don't see it as a minus is that I think they're doing a fine job.

ADJUSTED TO AMERICAN-STYLE ACCOUNTING, EVEN THEIR DEPRESSED EARNINGS ARE IMPRESSIVE.

OID: I gather Emin Leydier's historical earnings and

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returns would support your thesis about them averaging an 18-20% ROE over an average cycle?

Eveillard: I believe so. Emin Leydier is expected to only earn about FF12 per share in 1997. So we're talking about a return on equity in the low single digits.

But the paper industry has barely begun to recover. The recovery really only started two or three months ago. The first quarter of this year was still very poor for the paper business generally. Therefore, those estimates continue to represent depressed sales and earnings.

And, again, adjusting their earnings to reflect their huge depreciation and paper price cyclicality can be messy.

OID: Is there a condensed, sanitized version?

Eveillard: Not really. Let me have Elizabeth Tobin give you some of the figures so you can judge for yourself:

EMIN LEYDIER
AS REPORTED
FF (millions)

Year	Revenue	Net Income	Deprec.	Avg. Equity	ROE
1990	900	61	68	271[1]	N/A[2]
1991	877	66	67	300	22.2%
1992	829	33	78	338	9.8%
1993	877	(47)	138	322	N/M[3]
1994	1,115	12	131	300	3.9%
1995	1,421	82	125	377	22.0%
1996	1,158	10	147	446	2.2%
1997[4]	1,310	12	155	447	2.7%

[1] Ending equity.
[2] Not available.
[3] Not meaningful.
[4] Estimated.

OID: I see what you mean. If there's a clear pattern, it's certainly not clear to me.

Eveillard: That's because the business is so cyclical and because reported earnings are distorted by their enormous depreciation — FF125 million in 1995 and FF147 million in 1996. And it's expected to remain around FF155 million in 1997.

OID: That sounds serious, all right.

Eveillard: They're *extraordinarily* high levels.

OID: But I see that Emin Leydier's sales soared between 1993 and 1995.

Eveillard: Because of the new paper machine that they bought and the upswing in the price of paper.

OID: But then they nose-dived in 1996. Was the decline in paper prices the only cause or was something else happening there, too?

Eveillard: Their volume of paper sold went from 376,000 tons in 1995 to 400,000 tons in 1996. And their sales volume of corrugated board — where, again, they use some of the paper they make — was flat. So what took its toll on their results was prices.

The peak year for Emin Leydier's earnings this cycle was 1995. And it looks like 1996 will be the trough year — at least for their paper segment — because paper prices are already up about 5% from 1996 levels. But they're in both paper and corrugated board. And corrugated board prices have not yet turned.

So if you take their return on equity of 22% in 1995 and a little over 2% in 1996 — in effect, factoring in a good year and a bad year — you see that they reported an average return on equity of about 12% for that period.

OID: Which is a good country mile — in France or anywhere else — from your estimate of 18-20%.

Eveillard: Yes. But Emin Leydier's depreciation is far above what it would be were it an American company.

OID: What would their earnings and returns look like were Emin Leydier to use American-style depreciation?

Tobin: American paper companies — excluding their forest products and other non-paper segments — probably average depreciation of something like 6% of sales per year. By contrast, depreciation at Emin Leydier has averaged well over 10% of sales since 1993. So we can calculate the impact of American levels of depreciation on Emin Leydier's earnings easily enough.

However, if your objective is to assess the impact of depreciation on their returns, you should also consider that lower depreciation levels would also have the effect of increasing their net worth. So it's not that simple.

OID: No problem. We're happy to spare no effort in the analysis — so long as the effort's yours.

Tobin: I've noticed. As you see, their depreciation jumped dramatically in 1993. That was because they began their big spending spree on equipment that year.

So when I reduce their depreciation to 6% of sales in 1993, 1994, 1995 and 1996 and adjust their net worth accordingly, their return on average equity for those years would be about 15%, 17%, 26% and 11%, respectively.

EMIN LEYDIER
AS ADJUSTED*
FF (millions)

Year	Net Income (mil FF)	Retained Earnings (mil FF)	Average Equity (mil FF)	Return on Equity (average)
1993	56	46	368	15.2%
1994	74	64	430	17.2
1995	129	119	490	26.3
1996	62	52	555	11.2

*Assumes depreciation of 6% of sales in lieu of actual.

Tobin: Obviously, these are very rough figures that I've done on the fly.

OID: What we call back-of-the-envelope.

Tobin: Not quite *that* rough. But with those

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adjustments, their average ROE for the four year period would have been approximately 17.5%.

OID: And, I see, roughly 18.75% in 1995 and 1996.

Tobin: That's right. And, again, they earned those returns on a much higher net worth. Using my figures, Emin Leydier's book value would have been more than FF350 per share as of year-end 1996.

OID: So with your back-of-the-envelope adjustments, not only would their returns be far higher, but their higher book value would also imply that today's price represents a very small premium to book, if any.

Tobin: Yes, that's right — which is as it should be — because they spent over FF800 million in 1993 for that one paper machine or over FF500 per share.

OID: More than their current stock price?!

Tobin: Exactly. And so long as they're properly maintained, those machines actually last quite a long time. It's not unusual at all for them to last 20 years.

OID: Fascinating.

Tobin: And I'm not saying that my analysis is perfect. For example, their book value would be higher were we to begin adjusting their earnings in prior years. And, therefore, their returns would have been somewhat lower. But I think it's much closer to the true picture. And so, obviously, both Emin Leydier's book value and its earnings are *very* understated.

OID: Applying your adjustments to the estimate for 1997, what do you estimate the impact would be on their earnings for this year and their year-end book?

Tobin: This year won't be a good one because they were barely breaking even during the first half of the year. But making those same adjustments, their 1997 earnings would be around FF46 per share — which would be equivalent to a return on average equity of about 12%. And their adjusted book as of year-end 1997 would be about FF385 per share.

OID: So using their 18.75% return on average equity as our guesstimate for their ROE going forward would imply normalized earnings of FF75 to FF80 per share and a P/E ratio of 5-1/2?!

Tobin: That's not the way we do it. But that's right.

AND EMIN LEYDIER HAS EARNING POWER
THAT IT HAS YET TO DISPLAY. BUT IT WILL.

Eveillard: And 1996 was basically as bad as it gets. It was the bottom of the paper cycle. And it wasn't only Emin Leydier that took a hit. The entire paper industry suffered a terrible bottom in 1996 *worldwide*. And it just happened to occur shortly after Emin Leydier added significant new equipment.

OID: So they have our knack for timing.

Eveillard: The primary use of their corrugated board is for packaging. So, as you might expect, the demand for their product is tied to the health of the French economy. And the last few years haven't exactly been salad days.

OID: So we're actually looking at a depressed period.

Eveillard: That's with them getting hit from all sides. Not only were they in the weak part of the cycle for paper, but the French economy was weak.

OID: So that 1995 probably didn't give them a chance to show their full earning power.

Eveillard: That's right.

Tobin: In part, that's because 1995 was a very short-lived recovery. What was also unusual is that there was actually a shortage of their primary raw material — which is waste paper. So their costs increased sharply. And the prices of their products and raw materials alike fluctuated wildly in a way that two generations of the company's managing families say they had never seen. So their operating margins did not expand as much as one might have expected considering how much corrugated paper and board prices rose.

OID: So that averaging out Emin Leydier's returns for 1995 and 1996 might be overly conservative?!

Tobin: That's right.

Eveillard: I think you can begin to get some idea of how much earning power this company has if you look at the results they reported in 1990 and 1991 — when, based on their unadjusted reported return on equity, their return on average equity was up around 22%.

OID: But could those higher profits simply have been because they had depreciated their equipment to zero and were, therefore, reporting inflated earnings?

Eveillard: Not at all.

Tobin: Not only did they have much less leverage in 1990, but they were much smaller, as well. So they *should* enjoy much greater economies of scale today — especially given the state-of-the-art machinery they have. They've automated their production to a far greater degree and, simultaneously, dramatically lowered their costs and increased their capacity — at least in their paper division.

And now they're working on increasing capacity in their corrugated board division to bring the same efficiency to it.

OID: And, presumably, you don't believe that everybody else has gotten more efficient, too?

Tobin: There has been ongoing consolidation in the industry which presumably leads to improved productivity. However, Emin Leydier today produces 1,600 tons of paper per employee versus the industry average of 1,100 tons.

Eveillard: Also, they've basically been in the process of assimilating acquisitions and equipment going back to 1990 and beyond — although not on the same scale. I don't think we've yet seen them demonstrate what they're capable of earning.

Tobin: That's right. They moved into high gear in 1993. That's when they added the new paper machine.

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Then they were busy working out the bugs on it. And don't underestimate the magnitude of that challenge. Installing it took them around six months. And later, in 1995, they significantly expanded its capacity — incidentally, at a very low marginal cost. So they continued to make fairly sizeable capital expenditures in 1995.

And in 1996, they invested in the corrugated board division by buying a new machine for one of their plants — and making a small acquisition in Italy which also increased their corrugated board capacity.

OID: This business sounds like it sucks up capital like a black hole and that the sucking never ends.

Tobin: As long as they earn the kind of returns that we think they can on that capital, we're happy to see them put more capital into that business.

But they're not going to earn those returns this year. In fact, they'll be lucky if they can be flat with last year because of vicious competition in the corrugated board division. But over an average cycle, I think so.

OID: Vicious competition seems to be the norm here.

Tobin: I think that's right. That's why the quality of management is so important in this business.

Eveillard: And the vicious competition is, of course, at its worst near the bottom of the cycle — which is pretty much where we are today. But looking out past the bottom of the cycle, I think we'll be fine.

[Editor's note: Tobin tells us a corporate tax increase in France — probably a sizeable one — is in store. If so, Emin Leydier's earnings and returns could take a haircut of 10% or so — at least for a couple of years — which was factored into the 1997 estimates.]

TELEGRAAF IS STILL QUITE A GOOD VALUE.
BUT WINTERS ALREADY LAID OUT THE CASE.

Eveillard: But if it's less competition that you want, then maybe we should talk about Telegraaf.

OID: At the very least, we should take the opportunity to point out that you told us about Telegraaf first — even before Tom Russo.

Eveillard: I talked very briefly about it.

[Editor's note: See our February 8, 1990 edition.]

OID: And, incredibly, at that time, you mentioned that it was selling at only 6-8 times earnings!

Eveillard: Actually 6-8 times *reported* earnings. And I didn't really elaborate on it at that time. But if you made the adjustments David Winters made [in your December 31st edition] which reduce its P/E from 16-17 times reported earnings to a single-digit multiple of adjusted earnings, who *knows* how low it would have been then.

As Winters laid it out, at 16-18 times earnings, Telegraaf is, in fact, *still* dirt cheap. Well, it was *twice* as dirt cheap back in 1990.

OID: Yeah — at perhaps 4-5 times adjusted earnings.

Eveillard: I think so.

OID: From your earlier comments, I gather that you basically agree with Winters' analysis?

Eveillard: I do. And even after having appreciated as much as it has since we first spoke, Telegraaf still looks *extremely* attractive. It still looks like *quite* a good value.

OID: But you haven't bought any lately?

Eveillard: No. But that's only because I'm not *smart*. If I'd been really smart, I would have bought it every year over the past 10 years. But from a psychological point of view, although I try to *fight* it, when you buy something and it goes up and up, you're very reluctant to buy more — unless you're Warren Buffett.

OID: Actually, at Berkshire's latest annual meeting, Buffett said the same thing: one reason to never sell is that once you do, it's often very tough psychologically to ever buy it back.

Eveillard: Exactly. So if what you're looking for are high return businesses that are selling at big discounts, then I think Telegraaf would still qualify today. Certainly, if it were an American company, it wouldn't be selling anywhere near where it's selling today.

But, again, Winters already laid that one out. So...

OID: Actually, we'd be happy to have the same idea in every edition. But some subscribers might not...

SO HERE'S ONE THAT'S JUST AS CHEAP
AND TRULY A QUASI-MONOPOLY.

Eveillard: Well, how about one that's just as cheap as Telegraaf after making all of the proper adjustments, however with one difference: Telegraaf is the Netherlands' *biggest* daily newspaper, but it's not the *only* one. Edipresse has what is truly a quasi-monopoly.

OID: Sounds too good to be true.

Eveillard: They have a near-monopoly on newspapers in French-speaking Switzerland — also called Suisse Romande. The only French language newspapers other than their own are extremely local newspapers in small towns. Edipresse has the newspapers in Geneva and Lausanne. And, overall, I think they have something like 90% or 95% of the market.

OID: In that case, we'll skip the customary 2-3 pages of competitive analysis.

Eveillard: We started buying Edipresse very late last year or early this year. And only over the past month or two have our analysts actually gotten to visit with management and do the additional work.

We're talking about a market cap of only \$250 million — with the float being no more than about half of that.

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And we'd love to have a full position in it.

OID: And you haven't told us about it yet?

Eveillard: Elizabeth Tobin is most knowledgeable about that one, too. So let me have her tell you about it.

Tobin: As Jean-Marie may have already mentioned, one of the things that we find intriguing about Edipresse is that it really has no competition to speak of.

EDIPRESSE SELLS AT HALF THE MARKET MULTIPLE.
ONLY ITS EARNINGS ARE VERY DEPRESSED, TOO.

OID: To hell with intriguing. First, is it cheap?

Tobin: We think Edipresse is *quite* cheap. The average newspaper company in the U.S. is probably selling for 10 times EBITDA or more.

OID: Everything's relative.

Tobin: Even most large publishing groups in Europe are currently selling for 10 times EBITDA or more. By comparison, Edipresse is selling at only about 6 times 1997 EBITDA. And very importantly, Edipresse's multiple is based on anything but peak earnings. Its earnings are extremely depressed.

OID: Why do you say that?

Tobin: First, Edipresse is based in Switzerland. And the environment in Switzerland is far from buoyant.

OID: I read somewhere that Switzerland has basically been in recession since 1991.

Tobin: That's right. Not surprisingly, there's been a slowdown in ad spending. Also, Edipresse has lowered its ad rates for the last three or four years. So, obviously, their advertising revenue is rather depressed.

Also, three years ago, Edipresse succeeded in running their leading competitor in the French language newspaper business into the ground by cutting prices and winning a price war. That Lausanne-based newspaper was their last meaningful competitor.

So Edipresse applied the coup de grace. And with it just about to go bankrupt, they basically bought its name and printing equipment for next to nothing. As a result, Edipresse has a monopoly in French-speaking Switzerland. And while the market's small, obviously, by U.S. standards — we're talking about a population of 1.3 million people — it *belongs* to Edipresse.

OID: Good answer.

Tobin: It works for us. So Edipresse essentially took it over and entered into an arrangement with the city of Lausanne not to lay off anyone in exchange for certain tax abatements which expire by the year 2000. And, therefore, their effective tax rate today isn't very high.

On the other hand, their expenses are temporarily bloated. I understand that they currently have substantial duplication in their operations. For example, they frequently have two journalists cover the same event for their two major Swiss publishing properties. And so there's room for significant cost cutting. They hint that they can reduce their personnel costs by about 40%.

OID: I think 40% would qualify as significant.

Tobin: Those savings won't come through right away. They're not laying off staff. But it's only a matter of time until they achieve those savings through natural attrition — through retirements and so forth. Also, presumably, other expenses are bloated besides staffing.

And they've been very cautious about raising ad rates or subscription rates since they won the price war. In fact, they haven't — despite having lowered both during the price war and the extended recession in Switzerland which has yet to end.

OID: It's sounding better and better.

Tobin: And there's more still. Believe it or not, in Switzerland, some people don't *pay* for their newspapers.

OID: How can that be?

Tobin: Many newspapers are distributed from boxes that rely to one degree or another on the honor system. And when people take their newspaper, it's assumed that they're going to pay. However, it appears that too many don't. So they're having a problem with newspapers being sold on the street. Too many are just being *taken*.

OID: Very interesting.

Tobin: They're talking about converting their boxes from ones that rely on the honor system to ones that are coin-operated. So they're tightening up that aspect of their business, too.

OID: And I imagine being a near-monopoly provider may mean that perhaps they can tighten up without compromising circulation in a life and death war.

Tobin: Exactly. And one more thing: Edipresse's approximate breakdown of revenue today is about 45% from advertising and 37% from individual sales and subscriptions, with the balance essentially printing revenue. That's not at all comparable to the Washington Post or even De Telegraaf. At those newspapers and others, a 60%/40% split is much more typical.

OID: In other words, Edipresse's advertising revenue is depressed?

Tobin: You've got it — particularly considering how people subscribe to newspapers in Switzerland. For example, most coffee shops or restaurants are also subscribers. And people read it there. So the readership is much higher than the apparent number of subscribers.

OID: Even before factoring in the unintended freebies that some people help themselves to from the boxes.

Tobin: Exactly.

EARNINGS ARE NOT ONLY DEPRESSED,
BUT THEY'RE UNDERSTATED, TOO.

Tobin: And, of course, Swiss disclosure isn't the best. Management doesn't speak with shareholders very much.

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Plus, they release their numbers only once a year. And they don't use international accounting standards and probably won't until they absolutely must.

OID: To tap into U.S. capital markets.

Tobin: Exactly. Switzerland has a fairly high tax rate — although that varies from area to area within the country. So companies tend to use a lot of provisioning and that kind of thing to understate their earnings.

Edipresse expenses a lot of what would normally be capitalized and provisions — sometimes for highly unlikely events — to minimize its tax liability. And if you look closely at Edipresse's financial statements — although that's not expressed extremely clearly — you'll see that every year, there are provisions that are reversed. So their provisions include things that are not necessarily truly costs.

For example, three or four years ago, they began to aggressively, but cautiously, invest in newspapers and magazines in other countries that they believed were underserved — such as Spain, Portugal and Eastern Europe. And I say "aggressively, but cautiously" because although they've invested quite a bit in those countries, they've done it via joint ventures. They go out and acquire one property in a market — or establish a joint venture. And, then, once they're more knowledgeable about that market and sufficiently comfortable with it, they'll go out and use it as a springboard to launch and/or acquire other titles. They may also buy out minorities at that stage.

OID: Sounds smart. But what can you tell us about the prices they've paid?

Tobin: They don't really fully disclose that, but as far as we can tell, they've been very prudent. In Poland, for example, they basically bought some equipment — what you might call a tiny operation — which they've developed somewhat since. So I don't think they paid too much for it.

But the cost of those titles, whether they're launched or acquired, is treated in an interesting way. What they typically do is immediately write down the goodwill created in the acquisition — the excess of purchase price over book value of the acquired interest. In addition, when they recently launched new titles in Poland, they completely expensed the cost of launching them in year one. So they're carried for nothing or next to nothing on Edipresse's books.

OID: Expensing the cost of launching businesses is obviously extremely conservative. But they actually write down the goodwill on their acquisitions, too?! That's beyond conservative.

Tobin: Yeah. Again, they use their *own* accounting standards — nothing near GAAP. They're not reporting under international accounting standards yet — although it's probably just a matter of time until they do.

And they've launched or acquired, or are in the process of launching or acquiring, quite a few titles outside Switzerland. For example, besides launching titles in Poland, they're acquiring titles in Spain and Portugal. And they haven't been capitalizing any of those costs — although they say that they may start capitalizing them in the future.

So all of those things, in effect, suggest to us that Edipresse's earnings are very depressed.

OID: And understated, too. You've convinced me.

Tobin: Very much so. Yet, despite all those things, Edipresse generates substantial free cash flow even today. And, despite its earnings being extremely depressed, Edipresse sells for a much lower multiple of EBITDA than does its peer group in the U.S. or even Europe.

OID: You think it should be more?

Tobin: Absolutely — because not only does Edipresse have a monopoly position in its home market which no one can take away from them or duplicate, but it also has growth potential outside its home market. And that's quite a wonderful combination. So I would think that a multiple of 10 times EBITDA would be very reasonable. But that's 10 times *normalized* EBITDA, not *depressed* EBITDA.

OID: I understand that it hasn't been at all unusual historically, at least in negotiated transactions, for newspapers to sell at 10-12 times EBITDA.

Tobin: Not at all.

OID: In part because it's a natural monopoly — one of the few that's also legal and unregulated...

Tobin: Exactly.

OID: And, in part, because relatively little is required in the way of recurring capital expenditures.

Tobin: That's right.

OID: So that almost all of their cash is free cash.

Tobin: Yes. And that should be especially true of Edipresse's Swiss operations going forward because they recently updated their printing facility and upgraded their technology infrastructure. That's where the bulk of what recurring capital expenditures there are come from. Plus, there's been far less of those capital expenditures required in their foreign operations to date because they've so far subcontracted a lot of the magazine printing. That may change once those operations grow larger, but that's what they've done up until now.

So now that those expenditures are behind them, you're right — most of their cash flow will be *free* cash.

IF YOU THINK ITS EARNINGS ARE UNDERSTATED,
YOU WON'T EVEN BELIEVE ITS BOOK VALUE.

OID: And Edipresse is selling at a lower price-to-book than most U.S. newspapers despite almost certainly having a book, for all the reasons you've mentioned, that's much more conservatively stated.

Tobin: Absolutely. Its book value is less than SF150 per share. So it's selling at a little over 2 times book. But it's a *very* understated book.

For example, in Edipresse's 1996 annual report, for whatever it might be worth, they provide insurance values. For their building alone, they say the fire insurance value is SF240 million. And for what they call "Other" — whatever that might be — they say it's SF297 million. So their total insurance value is SF537 million.

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OID: That's SF500 per share!? Even net of debt, that's more than their current stock price!

Tobin: Yes. That doesn't mean those things are worth that exactly.

OID: That's true. As I understand it, real estate is often insured for the greater of market value or replacement cost. And the latter can vastly exceed the former. What kind of real estate is it?

Tobin: They have an office building which served as their former headquarters. It's a pretty big building — about 20 stories, if I recall properly — of which they only occupied a few floors. At their annual meeting, they said that they were going to start working on it a little bit over the next year and renting it out.

OID: It's empty now?

Tobin: Yeah. I think they use 20% of it — at most. It's been empty for several years. What happened, I think, is that when they moved to their current headquarters, they considered selling it. But the real estate market wasn't exactly favorable and they saw that they couldn't get the kind of price they wanted. So they just held onto it.

OID: Although the fact that they couldn't sell it for a satisfactory price along with everything else you've told us about the state of the Swiss economy suggests that it may not be worth anywhere near insured value.

Tobin: True. But, again, it's large. And it's on the main avenue behind the building they currently occupy. Also, they may have been busy with their acquisitions. It wasn't their first priority. Therefore, they let it sit empty.

OID: And it's hard to imagine anyone insuring something for more than its replacement cost unless they were planning on burning it down and collecting on the insurance. I assume there's no history of arson at the company?

Tobin: Not that I'm aware of.

OID: Did they provide any specifics about its size, what they were willing to sell it for or anything?

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Tobin: Of course not. But I've seen it. It's catty corner from their new headquarters — right next to the train station in Lausanne. So it's definitely in a prime location.

OID: Have you heard any estimates from anyone about its size or value or anything?

Tobin: No. I tried to get that, but couldn't. And as to what it's worth, frankly, your guess is as good as mine. However, again, I do find it fascinating that they say in their annual report that they insure their real estate for SF240 million.

WHAT 6 TIMES EBITDA MEANS:
A LESSON IN CALCULATING EBITDA.

OID: Could you give us a nutshell summary of their operations and their assets?

Tobin: Edipresse is, in effect, a holding company that owns 75% of an entity called PPSR — which includes all of their Swiss newspapers plus their printing plants. And the remaining 25% of PPSR is owned by Publicitas — which is another publicly traded Swiss company.

The relationship between Edipresse and Publicitas is extremely tight because Publicitas does all of their advertising work. That's a standard way of doing business in Switzerland: Publicitas sells the ad space for Edipresse. They market some of Edipresse's book titles and do other promotional work for them. And they actually handle client administration and billing.

Incidentally, Publicitas has a very large market share of that business in Switzerland — not just *French*-speaking Switzerland, but *all* of Switzerland. And, in exchange for that, Publicitas charges a flat fee to their clients — usually on a long-term basis under five to seven-year contracts.

But there is a very close relationship between Edipresse and Publicitas — not only on an operational level, but also at a shareholder level since, again, Publicitas owns 25% of their Swiss newspaper properties.

OID: And that's important because it, in effect, locks in a strategic alliance?

Tobin: Absolutely.

OID: What do they own in their foreign operations?

Tobin: Largely magazines. In Spain, they own several magazines: *Tu Bebe* — the equivalent of *Parents* magazine — and a woman's magazine among others. And in April of this year, they acquired a 50% stake in La Semana — a publisher with two weeklies, the third most popular magazine in Spain, and a printing operation. It is a significant development — because they now rank #2 in Spanish magazine publishing.

Incidentally, they don't really own much in the way of magazine properties in Switzerland — two weekly TV Guide -type publications and a weekly woman's magazine.

OID: And Portugal and Eastern Europe?

Tobin: In Portugal, they own 100% of a combination of magazines: a business weekly similar to *Business Week*, a national newsweekly similar to *Time* or *Newsweek*, a magazine similar to *TV Guide* and a literary review. In all, they have over 194,000 readers.

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In Poland, they own 50% of a woman's magazine that sells approximately 500,000 copies each week. Plus, they have a monthly equivalent of *Parents* magazine there. And it has a circulation of about 80,000.

OID: Are we almost done?

Tobin: Almost. Finally, there's what they refer to as "Other Assets." Their contribution to pretax earnings is currently SF3± million. And Edipresse's carrying value for them is SF23± million.

But, again, the way that Edipresse treats acquisitions is to write off their goodwill immediately. So I suspect that their numbers are extremely conservative — both in terms of carrying value and earnings. I suspect they're worth much more.

OID: What are they?

Tobin: Their "Other Assets" include a broad array of different businesses. There's a movie theater chain of which they own 50%. They also own 35% of Payot Naville — a distribution group with kiosques that sells newspapers and magazines and distributes books.

Edipresse's management says they own them to help ensure their own newspaper distribution. But since they have a monopoly, they don't look all that essential to me. So I just call them "Non-Strategic Stakes."

OID: When you say Edipresse is selling at 6 times EBITDA, might you very briefly explain how you arrive at that figure?

Tobin: Edipresse has the equivalent of 1.1 million bearer shares outstanding. That's the total of their 545,000 bearer shares plus 2,725,000 registered shares — which, economically, are equivalent to 1/5th of a bearer share each, (although they're equivalent to 1 bearer share for voting purposes).

So I simply multiply Edipresse's current price of SF350 per share by its 1.1 million shares outstanding to come up with its current market cap of SF385 million.

And to its market cap, I want to add its net debt and subtract the value of its "Other Assets."

OID: And you do net out the value of those because...

Tobin: Because they aren't consolidated in Edipresse's income statement. Their share of net income is simply included in financial income. I assign a value to it and net it out of enterprise value.

OID: Gotcha.

Tobin: Edipresse's share of their earnings last year was roughly SF3.2 million. So let's say their non-strategic assets are worth SF36 million. (That's probably low, but they're not really big enough to worry about in any case.) And, therefore, when I take their current market cap of SF385 million and add their net debt of SF125 million and subtract SF36 million for their non-strategic assets, I arrive at an adjusted enterprise value of SF474 million.

OID: In other words, that's what one effectively pays for Edipresse's business given today's stock price when you add its net debt and net out its other assets.

Tobin: Exactly.

OID: And that's your numerator.

Tobin: That's right. And Edipresse owns 75% of the Swiss operation, 79% of their operation in Spain, 100% of their operation in Portugal and 50% of their operation in Poland. So they consolidate 100% of the sales from those operations in their income statement and 100% of their assets in their balance sheet and back out their partners' share of income subsequently as minority interest.

Of course, when I estimate the ratio of Edipresse's enterprise value to its EBITDA, I should only use the portion of consolidated EBITDA and debt which I estimate is theirs. And, when I do, I come up with SF68 million of EBITDA for 1996 and, I estimate, SF76 million of EBITDA for 1997.

OID: And that's your denominator.

Tobin: Exactly. And, then, dividing my estimated enterprise value by my estimated EBITDA, I estimate that Edipresse is selling at roughly 7 times 1996 EBITDA and 6.2 times 1997 EBITDA.

Stock Price	SF350/share
÷ Shares Outstanding	1.1 million
= Market Cap	SF385 million
+ Net Debt	SF125 million
= Enterprise Value	SF510 million
- Non-Strategic Assets[1]	SF36 million
= Enterprise Value (adjusted)	SF474 million
1996 EBITDA[2]	÷ SF68 million
EV/EBITDA	7.0 x
1997 EBITDA[2]	÷ SF76 million
EV/EBITDA	6.2 x

[1] Non-Strategic Assets were valued at SF36 million for Edipresse's share — which was roughly 11-1/4 times the reported net income of SF3.2 million.
[2] Adjusted for minority interests.

NORMALIZED EBITDA IS MUCH HIGHER.
BUT DON'T HOLD YOUR BREATH.

OID: You mentioned that Edipresse's earnings are very understated and depressed and laid out what seemed like a pretty persuasive case that they are. Is it possible to quantify its normalized earning power?

Tobin: That's very hard because while I know that Edipresse's earnings are significantly understated, I don't know by exactly how much. And I don't have any idea when the Swiss economy will recover.

OID: Ignoring timing altogether and looking out to average conditions in the economy, the industry, etc.,

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what's your sense of their normalized EBITDA?

Tobin: I believe their normalized EBITDA for 1997 is at *least* 20% higher than their 1996 EBITDA.

OID: Or about SF82 million?

Tobin: That's right. And they could do that from increased advertising spending in Switzerland alone — without any added contribution from foreign operations, without any cost savings, without capturing any lost box revenue or anything else.

That's just assuming a normal economy and normal advertising spending.

OID: So you think it might actually be more?

Tobin: To put the Swiss economy and ad market in perspective, there was an 8% decline in ad spending in 1996 alone. And 1996 was the second year in a row that ad spending declined.

So Edipresse's ad revenue should improve with the economy. It's been extremely depressed. But once the Swiss economy finally does reach bottom and start up, (and ad spending is expected by many to be stronger in the second half), I don't think a 10-15% increase in ad spending over a couple of years would be overly optimistic at all. And that wouldn't represent peak numbers either.

OID: Don't stop on my account, please.

Tobin: And I mentioned earlier that when they acquired their leading competitor in 1994, they absorbed its entire staff and so on and got a tax break from the city of Lausanne as a result. Again, they hint that they can reduce their headcount by about 40%.

OID: I understand Edipresse has total personnel costs of SF175 million. So even if they only save 10%...

Tobin: That's not something I want to try to quantify.

OID: Spoilsport.

Tobin: But because they're not going to start laying off people tomorrow, we're not talking about them actually realizing those savings anytime soon.

OID: We can wait. And we know from experience that most of our subscribers make Job look fidgety.

And I believe you mentioned that Edipresse had lowered its ad rates more than once in recent years.

Tobin: That's right.

OID: They can't raise them back to where they were now that the price war is over?

Tobin: They've chosen not to because of the recessionary environment in Switzerland. Presumably, as things improve, they could. But I get the impression that they're somewhat reluctant to raise either their ad rates or their subscription rates. In part, I think that may be because the last time they raised their subscription rates, although they didn't lose subscribers, there was apparently quite a bit of unpleasant reaction.

DAMN THE INCOME STATEMENT
AND DON'T PASS UP THE OPPORTUNITIES.

Tobin: And don't forget that I'm also not assuming any additional contribution from their foreign operations.

OID: Assume away, please.

Tobin: Their foreign operations are clearly going to grow much faster than their Swiss operations. After all, they went from a standing start — from zero in revenues — to 25% of their sales in 1996.

And they're going to continue growing. They've said that they want to launch an additional magazine in Poland, two more in Spain, and two more in Portugal. So their foreign segment will probably enjoy a much greater rate of growth than their Swiss segment — even if you assume that it experiences a 10-15% rebound in ad volumes.

OID: And you view those acquisitions as a positive?

Tobin: I *do*. They seem to be handling them very intelligently. For example, they believe the market for magazines in Northern Europe is already relatively well developed. So they're not going after them. Instead, they're focusing on markets that they believe are relatively underdeveloped — and, therefore, where there's more opportunity for their publications to succeed and grow.

For example, they believe the market in Spain is one that's still relatively underdeveloped and that there's a lot of growth potential for their magazines in that country. And, believe it or not, their operating margins there are already higher than they are in Switzerland.

OID: Really?!

Tobin: Granted, Swiss margins are depressed. And some of those higher margins may be the result of subcontracting out their printing. But they seem to be achieving good success in their foreign segment.

And what they started with in Spain was the equivalent of *Parents* magazine. It was very focused. And, next, they wanted to start an arts and crafts magazine containing patterns for embroidery. So they hired a couple of people to develop the patterns and launched it in Spain.

Then, cleverly, they introduced the same magazine in Poland and Portugal after confirming that there was the opportunity to do so because it had no such magazine yet. And it essentially became a translation issue. They used the same format and the same content. So all they had to do was to contract out the printing.

OID: And the research report you sent me mentions them using the same baby pictures in their magazines in different countries.

Tobin: Exactly. And, as you can imagine, that does wonders for their profitability.

And I mentioned how they bought a 50% stake in a small operation in Poland and how they're using it as a platform from which to launch new titles.

So they aren't contributing much in terms of earnings — at least not just yet. But, in part, that's because they've been incurring heavy startup-related costs and, in part, because Edipresse's accounting is so conservative.

Remember that when I say their Spanish operation

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actually has higher profitability than their Swiss operation, that's even with all of the costs associated with the launching of their new magazines *expensed*.

OID: Do they tell you those?

Tobin: No, they don't. But they gave an indication this year at their annual meeting.

OID: They allow non-family members to attend?

Tobin: I know that's hard to believe. And they said they weren't going to sacrifice growth opportunities in order to improve their income statement — that launching new products in new markets was far more important at this time.

Also, for the first time, they disclosed what they've spent to launch new products in foreign markets — which was SF760 thousand in 1995 and SF2.4 million in 1996. And they said that they expected it to total SF8-9 million in 1997 and 1998.

So SF4-5 million of incremental contribution from their foreign operations may be a conservative assumption — although, frankly, it depends on so many factors.

OID: But you think it would be at least that.

Tobin: That's what I think. But it depends on so many things. For example, what happens if they decide to launch seven titles instead of five?

OID: They go deeper into debt?

Tobin: It could be. But up until now, they've reduced their net debt by at least SF20 million in 1996.

Personally, I don't mind their adding titles just as they have in the past — where they simply respond to opportunities as they arise. And based on all of the evidence that we can find, they seem to be doing this at very reasonable prices.

IT'S ALWAYS RISKIER TO ENTER NEW MARKETS.
BUT, SO FAR, THEY'VE HANDLED IT WELL.

OID: How far back does this company go? And how far back can you review their track record?

Tobin: Edipresse's latest annual report is #90. So they've been around for a long, long time. Unfortunately, they came public in 1990, so we can only go back that far.

But it's a very different company today. It wasn't a quasi-monopoly then. And they only began to diversify into foreign markets in 1992. I understand that the controlling shareholder passed away in 1992 or 1993. And there were some succession/inheritance issues among the members of the controlling family. Some wished to remain heavily involved in the business and others didn't.

OID: Which may help explain why the stock is cheap: management uncertainty on top of everything else.

Tobin: That's right. So they restructured the capital — largely as a result of an inheritance problem, I believe. And, in early 1995, there was a split in the nominal value of the bearer shares and the introduction of a new class of share — which is their registered share.

Around 93% of the registered shares were held by the Lamuniere family. And some family members apparently wanted out. They didn't want to monetize their assets. So they sold their portion of the bearer shares — 150,000 or so shares in all — to outside investors.

OID: Do you know what percentage of bearer shares the family owns?

Tobin: Very little. The family got 9-10% of Edipresse's bearer shares on the issue — which gives them about 5% of Edipresse's capital value and 1.7% of its votes. But they have about 93% of its registered shares — which gives them about 46-1/2% of its capital value and, between 77% and 78% of its votes. So the family owns about 51% of Edipresse's capital value and, once again, about 79% of its total votes. But I don't know much more than that.

There are three members of the family on the board. Edipresse is managed by one of those family members — Pierre Lamuniere — the current president and chairman of the board. And he's a very young guy — only 46 years old.

OID: That is sounding younger and younger.

However, I have to conclude from your comments that you don't think he's in over his head.

Tobin: No. Again, their results going forward really aren't comparable to their past figures because they didn't have the monopoly position then that they do today.

But I think they know their business extremely well. They operate within a very small area in Switzerland. Historically, they have stuck to their knitting. The family has always been in publishing. And, after all, they have managed to achieve a near-monopoly position.

OID: What could turn Edipresse into a mistake?

Tobin: They are fairly small. So any acquisition that turns out to be a big mistake could be devastating. That's the greatest risk — that they overpay for something or they buy one of those turnarounds that never turns around.

In some ways, of course, Edipresse is different than Telegraaf. But like Telegraaf, it's very cheap. And, like Telegraaf, there's a controlling family that isn't exactly out promoting the stock to the investment community. They provide shareholders with very little information. And they held their first analysts' meeting ever last year.

OID: That sounds encouraging.

Tobin: Less encouraging than you might think, unfortunately. We suspect that they held that meeting because they were close to making an acquisition and figured that they needed to talk to the financial community for the first time ever.

And at last year's annual meeting — in June of 1996 — they said that they were looking at larger acquisitions outside Switzerland and that they might issue stock to pay for them. They even passed a resolution authorizing the issuance of additional shares for that purpose. And that wasn't to anyone's liking.

OID: At least anyone who believes that their shares are undervalued.

Tobin: Exactly. Edipresse's bearer shares were up near SF500 in 1991 and dropped as low as SF220 early in

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1996. So their stock was hit very hard — particularly last year. And I think it was three things that hit it hard: First, despite expectations to the contrary, the Swiss economy wasn't recovering. Second, higher paper prices. And, third, management talking about making an acquisition by issuing additional stock at depressed prices.

I imagine that they saw an opportunity that they couldn't afford without issuing shares or taking on more debt than they'd like. And, certainly, that was a bit depressing all by itself.

OID: Depressing, but familiar — a company with an undervalued stock makes a full-priced acquisition.

Tobin: And that was certainly a concern of ours when we started buying it — in November, as I recall. At that time, management said they hadn't found a target. Fortunately, that authorization expired in February. That possibility looks unlikely today — because unless they paid next to nothing for it, they'd dilute existing shareholders including themselves. So, hopefully, they won't.

But, again, you do have the risk that they don't continue to manage their expansion, or future acquisitions, well. It's always riskier to enter new markets, obviously. So far, they appear to have managed their forays into foreign markets very well. They have a relatively short, but very successful history of making acquisitions. However, that is one of the risks here.

OID: And, yet, you don't sound worried.

Tobin: No. It's not something we worry about much. I understand they were looking at opportunities in Poland and, perhaps, elsewhere in Eastern Europe last year. But I suspect they decided to launch titles themselves instead. And they've said that they intend to focus on internally generated growth going forward rather than growth from acquisitions.

Also, they're big shareholders, too. So overpaying for an acquisition would hurt them more than it hurts us.

OID: If your analysis is even roughly right, it's a shame that they can't repurchase their own shares.

Tobin: It really is. And, again, we certainly hope that they won't issue shares anywhere *near* today's stock price.

WE'RE INTRIGUED WITH THE OPPORTUNITY
TO BUY AT 50%+ OFF ALREADY DEPRESSED PRICES.

OID: Any other bargains you can tell us about?

Eveillard: We've also been buying a number of Korean companies. One of the things that intrigues us about them is that the Korean market had already declined before we began buying. But after we started buying them, it proceeded to decline even further.

OID: Don't look at me. I was busy cursing gold. But what's the problem been there?

Eveillard: Basically, Korea seems to have a powerful, catch-up mentality vis-a-vis Japan. And, therefore, the Korean industrial conglomerates, (which they call "Chaebols"), have invested heavily in industries such as semiconductors, automobiles and petrochemicals — mostly financed by debt, often at subsidized rates. And many of those industries are at the point in the cycle where they're experiencing overcapacity — particularly semiconductors and automobiles.

Also, they've been suffering through deflation — particularly in real estate. That was somewhat surprising since South Korea, unlike Thailand, had tried assiduously to constrain real estate appreciation with capital gains taxes of up to 50% and tight controls on capital inflows. However, they're suffering deflation, nonetheless.

OID: So they're basically getting it with both barrels.

Eveillard: Exactly. The result, not surprisingly, has been severe stresses on their financial system including a number of bankruptcies and fears of many more.

So the negatives are obvious. And, therefore, we haven't done well so far with our Korean stocks.

OID: Wasn't it only a year or two ago that investors were excited about investing in Korea and very happy to pay huge premiums to do so?

Eveillard: Yes — because Korea's one of the *dragons*. It's one of the most powerful economies in the Far East — having had real growth of 6-8% per year for a long time.

Investors are still paying a premium to invest in Korea, albeit much less of a premium than before — because the Korean market has just absolutely *collapsed*. It's gone down tremendously over the past couple of years. And it's one of the very few markets that have done terribly over the past couple of years. The overall market is still selling roughly 40% below its lows. So we like that.

OID: Certainly a positive in our book.

Eveillard: Second, in Asia, two countries' accounting is very conservative: Korea and Japan. So Korean stocks may look expensive on the basis of price-to-earnings. However, often, they don't look all that expensive on the basis of price-to-cash-flow or enterprise value to EBITDA.

OID: So there's, in effect, hidden value.

Eveillard: That's right. And third, there was, and still is, the possibility of buying so-called "preferred stocks" — which are basically Korean companies' non-voting stock — at a discount of 50% to 60% to the voting stock.

THE BUSINESSES WEREN'T SO HOT TO BEGIN WITH
— AND THEY SEEM TO BE GETTING WORSE.

Eveillard: Korea is a little bit like Japan was 15 or 20 years ago. Very simply, sales growth comes first. They don't appear to care very much about profits — at least in the short term.

OID: If you meet any Korean venture capitalists, would you have 'em give us a call?

Eveillard: Most Korean companies are out to grow market share at any cost. They know, or *think* they know, that they can always borrow from their banks — that

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they'll always be there with outstretched arms to give them the money they need since they always have been.

OID: I imagine you wouldn't have the phone number for their Chamber of Commerce...

Eveillard: So they tend to be very expansionary. They tend to have a lot of debt. And they tend not to pay much attention to profits and return on equity. They say, "Profits will come later, but first we must make our mark. And to do that, we have to get *volume*."

So if you look at the financials of Korean companies, they're generally not very impressive. It's hard to find attractive companies in Korea. And when I say "attractive", I mean the way we think of a company as being attractive — one that generates cash, has a good return on equity, whose management is able to allocate its capital well, etc.

For example, the basic business of Cheil Jedang, formerly Cheil Foods, as its former name suggests, is food, including sugar refining. So it's not a very attractive or a very profitable business.

OID: Sounds lovely.

Eveillard: But their management *understands* that. So they've used the business as a cash cow, if you will, to diversify into other businesses which, theoretically, should be more profitable. And among those other businesses are detergents, pharmaceuticals, restaurants and media.

But because Cheil has several classes of stock — and half a dozen different lines of business and stakes in other companies, some listed and some not — it's relatively complicated and, therefore, not very easy to explain.

OID: Is it worth the trouble?

Eveillard: Absolutely. But let me have one of my associates, Charles de Vaulx, join us and help me tell you about it.

Charles De Vaulx: Jean-Marie's not so hot on Cheil. However, I'm even a little more negative about it than him. I think what management will do best is destroy capital.

OID: Don't hold back. Tell us what you really think.

De Vaulx: Also, many Korean domestic businesses have been protected for a long time. And that's changing with GATT, South Korea's entry into OECD and many other things. So their food business will, at best, become a low growth cash cow or, at worst, become more competitive and therefore, obviously, less profitable.

Therefore, what they've done — in order to destroy even *more* value — is to invest in DreamWorks. That's the movie studio with Steven Spielberg, Jeffrey Katzenberg and David Geffen.

Eveillard: Believe it or not, they've committed to invest $300 million over five years into DreamWorks.

De Vaulx: Which, by the way, is more than half of the company's current market cap.

OID: The synergies are certainly obvious...

Eveillard: Yes indeed. And, as I'm sure you know, the track record of Asian companies who acquire American movie studios isn't an exciting one. Sony and Matsushita each acquired movie studios in the late '80s and early '90s, for example. And both did terribly.

OID: As I recall, Munger has observed that people invest in movies for reasons involving ego as often as returns.

Eveillard: Absolutely. It's like racing horses.

De Vaulx: In their defense, part of their rationale is that not only do they acquire an equity interest, but they also acquire some exclusive rights to distribute some of its products in Korea, in China and most or all of Asia.

OID: That certainly sounds exciting.

De Vaulx: It does. And they're expected to spend nearly $200 million per year for the next five or so years building movie theatre complexes.

And I'm not trying to perform any kind of sophisticated analysis about the price they paid. But it doesn't have anything to do with their core business. It's completely unrelated. They have no expertise in that area. Also, their basic business might suffer going forward because they're trying to diversify.

And, unfortunately, that's all too common in Korea. So I suspect Cheil Jedang's management will be successful at destroying shareholder value — especially now that they've separated from the Samsung Group and are eager to expand their business horizons.

OID: And I gather they haven't done such a good job managing their core business either?

De Vaulx: That's right. And for good reason — namely, that Korea is protected by a huge 60% import tax on refined sugar and milled flour. Conversely, many food prices are de facto government controlled.

OID: And, so, once that protection is eliminated, you expect their profits to take a big hit.

De Vaulx: That's right. And, then, if you believe that some commodity prices will rise — for wheat and so forth — that will hurt them on a cyclical basis, too. But that's not the big thing. The big thing, as you say, is that they've operated in a protected environment. Therefore, they haven't been cost-effective. And now that protection will probably be eliminated over time.

Worse still, they haven't even embraced the idea of cutting costs, becoming more efficient and so forth. The fact that their primary response is to diversify away from their core business indicates just how afraid they are about their basic business. I think that says it all.

WE GOT AN OFFER WE COULDN'T REFUSE:
CHEIL AT 75-80% OFF ADJUSTED NAV.

OID: Is this a long or a short?

De Vaulx: But we try to keep an open mind about what stocks we buy — from Ben Graham, asset oriented types to Warren Buffett, wonderful business type stocks.

So I think Jean-Marie would agree with me that they're likely to destroy capital. But I think he believes that Cheil is so cheap — especially the preferred — that there's room for them to destroy lots of capital and for us to still be ahead.

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And that's saying a lot — because although Cheil is very asset rich, they also have a lot of debt. Therefore, those assets can go fast.

OID: A little damage can go a long way.
De Vaulx: Actually, we first got involved with Cheil via a convertible bond that was denominated in dollars. And we bought it primarily with the investment rationale that it offered a relatively generous yield to put value. And if the share price just happened to go up a lot, then we might do even better.

OID: But, if so, that would be gravy.
De Vaulx: That's right. And it's only very recently that the share price fell — particularly the preferreds — and that we decided to buy some of them.

OID: But I gather you've bought both.
De Vaulx: That's right. And Cheil's common is indeed very cheap.

Eveillard: Yes, it is. In fact, it's actually selling at roughly the same price it sold for 10 years ago.

OID: Usually a plus.
Eveillard: And its preferred — which is selling at roughly a 50% discount to the common — is even cheaper. It's *extraordinarily* cheap.

OID: Could you quantify "extraordinarily cheap"?
Eveillard: As always, it depends on one's estimate of intrinsic value.

OID: As always. But please bear in mind that we're talking newsletter valuation. So don't hold back.
Eveillard: We don't try to cut it too fine. However, like many Korean companies, Cheil owns large chunks of other companies — among them stakes in Samsung and a number of its affiliates — and a lot of real estate that they carry on their books at what we believe is a relatively modest price. And on that basis, the common is *cheap* — probably 50-60% below its intrinsic value.

OID: Super.
Eveillard: And if you buy it through the preferred, the discount is probably more on the order of 75-80%. So, again, it's *extraordinarily* cheap.

OID: As you know, we like extraordinarily cheap. But might you give us a brief explanation of how you arrive at a 50%+ discount figure for the common?
Eveillard: Brief? Probably not. But at current rates of exchange, there are about KRW890 to each US$1. Therefore, to convert figures from South Korean Won into U.S. dollars, you simply divide by 890.

OID: So keep your calculator handy.
Eveillard: If that's too much trouble or you don't need that much precision, you can just divide by 1,000.

OID: Close enough for government work.
Eveillard: And what our analyst did was to take Cheil's stated book value of KRW628 billion — which he refers to as their "nominal NAV" [net asset value] — and add the estimated after-tax gains that they would realize from the sale of their meaningful portfolio holdings to that figure to arrive at what he calls "true NAV."

OID: In effect, to come up with adjusted book value.
Eveillard: That's right. Again, Cheil has a portfolio of securities of companies in the Samsung Group including a big chunk of two companies: Samsung Electronics, the well known manufacturer of semiconductors, consumer electronics and telecommunications and what have you, and Samsung Life, which is the life insurance company of the Samsung Group.

OID: Samsung Electronics, I gather, is the company that manufactures TVs, VCRs, microwaves, etc.?
Eveillard: Right. Samsung Electronics is best known for semiconductors. It's one of the major manufacturers of semiconductors — *commodity* semiconductors, unfortunately — in the world. But it's also well known for consumer electronics and telecommunications equipment.

However, they carry their stake in Samsung Electronics for only KRW15 billion — versus a current market value of about KRW150 billion. And their stake in Samsung Life is carried at only about KRW2 billion versus a market value of nearly KRW120 billion.

OID: Wow.
Eveillard: They must have gotten their stake in Samsung Life when the insurance company was created or not long thereafter. Remember that the Korean economy has really only developed in the 1970s and 1980s. Back in the 1960s, it was nothing.

And Korea imposes a 32% tax on capital gains. So we're talking about a big tax. And therefore, obviously, their low basis considerably reduces its economic value.

OID: If and when they sell.
Eveillard: That's right. But they've said that they intend to sell all of their holdings over time. So our analyst takes the current prices of their *publicly* traded holdings — including Samsung Electronics, Samsung Company, Samsung Aerospace, Samsung Electromechanics and Samsung Heavy Industry. And using their prices as of July 1st, he arrives at a total value for those holdings of KRW178 billion — or roughly KRW124 billion in excess of their carrying value.

OID: Gotcha.
Eveillard: Then, he values Cheil's *unlisted* holdings, including their stake in Samsung Life Insurance. And Samsung Life may be taken public at some point. But because it's not publicly traded now, we make comparisons with life insurance stocks that are traded in Korea.

And when we do that, we value their unlisted holdings at KRW138 billion — which exceeds their carrying value by KRW114 billion. And, so, totaling the two, we come up with unrealized gains of roughly KRW238 billion. And, then, we assume that Cheil would pay a 32% tax rate on those gains. Therefore, net of taxes, that would increase

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Cheil's net asset value by roughly KRW162 billion.

And adding the KRW162 billion of unrealized after-tax gains to the KRW628 billion of nominal NAV, we arrive at a true NAV of KRW790 billion.

OID: And how many shares outstanding?

Eveillard: Just under 8.6 million common shares and just over 2.2 million preferred shares.

OID: So we're talking about a nominal NAV of KRW58,000 per share and a true NAV of KRW73,000.

Eveillard: That's right. So the current price of Cheil's common — which is roughly KRW40,000 — would imply a discount of roughly 45% to true NAV.

AND OUR NAV ESTIMATE IS CONSERVATIVE.
SO THE DISCOUNT MAY BE EVEN HIGHER.

Eveillard: One thing that many sell-side analysts do, however, that we have not done is to assume all sorts of fancy unrealized gains on their real estate. We've seen analysts come up with numbers like KRW400 billion.

De Vaulx: But we have no idea how they arrive at those numbers. There is deflation now in Korea. Real estate prices have been falling for the past two years and could fall further. So we just ignore unrealized gains in real estate.

OID: Maybe we weren't clear. We're a newsletter...

Eveillard: Cheil's real estate was revalued in 1995. However, only assets acquired before 1982 were revalued. And current real estate prices in Korea are a lot higher than they were in 1982. So the carrying value of Cheil's real estate may be understated.

OID: What sort of real estate is it?

Eveillard: Basically, it's the land on which they've built some of their plants. And up until the early 1970s, real estate was essentially worth almost nothing in Korea. And now it's worth a lot.

But I didn't want to start making adjustments — both because I really don't know what adjustments to make and because, again, the real estate they acquired before 1982 has already been revalued. So it's not like they carry it for almost nothing. Therefore, the real estate they acquired since 1982 is probably understated, but probably not by an enormous amount.

De Vaulx: Plus, because there's been deflation in real estate precisely when the partial revaluation was made by Cheil in 1995, some valuations may be high.

Eveillard: But, in any case, I don't know the amount. So we ignore it.

De Vaulx: Also, rules in South Korea limit total foreign ownership of any Korean company's stock to 23%, although that limit is very likely to be increased to 26% by year-end. It's also believed that the foreign ownership limits may be removed altogether by the year 2000 as a result of South Korea's entry into OECD.

And, in many cases — particularly in big stocks like Samsung Electronics — that limit has been reached. Therefore, the only way that foreigners can buy under those circumstances is to buy from another foreigner. So there is a grey market — unlike Thailand or Singapore where those are listed shares on the foreign board — on which the stocks of many South Korean companies trade among foreign holders at a big premium to the local prices.

And, depending on which issue you look at — there are common shares, global ADRs [called GDSs], etc. — the so-called foreign premium on Samsung Electronics can be 50% or more.

OID: Wow.

De Vaulx: And I think those prices may better reflect their true values than do the prices on the local shares. But because current foreign ownership restrictions prevent them from selling their shares to foreigners, for purposes of calculating NAV, we ignore the foreign premium and just value those stakes at the local share prices.

OID: So if the real estate optimists are 25-50% right, Cheil's real estate would be undervalued by KRW100 to KRW200 billion — which could add KRW6,000 to KRW12,000 per share after tax to Cheil's NAV?

De Vaulx: Actually more like KRW5,000 to KRW10,000 because the taxes on capital gains from real estate are higher. But that's right. However, there, your guess is as good as ours.

OID: So the discount could be 50-60% off adjusted net asset value on the common.

De Vaulx: That's not the way we calculate it. However, you're exactly right.

BUT IF IT'S NOT CHEAP ENOUGH FOR YOU YET,
HERE'S A WAY TO POSSIBLY TAKE OFF ANOTHER 50%.

Eveillard: So, again, Cheil Jedang's common shares are selling at KRW40,000± each. But its non-voting stock, (what the Koreans call a "preferred"), sells at KRW*15,000*.

OID: At a discount of more than 60%!

Eveillard: To the common, that's right. However, unfortunately, although the common of Cheil Jedang sells *without* a "foreign premium," its preferred sells at a big premium. In other words, if a foreigner wants to buy the preferred, they probably have to pay something like KRW21,000. So the foreign premium is nearly 50%.

But we think paying KRW21,000 for Cheil's preferred is better than paying KRW40,000 for its common.

OID: Rich or poor, it's good to buy wholesale.

Eveillard: Exactly. Incidentally, the one thing I'm not sure about is the KRW21,000 price — because there's really no active market. It trades by appointment only. And our guess is that in order to find shares today, one might have to pay a premium of 50%.

OID: But why do they call them "preferred"? They sound like just the reverse.

Eveillard: They're in a preferred position in terms of

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dividends. Also, their dividend is a touch higher than the common's. But we just view them as non-voting stock.

Of course, the trouble is that premiums can and generally do fluctuate widely: In effect, a 50% premium today can always drop to 15% tomorrow.

Also, as I mentioned, the liquidity of Cheil's preferred is much less than it is for its common. Therefore, let's just do the analysis using the valuation of the common shares. Then, if you wish, we can factor in the effect of the discount at the end.

OID: What do you give up when you take the discount — besides the right to vote and liquidity?

De Vaulx: That's a very good question. Owners of the preferred shares enjoy the same rights as the common in the event of a liquidation or the raising of additional capital. On the other hand, we can't find any precedent in Korea for an issue of preferred being taken out. That's because merger and acquisition activity has been dormant in South Korea since World War II, although that's likely to change with the recent collapse of several second-tier conglomerates — Kia, Nanbo and Sammi — what they refer to as "chaebols." So we don't know that we would be offered the same price as the common shareholders in the event that the company was acquired. In fact, it's even conceivable that someone could try to acquire the common shares and leave the preferred shares outstanding.

OID: Interesting.

De Vaulx: But we are heartened by the fact that in 1994, the Korean government requested some companies whose preferred shares were trading at significant discounts — say 40% or more — to repurchase some of their shares.

Also, we gather that most of the preferreds were issued at discounts of less than 10%, although we've been told that one or two were issued at a discount of 30%. So I guess the honest answer is that we really don't know.

OID: But you're very comfortable going in at an effective discount of nearly 50%.

De Vaulx: Exactly.

I DON'T KNOW THE TIMING. BUT LOOKING BACK, WE'LL SEE THAT SAMSUNG WAS CHEAP TODAY.

OID: Since they own so much Samsung Electronics, might we ask you to say a few words about it?

Eveillard: Samsung Electronics is considered the top name in electronics in Korea — including semiconductors. And I believe it's selling at roughly 2 times cash flow.

OID: That sounds very cheap. Is it?

Eveillard: I think so. I agree with Marty Whitman. We were together on a panel shortly after he bought his semiconductor equipment companies. And I should have, too — because he's very smart.

OID: You don't have to tell me.

Eveillard: Again, he was buying semiconductor equipment manufacturers, not semiconductor companies — KLA Instruments, Applied Materials, things like that. His point was that the stocks had collapsed because they had no earnings visibility. The semiconductor companies weren't buying equipment. So backlogs had disintegrated.

So, because there was no visibility, Wall Street folded up their hands thinking, "Hmm. There's no visibility. We don't know what their earnings will be next quarter. Maybe they'll lose money for the next one or two quarters."

OID: And that's hard to sell to clients — because there's no pretty picture in the rear view mirror.

Eveillard: Exactly. But Marty said, "The ones that I'm buying have balance sheets that will let them survive. And within two or three years, the cycle will *turn*. There *is* demand for semiconductors. There's just excess capacity today as a result of too much capacity having been built. So what we need is very simply for the demand to catch up with capacity. Once that happens, semiconductor prices will improve. And when they do, semiconductor companies will start buying equipment again."

He said, "I don't know whether those stocks will go up or down over the *next* year. But within two or three years, the cycle will turn and the profits will be there."

And he didn't have to wait that long. I think that those stocks already have gone up tremendously.

OID: In his letter, Whitman said that he had no idea when he bought 'em that they'd start up immediately.

Eveillard: That's right. But he was willing to wait. If they don't have confidence in the next quarter, most security analysts and portfolio managers refuse to buy. They're afraid that either the stocks will go down further — because who knows how low is low — or that they'll do nothing for nine months. Then, if the S&P 500 goes up 20% over that nine months, they'll look terrible.

OID: Which wouldn't be conducive to their job security or their ability to retain clients — many of whom have the time horizon of a TV commentator.

Eveillard: Exactly. But Marty thinks independently. He's not worried about losing his job or his clients.

So, today, there is still tremendous uncertainty. Prices for semiconductors have come down very sharply. And there's such tremendous uncertainty about when the cycle will turn that there's no earnings visibility.

But cash flow is high because they have enormous depreciation. That's another thing about Korea — the accounting, particularly accounting for depreciation, tends to be very conservative.

So how low is low? I don't know. How will the cycle for semiconductors evolve and when? That I don't know either. So there's no earnings visibility and excess capacity for nobody-knows-how-long. But semiconductor prices have already come down a lot. Eventually, they'll bottom. And when the cycle turns, I know that when I look back, I'll see that I was buying Samsung Electronics cheap.

OID: So Samsung Electronics' intrinsic value may be substantially in excess of its current stock price — although I know you're not counting on it.

Eveillard: That's right. Samsung is no joke. Granted,

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they are in a commodity business. However, they are a terrific competitor. And they're considered the most likely to come up with the next generation DRAM, for example.

I'm not really sure how to calculate its intrinsic value in view of how Korean companies operate and in view of the commodity business that they're in. But at least you know that we're computing the value of Cheil's stake in Samsung using a depressed stock price. After all, Samsung's current stock price of KRW68,500 is down from its high of KRW125,000.

OID: I gather from your comments and your portfolio that you've been buying Samsung, too?

Eveillard: Correct. However, Samsung Electronics has moved out of our buying range.

De Vaulx: In fact, we've even been selling some of our Samsung Electronics GDSs since they've been trading at a premium of 57% over the local share price!

Eveillard: That's right. On the other hand, I don't think Cheil has moved up very much at all.

OID: Especially nice since you're getting a substantial chunk of Samsung stock with each Cheil share.

De Vaulx: That's right. Each share of Cheil Jedang owns about KRW9,250 worth of Samsung Electronics shares — net of the 32% tax on the unrealized gain.

OID: Just out of curiosity, what would that be pretax including the current 57% foreign premium?

De Vaulx: Believe it or not, more than KRW20,000.

THIS ISN'T A GREAT BUSINESS.
AND THEIR RETURNS REFLECT IT.

OID: You haven't raved about Cheil's management. But doesn't the fact that the current market prices of their holdings exceed their cost basis so much speak well of them — at least in their capital allocation?

Eveillard: I think that was not so much a capital allocation decision that they made to invest in Samsung Electronics and Samsung Life. They were just part of the same family. Many years ago, the same family created both Samsung and Cheil Jedang.

And now they're moving away. They've indicated that they're going to liquidate their portfolio of Samsung shares over time.

OID: And when you say Cheil's core business isn't so hot, I gather that's supported by its historic returns?

Eveillard: Yes. Cheil has a very poor ROE — something like 3%. That is excluding extraordinary gains — because every now and then, they'll take a gain on one of their holdings or on their real estate, etc.

OID: The largest branded foods business in Korea sounds like it perhaps should be a good business. Their returns aren't just hidden or understated somehow? And is that 3% ROE on their total book or the portion of their book invested in their businesses — thereby excluding their securities portfolio?

Eveillard: It's on their reported book. So if you take out the securities portfolio and the real estate, it improves their returns by a little, but they're still not great.

De Vaulx: We estimate that Cheil Jedang's return on invested capital crudely defined is only about 11% pretax. Granted, that includes pharmaceuticals and household products — which aren't yet profitable. So maybe it's more like 14%. However, considering that short-term rates have been hovering around 12%, that's very unimpressive.

Eveillard: Yeah. It's hard to figure out *what* their returns are by segment because we don't know how much of their equity is in the food business. And we don't even know for sure what their profits are in the food business. They don't provide a breakdown by segment.

OID: Like you mentioned earlier, good accounting and lousy transparency.

Eveillard: Cheil is the largest food company in Korea. However, its sales aren't in the most desirable categories. The latest breakdown we have of their sales by segment is a July 1996 forecast of their 1996 sales. And, at that time, they were projecting 1996 sales of KRW1.755 trillion — which was slightly below their actual sales that year of KRW1.806 trillion.

And they estimated that KRW770 billion of that KRW1.755 trillion of sales — or just under 45% — were in what they call "Primary Foods," (sugar, flour, edible oil and feeds). And then, they estimated sales of KRW200± billion — about 11% of total sales — in "Seasonings." So more than half of their sales consisted of primary foods and seasonings — which are relatively commodity-oriented products.

OID: Gotcha.

De Vaulx: Those products tend to be viewed as commodities in the mind of the consumer. In other words, people are far more likely to buy the cheaper flour or sugar — or be unwilling to pay much in the way of a premium for a particular brand — than they might in certain other food categories. So price is usually the key consideration.

Actually, that hasn't been the case for Cheil Jedang — at least so far — because food is still one of the most rigidly controlled segments of the Korean economy. Prices are closely monitored by the government. And, therefore, Cheil's core business is still akin to a regulated utility — particularly in sugar and flour.

But, long term, we believe cheap imports are more likely to hurt Cheil than producers of most food products.

Eveillard: And the remainder of their sales in their core business was comprised of sales of KRW250± billion in processed meat, KRW100± billion in beverages and KRW100± billion of what they call "Other."

OID: Are their products branded or produced for other food processors or something else?

Eveillard: They're branded — although I'm not sure if people buy sugar because of the brand. I know that they have a well known brand for seasonings in Korea. Actually, that's one reason why they decided to diversify into detergents and other household goods — they thought the Korean consumer already knew about their brand.

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But another thing they probably suffer from is the changing retailing scene in Korea. It's changing because some foreigners, including the French, are coming in and starting big discount stores and big hyper-markets.

I suspect that Cheil Foods has had the upper hand vis-a-vis small retailers so far. But whether they can charge the same prices to big retailers is another story altogether. There is a difference in the U.S. between being a supplier to a mom and pop store and being a supplier to Wal-Mart.

So, with the blessing of the South Korean government, they've managed the food business as a cash cow — understanding there wasn't much growth in it and that the government wouldn't allow them to have very high profits and returns in that business anyway.

CHEIL HAS LOTS OF DEBT AND UNCERTAINTY, BUT IT HAS A DISCOUNT TO NAV TO MATCH.

Eveillard: And, again, like many Korean companies, they're diversifying. But whether they're diversifying wisely remains to be seen. The businesses they've diversified into so far have basically been incurring *losses*.

OID: We've developed enormous patience there.

Eveillard: As I mentioned, they've diversified into pharmaceuticals — and, so far, they've lost money. They believe that they can break even in 1997. But it only had KRW175 billion in sales in 1995.

OID: Dividing their KRW175 billion of sales by their 10.8 million shares outstanding would imply pharmaceutical sales of over KRW16,000 per share.

Eveillard: That's right. And that is certainly large by Korean standards. But it doesn't exactly make you a competitor of Pfizer. And maybe things are different in Korea. However, with only \$200 million in sales, I wonder how long it will take their pharmaceutical segment to make a real profit. In any case, we're not counting on it.

De Vaulx: In all fairness, they have rapidly become Korea's largest exporter of pharmaceuticals and the fourth largest player domestically. And they're supposedly spending over 30% of their pharmaceutical sales on R&D. However, that's a big percentage of a small number. And, from what I can see of their products, they don't exactly look groundbreaking to me.

So don't make the mistake of confusing them with an American-style pharmaceutical company. More often than not, pharmaceutical companies outside the U.S. and Europe are nothing to write home about.

Eveillard: That's right. And then, besides media and pharmaceuticals, as I mentioned, Cheil's diversified into household goods like detergents. And they had KRW130± billion of household product sales in 1995 — although they're still having some moderate losses there.

Again, all told, Cheil had sales of over KRW1.8 trillion in 1996 — or about \$2 billion. And they're expected to have 1997 sales of between KRW2.0 and KRW2.1 trillion.

OID: Or roughly KRW190,000 per share.

De Vaulx: But, again, Cheil has a lot of debt — something around KRW850 billion of net debt. That's nearly 1-1/2 times its book value and more than 2 times its current market cap.

OID: So that because of the high leverage, it's almost like buying a long-term warrant.

Eveillard: That's right — which, again, is true of the Korean stock market generally.

OID: What sort of interest rate are they paying?

Eveillard: Fairly stiff, although some of the debt is denominated in dollars. Actually, I could have mentioned a convertible issue they have that's denominated in dollars, but I didn't because it's almost impossible to buy — because I own most of it.

OID: Good reason.

Eveillard: It's a convertible with a put. In other words, unless Cheil goes bankrupt, either its stock does well and I do well by converting to equity — or it does poorly and I put my convertible bond back to the company, in 1999, I believe, and earn a 5-6% yield to maturity.

OID: So, absent bankruptcy, that's your floor return.

Eveillard: That's right. Absent bankruptcy, I can't lose. I may only make a modest amount of money. But a 5-6% yield to maturity is not peanuts. It's better than a money market fund.

OID: And better than losing money, too.

Eveillard: Right. Or if the equity kicker comes in, then I make a *lot* of money.

Again, interest rates in Korea tend to be fairly high — something like 10-12%. Maybe that's why they issued a convertible with a put denominated in dollars.

De Vaulx: Incidentally, Cheil's interest expense in 1998 is expected to be around KRW120± billion. And if their operating profits even cover that interest, I don't think that they're likely to exceed it by much.

But inflation is running around 4% or 5% in Korea. So interest rates are probably too high. And, obviously, Cheil would be a beneficiary of any interest rate decline.

OID: Since you emphasized it earlier, (and I don't want you to think I wasn't listening), what can you tell us about Cheil's valuation relative to EBITDA?

Eveillard: Of course, you net the securities portfolio out of the enterprise value. And when we do that, we estimate that Cheil's selling at only 5 times 1997 EBITDA.

OID: And correct me if I'm wrong, but aren't commodity foods and branded food companies alike selling for 10 or more times EBITDA in the U.S. and, much more often than not, for 1 times sales or more?

Eveillard: That's probably true. But the average multiple of EBITDA for the S&P 400 is between 12 and 14. And I don't know exactly what it's been historically. However, I'd guess that it's been no more than 7 or 8.

OID: So we're talking about a yardstick that's at the upper end of its historical range.

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Eveillard: Exactly.

De Vaulx: And, again, Cheil's earnings may take something of a hit if, as we expect, the government allows foreign competition to intensify. However, whether they do and when is anyone's guess. How long have we been told sugar producers would lose their protection in the U.S.? Obviously, that gets into assessing the power of lobbies, politics and so forth.

Eveillard: Right. And that's unknowable in advance. Plus, we don't know to what degree increased competition would help them by lowering their costs. Also unknowable is to what degree, if any, profits from their new businesses — household products, pharmaceuticals, media, restaurants, etc. — will offset any such losses.

In effect, Cheil is in the awkward stage of attempting to transform itself from one type of company into another. And it's not going to be quick and easy or painless.

OID: Kind of like turning around a battleship or maybe even producing a 64-page edition of OID.

Eveillard: Exactly. So even if they *are* successful, it's hard for me to imagine those new businesses contributing much for five or six years at *least*.

OID: Which is why you focus on Cheil's NAV.

Eveillard: You've got it. And, fortunately, that's enough. Again, I don't think that Cheil's a great business. I don't even think it's a *good* business. Rather, I view it as a fair business at what I think is a good price — good because we get a very attractive discount to an asset value which itself is depressed because of the depressed state of the Korean stock market.

De Vaulx: And, again, what we own is the preferred. So our total discount must be at least 75%.

AN ROE ON INVESTED CAPITAL WELL OVER 20%
AT A HARD-TO-BELIEVE 1.6 TIMES EBITDA.

OID: Are you finding any bargains among attractive Korean businesses — preferably ones that are easier to explain and understand?

De Vaulx: We are finding a few. Believe it or not, we've also been buying Dong Ah Tire — which is a manufacturer of inner tubes and inner tube tires for cars.

OID: Believe it or not?

De Vaulx: I say that because inner tube tires are outmoded in most developed countries. With the exception of some off-the-road vehicles, no one in the Western world uses those things anymore. So people tend to think of them — and, therefore, that business — as being obsolete.

OID: It's not?

De Vaulx: Not at all. Tires with inner tubes are still the preferred car tire in emerging countries — especially in countries with warm climates or bad roads. Whenever people are driving on poor back roads, it's much better to use tires with inner tubes than regular tires.

OID: If that's true, why aren't they the preferred tire in the Northeast U.S. — especially Manhattan?

De Vaulx: Therefore, sales of tires with inner tubes are thriving in places like China and Africa.

Meanwhile, the big tire manufacturers — Goodyear, Firestone, Michelin, etc. — have reduced their capacity for manufacturing that type of tire. So capacity's shrunk. And Dong Ah Tire is one of the few companies left in the world specializing in that type of tire. Therefore, it has a big market share worldwide of that business — over 20%.

Plus, they're very profitable. They're not a part of a conglomerate. They're family controlled. And, unlike many conglomerates, they haven't used the free cash flow generated by the business to diversify.

OID: They're not tired of the business.

De Vaulx: No. They've stuck to their knitting. And they've accumulated cash to the point where, today, roughly 60% of their market cap is accounted for by cash. To our chagrin, they've never paid out any dividends. And, sadly, share repurchases aren't practical in Korea — as is too often the case in foreign countries. As I understand it, once a company buys back its shares, it's very difficult for it to reissue shares in the future.

OID: What kind of valuation are we talking about here?

De Vaulx: At around KRW51,000, Dong Ah is selling very close to year-end 1996 book value, at slightly more than 7.1 times 1996 earnings, 1.9 times 1996 EBITDA, and 1.6 times estimated 1997 EBITDA.

OID: Less than 2 times EBITDA!?

De Vaulx: That's right.

OID: Wow. Does that mean its earnings have gone flat?

De Vaulx: Not at all. We're just trying to keep our expectations modest. So we assume they have no growth in revenues and a modest decline in margins. But those should be more than offset by higher interest income.

Its return on average equity is around 15% or 16%. However, if you strip out its cash and calculate the return that Dong Ah is earning on its actual invested assets, you'll see that the business enjoys extremely high returns — well over 20%.

OID: Based on reported earnings or with adjustments?

De Vaulx: Based on *reported* earnings.

OID: Super.

OR, IF YOU PREFER, A WELL RESPECTED BRAND
EARNING 30-40% ON BEGINNING EQUITY AT 3X EBITDA.

OID: Any others?

De Vaulx: We're buying a dairy products company in Korea — Nam Yang Dairy Products. We own over 4% of the

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company. And one beauty of this one is that the limit on foreign ownership has not yet been reached. So perhaps we might be able to double our position.

OID: Could you give us its fundamentals in a nutshell?

De Vaulx: At KRW98,000 per share, we estimate that Nam Yang is selling at about 5-1/2 times 1997 earnings, 3.2 times 1997 cash flow, 2.6 times 1997 EBITDA and only about 1.3 times book value.

OID: Wow! And based on the materials you've sent me, this company appears to be no slouch in their returns. It looks like Nam Yang has earned a return on equity north of 30% as recently as 1994 — although it's come down closer to 20-25% for the last couple of years.

De Vaulx: That sounds about right — although, going forward, we would expect their ROE to decline a bit, maybe down to around 20% — especially if they deleverage. Their return is assisted by some leverage. Their ratio of debt to equity is roughly 40%.

OID: Still...

De Vaulx: Plus, their business isn't really all that capital intensive. And they have a highly respected brand.

OID: Why, then, is their stock so cheap?

De Vaulx: Because of trade being liberalized, tariffs being lowered and so forth over the past 18 months, imports have become much cheaper and much more competitive than before. And I think what happened is that some other publicly traded dairy companies haven't done well as a result.

So, in effect, people are worried about Nam Yang being overwhelmed by a flood of cheap imports.

OID: But you're not worried?

De Vaulx: No. Some of Nam Yang's competitors that offer mostly commodity-type products — cheese and butter, for example — have been hurt as people are not willing to pay a premium for their goods.

But I believe it's quite different with infant formula. If parents believe that one brand is better than another, they're much more likely to be willing to pay up. And, therefore, the brand becomes really valuable.

And Nam Yang has well recognized brands — especially in yogurt and baby formula. In fact, their product line is truly very different than those of other companies in the dairy product business. And their results reflect that.

OID: You don't worry about the inevitable onslaught of the global brands?

De Vaulx: Not really. I don't know to what extent that onslaught has actually begun. But, so far, so good. Unlike some of their competitors, Nam Yang has done well since trade began to be liberalized in late 1995, although one of their segments — cheese and butter — did suffer because of imports.

OID: Although that's certainly not obvious from their reported sales and profits.

De Vaulx: No — because it's not a very big portion of their sales. But the investment community lumps them together with other dairy product companies. They don't yet appreciate just how strong their brand is and that the bulk of their profits don't come from basic milk or dairy products, but from very specialized products like infant formula for babies. And they control 60% of the baby food market.

OID: Interesting. And I gather that they're actually increasing market share?

De Vaulx: That's right. They're doing that partly by introducing new products — some in Korea and some in the emerging economies. And they're doing other things to build their brands — including aggressive advertising.

OID: Also, margins don't look inflated and vulnerable. They actually look quite modest. For example, I see that operating profits are only running 6-7% of sales.

De Vaulx: That's because, as I mentioned, it isn't a particularly capital intensive business. For example, in 1995, they had sales of $348 million and operating profits of $21.4 million. And, yet, they managed to do that with fixed assets of only $35-40 million.

OID: And a market cap of only $84 million.

De Vaulx: That's right. And, again, the limit on foreign ownership has already been reached for many of the big Korean companies' stocks — companies like Samsung Electronics. And, so, their stocks trade at a substantial foreign premium — which tells you the locals aren't valuing those companies as dearly as foreigners are.

But because most foreigners require liquidity when they invest in most foreign markets, they tend to invest in the blue chips and neglect small companies like Nam Yang. So if the locals and the foreigners are neglecting them...

OID: Allowing a company earning returns like those to sell at 5-6 times earnings and 1.3 times book certainly sounds like neglect to me.

De Vaulx: Agreed. By the way, the bad news is that foreigners can only buy another 2% of Nam Yang's shares without running up against the foreign ownership limit until they raise it again — although on a company like this one, the foreign premium will probably never get very high.

OID: Never say never.

De Vaulx: I should also mention that the credit for finding and crunching the numbers for both Dong Ah Tire

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and Nam Yang Dairy Products should go to one of my associates — Charles-Edward De Lardemelle. So if you ask me too many questions, he'll have to answer them.

OID: We better not. We have more ideas than pages as it is.

WOONGJIM PUBLISHING HAS MORE LEVERAGE AND MORE UNCERTAINTY THAN WE'D LIKE.

De Vaulx: Then, I shouldn't mention another one?

OID: You really know how to hurt a guy.

De Vaulx: I'll try to give you the condensed version. Woongjim Publishing was founded in 1980 as a publisher of children's books. The founder had been a sales agent for the English language version of *Encyclopedia Britannica* during the 1970s.

Over time, Woongjim's evolved from publishing children's books to publishing educational supplements and adult-directed magazines such as *Korean Culture* plus a nature magazine. And it has plans to launch others.

So it's hard to categorize the company except to say they're in publishing and that they have an extremely large door-to-door sales force — more than 50,000 strong.

OID: That sounds extremely large, all right.

De Vaulx: But, first, let me tell you what I *don't* like about Woongjim Publishing.

OID: A novel approach, albeit one that you share with Jean-Marie.

De Vaulx: First, although they're not a conglomerate, they couldn't resist the temptation to get involved in a lot of other businesses. So they have minority stakes in various other companies.

OID: You obviously like companies who stick to their knitting. But based on their rapid growth, whatever it is they're doing certainly seems to be working.

De Vaulx: Yes, it does. But it looks to me like they're earning much higher returns in their core business. I haven't done the calculation myself, but I understand that they're earning around 22% on invested capital — which is much higher than their reported returns. And, so, I believe that their returns are being diluted by their forays into these other ventures.

And because their stakes are less than 30%, they use the equity method to account for them. Therefore, instead of including the revenues and expenses of those stakes in their income statement, they simply add their share of those companies' earnings at the bottom of their statement as "Earnings from Minority Interests."

But regardless of how they account for those stakes, they appear to be diluting Woongjim's returns — all the more so because they're financed with expensive debt.

OID: Gotcha.

De Vaulx: Also, this business is one that changes more quickly than I'm completely comfortable with — unlike dairy products, for example. It's a little more fluid — in a state of flux, if you will — than I would really like. For example, now they're moving into publishing CD-roms.

Also, their total market share in children's books is apparently only about 10%.

OID: And you would prefer if they already had the superior economies of scale of the market leader.

De Vaulx: Exactly. Granted, they seem to be handling that situation just fine so far. But, nonetheless, to me, it's a negative.

Also, Woongjim is more leveraged than I would like. At their current stock price — which is around KRW46,000 — their market cap is around KRW100 billion. And their net debt at the end of 1997 will be around KRW87 billion. But that's typical of Korea.

BUT 20%+ UNDERLYING RETURNS AND GROWTH AT 4-1/2 TO 5X EBITDA & A 10-12% FREE CASH YIELD...

OID: I gather there's something you like here, too?

De Vaulx: Yes. Woongjim has a good, profitable business. Again, they have earned high returns in their core business — something in excess of 20%. In addition, that business is still growing. So Woongjim not only has the opportunity to grow along with the business, but also to continue increasing their market share within it.

And they haven't diversified away from it too much — yet, at least. And their balance sheet is decent — especially by Korean standards.

OID: Everything's relative, I suppose.

De Vaulx: Also, historically, they've grown their sales and earnings very rapidly. For example, their sales and earnings have grown at a compound rate in the mid-20s over the last three and five years — although their growth did slow substantially last year.

OID: Do you have any idea of how much of the slowing was due to tougher competition, etc. and how much was due to tough times in Korea?

De Vaulx: Not really. But ignoring growth altogether and simply focusing on their current earnings, we estimate that at today's stock price of around KRW46,000, Woongjim is selling at just over 5 times 1996 EBITDA. And if you assume even 13% sales growth and similar margins going forward, it's selling at 4-1/2± times 1997 EBITDA.

OID: I gather that's good?

De Vaulx: I think a comparable American company might command more like 11 times EBITDA. And it's hard to imagine that comparable American company having the same kind of future potential growth ahead of it.

OID: Based on rapidly growing living standards alone.

De Vaulx: That's right. And this country's still growing despite being in the midst of a recession. We're talking about 5% GDP growth.

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OID: We should all suffer such recessions.

De Vaulx: Exactly. And as you know, publishing can be very profitable for companies which don't get involved in the actual printing.

OID: Or in building web sites or tying subscriptions to issue number and publishing infrequently or...

De Vaulx: And Woongjim is not involved in printing. So they only need fixed assets of KRW35-40 billion in order to support sales last year of slightly over KRW240 billion. Therefore, they generate lots of free cash flow. For example, we estimate that even after netting out their current levels of depreciation and amortization, Woongjim will generate a free cash flow yield of more than 10% this year on its current share price.

OID: And the likely free cash flow yield for a comparable American company?

De Vaulx: Probably 4% to 4-1/2%. And when we assume growth of only 13% — and remember that the historical average has been roughly double that level — we estimate that Woongjim's free cash flow yield could very easily grow to more than 12-1/2% next year.

OID: Sounds impressive.

De Vaulx: I think so. But, actually, there is one more negative that I forgot to mention earlier.

OID: You're kidding.

De Vaulx: I haven't asked Woongjim's management about this. In fact, I haven't spoken with them at all. But, apparently, this business requires lots of receivables — something, it appears, around 25% of sales.

OID: Which means that it requires more capital and opens up credit risk — since their receivables actually exceed their net worth.

De Vaulx: Exactly. But that doesn't bother me so much as long as their profitability remains high. Actually, the need to finance highly profitable growth is a very nice problem to have. Lots of companies would *love* to have that problem.

OID: It certainly hasn't kept shareholders of NIKE and Reebok from enjoying many happy returns.

De Vaulx: That's exactly right. Still, for the reasons that I've already mentioned, I don't like Woongjim as much as I like Dong Ah and Nam Yang. However, clearly, I think it does have a lot to like.

OID: A compelling combination of price and return.

De Vaulx: Very much so. Exactly.

SMALL KOREAN STOCKS ARE CHEAP TODAY, BUT THEY WON'T STAY THAT WAY FOREVER.

OID: I gather that Cheil is currently trading below its average historical valuation — based on price-to-book, anyway. But it looks like the others have generally sold at multiples similar to today's.

De Vaulx: Yes. That's true. In part, that's because Korea's had import restrictions. So there's been the fear — often unjustified, we believe — that these small companies would be unable to hold their own once the Korean market is opened up.

OID: And now we'll get to see who's right.

De Vaulx: Exactly. Import restrictions were eased about 18 months ago. And, so far, it hasn't been a disaster for Nam Yang, although it appears that Cheil could suffer some decline in its margin. But we'll see.

And the Korean stock market is opening up. Granted, it's opening slowly, but it is opening. As you may recall, the market was totally closed until 1991. The only route before that was through a handful of closed-end funds.

Within the last few years, the foreign ownership limit on Korean companies has risen from only 12% up to 23%. They'll continue to increase that percentage over time until, perhaps, there'll be no foreign ownership limitation by the year 2000 or thereabouts.

And we've talked about the difference in many cases between the perception of the value of Korean companies in the eyes of locals and the eyes of foreigners.

OID: So Korean companies should enjoy better access to debt and equity alike — not to mention cheaper.

Eveillard: Certainly.

De Vaulx: Small company stocks in Korea have *generally* sold at lower multiples than big company stocks. And in addition to concerns about their ability to compete, one of the reasons why is that local investors very often want to trade in and out. And the liquidity just isn't there to do that in the small company stocks.

OID: But have they always traded this cheap?

De Vaulx: They've always traded at lower valuations than the big company stocks. However, in the late 1980s, when big company stocks were trading for over 25 times earnings, (albeit understated earnings), small company valuations were much higher than they are today, (I believe 16 times earnings), although they were still much lower than those of the big companies.

Incidentally, at that time, Nam Yang and Dong Ah sold at only 6-1/2 and 10 times earnings, respectively. But the next time stocks get expensive in Korea, I think things have changed enough that those companies' stocks will get much higher multiples.

OID: Because the markets have matured a bit.

De Vaulx: Exactly. For example, no foreigners were present then. And now they're present.

Eveillard: That's right. And I've seen this situation before — both in developing and developed markets alike — where stocks in a market trade extremely inexpensively. However, if the government policy isn't too irrational, eventually those stocks are valued accordingly.

OID: A la Japanese stocks at low single-digit P/Es when Templeton began investing there reaching

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stratospheric P/Es by the late 1980s — although, granted, it took decades.

Eveillard: Exactly — and, believe it or not, in France in 1981 when Mitterand came into power and at first tried to implement the socialist policies he'd run on.

Interestingly, when Templeton was first buying Japanese stocks, there, too, it was the small companies that were particularly cheap. However, today, in many cases, they're as expensive or more expensive than the stocks of similar U.S. companies. But in no way are we predicting or even expecting stratospheric valuations in Korea.

OID: Not to worry. With sufficiently skillful editing, I'm sure that we can make it sound like you do.

Eveillard: What would the average P/E be on the stocks of small Korean companies today? Do you think they're selling for around 8 times earnings?

De Vaulx: That sounds about right.

Eveillard: I can't tell you exactly when the valuations of those companies will rise. But I don't think I'm making any great leap of faith to say that we'll wake up one day and see these stocks no longer trading at 8 times earnings, but maybe at 15 times earnings. If it's higher, that's fine, too. And who knows? Maybe it won't even take *decades*.

De Vaulx: But even if it does, I think we'll be OK with most of the ones we've talked about.

VAE DOESN'T LOOK CHEAP, BUT IT IS.
IT'S #1 ALREADY AND WIDENING ITS LEAD.

OID: Although we're officially out of pages already, are there any others you'd like to mention?

Eveillard: I sometimes think that you're biased toward things that are selling at 50¢ or less on the $1.

OID: You noticed.

Eveillard: Sometimes you're better off paying 65¢ or more on the $1 for something if you're unusually confident that it will be worth much more not too far down the road.

We own what Buffett calls fair businesses at a good price and good businesses at a fair price.

OID: Although you've already told us about three or four ideas whose values seem likely to grow nicely, (whether they're technically good businesses or not), at a very good price.

Eveillard: I agree. But we own some securities where I think the businesses are better than some of those we've talked about, but where we may have to pay more.

OID: So if you'd also like to mention one or two ideas that are overpriced, be my guest.

Eveillard: There's a company in Austria called VAE which I don't believe is overpriced at *all*. In fact, I believe it's *truly* cheap. However, I suspect you might not.

OID: Usually a very good sign.

Eveillard: VAE's a fascinating, little company that produces railroad turnouts — the equipment that allows trains to change from one track to another. And that may sound like a very mundane business, but it's not. In fact, it turns out, (no pun intended), that turnouts — especially VAE's — are actually powerful productivity enhancers. They're no longer simply pieces of metal. They've become quite technologically complex.

And VAE's the world leader in that business — in market share and technology — with 30% of what they call the "accessible" market. By the accessible market, they mean excluding that portion of the market which is captive for one reason or another — because the railroad is mandated to buy from local suppliers or what have you.

OID: You say that they're the market share leader. What can you tell us about the #2 player?

Eveillard: There are only three other significant players in that business that I'm aware of — including one each in Germany and the U.S. But neither of them have much of a presence outside their home markets.

So VAE's closest competitor is a French company that dominates its home market. However, even including the French market, it probably only has a 15-20% share.

OID: So VAE has nearly twice the share of the #2 guy.

Eveillard: That's right. And, again, they're the leader technology-wise, as well. And I think that's best illustrated by their entrance into the U.S. market. They only entered the U.S. five or six years ago. And, yet, they're already in the process of building their third production facility here. Granted, they're not huge plants by any means. But among their clients already are major companies like Burlington Northern and CSX.

OID: Sounds like they're rolling right along.

Eveillard: They're gaining market share like crazy in many countries — particularly in the U.S. Also, VAE is very well positioned to be the prime beneficiary of a number of trends: First, railroads are enjoying a resurgence — both because rail is the cheapest, most energy-efficient method of transporting goods overland. Second, they reduce the highway congestion and pollution associated with trucking.

OID: Very interesting.

Eveillard: Also, the trend toward privatization has energized the managements of many railroads and created incentives for them to seek out new routes and upgrade their systems to be as efficient as possible.

[Editor's note: Mutual Series Funds' David Winters told us about some of those same trends when we spoke with him about Telegraaf. Unfortunately, pages and prices did not allow.]

Eveillard: Also, the trend toward privatization and efficiency are leading railroads to increasingly outsource their purchases of services and equipment and look at their existing suppliers with a much more critical eye. And there again, VAE stands to be the prime beneficiary.

So I believe VAE is in the process of repeating its U.S. success in lots of places around the world. And, therefore,

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I feel comfortable that its sales and earnings are going to grow nicely and that they'll continue to earn a high return on equity along the way. But don't ask me *how* nicely or how high because I really don't know.

However, for all of those reasons and more, rightly or wrongly, I have unusually high confidence in VAE's future.

IT'S SELLING AT 15 TIMES *DEPRESSED* EARNINGS DESPITE HAULING AROUND LOTS OF CASH.

OID: Having been clearly forewarned, would you mind if we were to bring up the delicate matter of price?

Eveillard: VAE is selling at something over AS1,300 [Austrian Schillings]. And they're expected to earn about AS80 in 1997. So they're selling at more than 15 times estimated 1997 earnings. Therefore, based on today's reported numbers, VAE doesn't look all that cheap.

OID: At a P/E well into the dreaded double digits, certainly not!

Eveillard: But it's not as expensive as it appears because it's at 15 times *depressed* earnings. Many of the operations they're starting up around the world not only aren't *making* money yet, but they're still *losing* money as they ramp up production. And based on everything that we've learned about this company, we don't think that they're likely to stay unprofitable for long.

OID: Fascinating.

Eveillard: We think it's *quite* fascinating. Similarly, nearly 48% of VAE's book value is composed of cash. And, yet, when we strip out their cash and the interest they earn on that cash, we estimate that they're already earning 18% on the 52% of their equity that's already been deployed. And for all of the reasons I mentioned earlier, there appear to be plenty of opportunities for VAE to deploy that cash into their business.

OID: Could you give us its basic fundamentals?

Eveillard: This one is another company that Elizabeth Tobin is the most familiar with. Let me have her give you the specifics.

Tobin: As of year-end 1996, VAE's net worth was AS964 million. Therefore, dividing by its 1.4± million shares outstanding, its book value was just under AS700 per share. So at its current price of slightly more than AS1,300 per share, VAE is selling at just below 2 times book.

And it has a market cap of roughly AS1.85 billion. But less its net cash of AS964 million, its enterprise value is less than AS900 million. Meanwhile, it had 1996 sales of AS1.9 billion. So its market cap and enterprise value are roughly 1 times sales and 50% of sales, respectively.

Eveillard: And, by the way, those figures may sound somewhat substantial. However, US$1 is equivalent to more than 13 Austrian Schillings. So we're talking about a market cap and an enterprise value of US$140 million and US$70 million, respectively. So although it dominates its niche, it's relatively tiny.

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

Tobin: It's somewhat complicated because of fluctuating exchange rates. But we've probably paid up to about AS1,200, although we bought the bulk of our shares around AS950.

OID: So you haven't bought it at today's price?

Tobin: No, we haven't. But that's only because between all of our accounts, we already own nearly 10% of this company. But if we didn't have such a large position already, we wouldn't hesitate to buy more. And we may indeed buy more anyway.

OID: You said not to ask you how fast they'll grow. However, it's customary to ask the unknowable. So...

Eveillard: I'm very comfortable that VAE's earnings will grow at least 10-15% per year. And perhaps they'll grow faster. But I'm reluctant to count on it since so much depends on how quickly their overseas subsidiaries, especially their newer ones, become profitable. It also depends on how quickly they start new ones because those start-ups are detrimental to their short-term earnings — although, presumably, they help them in the long run.

VAE certainly generates enough cash to grow faster than 15%. Again, this is a high return business.

OID: And you don't think it's similar to Berkshire's old suit liner business where the customer bought the cheapest one because there's a technology moat?

Eveillard: *Yeah.* We're talking about the world *leader.* They have lots of patents for turnouts — especially for high speed trains and heavy load axles. So they've got the *stuff.* And they're taking advantage of their leading market share to spend 4%± of their revenues on R&D to *stay* ahead.

It's like Buffett says: When a company does its job right, there's no reason anyone should be able to catch 'em — as long as they stay on the "right track".

OID: Bad puns are exclusively our province. One more like that and I'll do more than rail.

But why wouldn't this business be inherently capital intensive?

Eveillard: Because their manufacturing process is not extraordinarily complex or all that capital intensive. Again, it's the *technology.*

OID: The manufacturing of heavy equipment isn't inherently capital intensive? And don't they have to finance inventories and receivables?

Eveillard: Those turnouts are fairly small. It's much more of an assembly process than it is any kind of integrated manufacturing process.

OID: So what could turn VAE into a mistake — a competitor coming out with a better turnout?

Eveillard: Always. But we don't worry about that because they're clearly the technology leader today and spending the time and money to stay that way.

OID: Nothing else?

Tobin: Any time a company has as much cash as VAE has, there's always the risk of them making an

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acquisition that they have trouble digesting — especially when it involves entering new markets.

But they've demonstrated substantial prudence and discipline in the past. They're very serious about staying highly focused within their niche. They don't want to make any acquisition — rail-related or not — outside of their niche because they recognize that they don't have the expertise in those other businesses.

OID: Sounds smart to me.

Tobin: Agreed. But all of the potential acquisitions they've looked at so far have included other businesses that were either very loosely related or unrelated altogether to their niche. Therefore, they've decided that rather than making an acquisition that includes unrelated businesses, they're building their operations from scratch. And I think they're applying that discipline to all of the markets in which they operate.

OID: And I assume they're efficient operators?

Tobin: Yes, they are.

OID: And their biggest weakness?

Tobin: They're probably *too* cautious. That's one reason why they have so much *cash*.

Eveillard: That's one reason. And the other reason, as I mentioned earlier, is their high returns.

OID: Not the worst weakness in the world in any case — especially under the circumstances.

Tobin: Not at all.

Eveillard: We can live with it.

AFFICHAGE DOESN'T LOOK LIKE A BARGAIN EITHER.
BUT, AGAIN, APPEARANCES CAN BE DECEIVING.

Eveillard: And as long as I'm giving you ones that you *should* like, but probably *won't*, let me also mention Societe Generale d'Affichage — Affichage for short. I think it's also a bargain.

It's *the* outdoor advertising business in Switzerland — which they call "posters" — with roughly an 80% share of the Swiss market. It includes billboards, backlit panels, shelter sites, phone booths and signs on trains and buses.

OID: On what basis is Affichage a bargain?

Eveillard: On the surface, Affichage doesn't appear to be a bargain. In 1996, they earned only a bit over SF33 per share. And, therefore, based on the current stock price, they appear to be selling for more than 17 times earnings. However, again, appearance and reality are quite different.

Besides its billboard business, Affichage has two other quite valuable assets. First, it has roughly SF57 million of net cash. And second, it owns substantial real estate. That real estate, by the way, has an insured value of about SF109 million.

That puzzled me because its rental income in 1996 was SF7.4 million. So a value of SF109 million would mean it's yielding nearly 7% — which is quite a bit in a country where 10 year government bonds yield 3.9%. Plus, I vaguely recall German real estate yielding closer to 5% or 6% when I looked at it a couple of years ago. So Affichage's real estate may be worth more. Nevertheless, we just use its SF109 million insured value.

OID: You're no fun.

Eveillard: Therefore, netting out its SF109 million worth of real estate and its SF57 million of net cash from its SF415 million of market cap at current prices leaves its billboard business with an adjusted enterprise value of SF249 million.

Then, deducting interest income on its cash, the rental income on their real estate and depreciation thereon from their total EBITDA of SF54 million, we estimate that their billboard business had EBITDA of SF27.3 million. Therefore, its billboard business is actually selling at only about 5.2 times EBITDA.

OID: And that's good?

Eveillard: We think it's *very* good. It's a very profitable and stable business that generates a lot of cash and earns very high returns.

OID: How high?

Eveillard: They report an ROE of only about 14%. But in fact, the returns Affichage earns on assets actually invested in the billboard business are much higher. On a pretax basis, we estimate that their billboard business is earning closer to 44%. So the effective return on Affichage's assets invested in the business is quite high.

OID: Hardly anything to get bored about.

Eveillard: We owned the stock of a French company whose primary business was the operation of a major Paris radio station. However, it also owned a stake in a French billboard business. We were struck by just how profitable it was. And we wondered whether other French billboard companies were that profitable. Therefore, we looked at one operating in a different region of France. And it *was*.

Also, Kluge made a good chunk of his fortune in outdoor advertising by way of MetroMedia. It was involved in other activities, as well. However, initially, it was based on outdoor advertising.

OID: But why should it earn high returns?

Eveillard: It's a very good business. To some extent, it may be because it's a service business. And to some extent, it may be because it's the most cost-effective advertising alternative available — *much* less expensive, for example, than newspapers or TV. I think that also provides their business with some stability it wouldn't otherwise have. And then its 80% market share probably doesn't hurt.

So at 5.2 times 1996 EBITDA, you can see why we think Affichage is *very* cheap.

OID: So far, so good.

Eveillard: And we're not talking about peak profits here or anything even close. We're talking about profits that are depressed by the recession in Switzerland. To give

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you some idea, in the early 1990s, Swiss ad spending declined for the first time since the 1950s.

And their 1997 earnings are expected to be flattish to possibly 3% to 5% down because the Swiss economy did terribly — both in consumer spending and ad spending.

Similarly, real estate markets may have recovered in the U.S. However, they have *not* recovered in Europe.

OID: What's going on there?

Eveillard: I think their problem is two-fold. First, the Swiss franc has been too strong for an extended period.

OID: Relative to the U.S. dollar or generally?

Eveillard: Vis-a-vis the U.S. dollar *and* other European currencies — although that's less so today. Most important, though, has been the Deutschemark since Germany is Switzerland's most important trading partner. It even got to the point where the Swiss national bank — which used to be so proud of having a strong currency — has even publicly announced in no uncertain terms that they want the Swiss franc to weaken, period.

I know some people who live in Switzerland who say real estate prices have come down, that the economy is flat on its back and that it's almost deflationary currently.

OID: So it's selling for 5.2 times <u>depressed</u> EBITDA.

Eveillard: That's right.

CONVENTIONAL WISDOM ASIDE,
AFFICHAGE CAN GROW AT HOME *AND* ABROAD.

Eveillard: However, <u>Affichage</u>'s 80% share of the Swiss market is both good and bad. It's good, obviously, because they dominate.

OID: And enjoy all sorts of economies of scale that no one else can even begin to match.

Eveillard: Exactly. On the other hand, even when it's not in the grip of recession, Switzerland — like Northern Europe — is a relatively mature economy. Rapidly growing it's not. And since <u>Affichage</u> has about 80% of the Swiss outdoor advertising market already, they're not going to experience tremendous growth by gaining share there. So unless they do something different — either in other countries or other business activities — there's no way that Affichage can grow any faster than the outdoor advertising market in Switzerland.

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

Eveillard: However, <u>Affichage</u>'s management realized their potential growth in Switzerland was not considerable. So they expanded their geographic presence in early 1996 by buying a 49% stake in the largest outdoor advertising company in Central Europe — a firm doing business in Hungary, Slovokia, etc. So not only have they successfully entered Central Europe, but it looks as if they've done so without paying very much for the opportunity.

In their letter to shareholders dated September 1996, they even mention that it's already making a modest profit, although it's hard to imagine it being anything substantial, at least for awhile — because the billboard business in Central Europe is, of course, still very much in its infancy.

OID: But there's the potential for growth you suggest had been missing.

Eveillard: Exactly. Second, their business, I think, is a function of spending on advertising in Switzerland in general and spending on outdoor advertising in particular. And, as I've already described, ad spending in Switzerland in general is quite depressed.

OID: So that they should enjoy the benefit of a cyclical rebound in ad spending — sooner or later.

Eveillard: Correct. Also, management contends that they can increase the portion of total advertising spend, (excluding direct mail), captured by outdoor advertising from 12% to *20%*. Whether they can do it or not remains to be seen. But that's what they contend they can do.

OID: What do <u>you</u> think?

Eveillard: I'd be happy to answer that question. But I think one of our associates, Charles-Edward de Lardemelle, could answer it better than I could.

Charles-Edward de Lardemelle: I think a 20% share by the year 2000 may be somewhat farfetched. But I think they could reach 15% sometime in the next decade.

OID: Which, from today's level of 12%, would still represent a 25% increase. Do you think that's <u>likely</u>?

Lardemelle: Yes. Outdoor advertising grew its share of total advertising in Switzerland from 9% to 12% between 1984 and 1994. And they say they've already begun to spend money to implement a variety of innovations such as having one side of a poster on bus shelters for tourist maps and information and the other side for ad space. Plus, they're doing a lot of things to enhance the quality and impact of their advertisers' message by upgrading their posters in a number of different ways.

Eveillard: And I keep coming back to the fact that outdoor advertising is the most cost effective advertising alternative because I think it's important. There again, being the least expensive alternative is a huge advantage in capturing a higher percentage of total ad spend.

Lardemelle: So I don't think there's any reason at all why outdoor advertising shouldn't capture 15% of total advertising spending sometime in the next decade.

But whether they increase their market share or not, I don't think we're *paying* for it.

OID: When you say outdoor advertising is the most cost-effective alternative, what do you base that on?

Lardemelle: <u>Affichage</u> refers to a measure which they call cost per thousand "OTS" — which stands for "opportunities to see." And according to the company, their cost per thousand OTS is less than SF10.

OID: Then it <u>must</u> be true.

Lardemelle: And <u>Affichage</u> has shown us figures that substantiate their claims to our satisfaction.

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OID: How would you assess this management?

Eveillard: Well, they did a good job in the early '90s when they realized the Swiss economy was doing poorly and that, accordingly, advertising spend was declining. Therefore, in the early 1990s, they cut costs. So when the business did finally start to get somewhat better in 1994 and 1995, they got to enjoy some earnings leverage from those cost savings.

OID: I gather you think they're adding value.

Eveillard: Well, they're trying to grow the top line. They've made some smart initiatives in Central Europe. And they're trying to be somewhat innovative in their current business. So I think they're at least decent.

Also, they haven't made any big mistakes. So, yeah. They've been fairly *smart.*

AFFICHAGE HAS NEVER LOST A SINGLE CONCESSION.
BUT WITH POLITICS INVOLVED, ALL BETS ARE OFF.

OID: And I gather that Affichage's moat is their market share and the economies it gives them and their advertisers?

Eveillard: Exactly. They have 80% of the market. But I think that they've also been smart not to abuse their dominance of the business because that might have encouraged new entrants. The 80% share of the business is no different from what it was 10 or 15 years ago. Basically, they have one competitor who has a 10% share plus two or three others who have almost no share at all. However, those competitors are in all likelihood a plus — because they probably keep them honest.

Lardemelle: Also, Affichage owns the street furniture — the bus shelters, the benches, the panels, etc. Therefore, should they ever lose the concession, Affichage would either tear them down or sell them to the new company. In either case, the new company would incur substantial expenses. So practically speaking, Affichage is quite entrenched.

OID: What could turn Affichage into a mistake?

Eveillard: I suppose recession and quasi-deflationary circumstances could continue to prevail in Switzerland — which, of course, would impact advertising spend. Also, they deal with city governments in some instances to acquire the rights to put up their advertising posters. So they have the risks of dealing with governments.

But besides those two, I can't think of any.

OID: And I gather those don't concern you too much.

Eveillard: No. In fact, I see *no* major threat currently to their business.

Lardemelle: There is one French company — Decaux — trying to enter the Swiss outdoor advertising market. However, so far, they've been unable to do so. In fact, Affichage hasn't lost a single large concession ever — in its entire history.

OID: Wow.

Lardemelle: But the outdoor advertising business in Europe is much more political than it is in the U.S. — because the European companies typically have to bid for concessions from the cities. So there is a political process involved which hasn't historically been the case in the U.S.

Actually, it's just beginning to appear in the U.S. You're starting to see outdoor advertising on bus shelters in New York, for example. But it's only beginning.

So U.S. outdoor advertising firms generally don't have to pay concessions, whereas French and Swiss companies generally do. Affichage doesn't disclose exactly what they pay in concessions. However, it's pretty big. We think it's something between 30% and 50% of their revenues.

OID: What's the equivalent expense for U.S. firms?

Lardemelle: Most of the time, U.S. firms don't build their billboards on the sidewalk. They might put them on the side of a building or on a piece of land. And, therefore, they may pay rent to the property owner. But the city generally doesn't get involved.

OID: And the implications for Affichage?

Lardemelle: If an American firm builds a structure to hold a billboard, typically, they'll obtain a long-term lease on the land and own the structure that actually holds it. And when the billboard company and the property owner can't agree on rent, they'll typically tear it down. And any other billboard company who wants to put a billboard up in the same spot will have to apply for a new permit — and it can take years to get an approval. So there's a barrier to entry — namely regulation — in the U.S.

OID: And in Switzerland?

Lardemelle: In Europe, the barrier to entry is more the relationship with the mayor and the political parties.

Affichage came very close to losing the concession in Geneva to Decaux. I understand that Affichage actually threatened to move their headquarters from Geneva if the city did award their outdoor concession to Decaux. And, therefore, it was renewed.

But that shows that Decaux is pushing very hard.

OID: Although I gather Affichage is pushing hard, too.

Lardemelle: That's true. But the ugly part is that there are political processes involved. So Affichage is always going to be subject to all kinds of aggressive tactics, political intrigue, etc. — be it by Decaux or someone else — who might be willing to buy their way into the Swiss market. I don't know if it works that way or not. But that's a risk.

OID: Why has Decaux apparently chosen to test the door in Switzerland versus all of the other places that they could try? Do they think it's ripe for the taking?

Lardemelle: As I understand it, they've expanded everywhere that they can in France. Perhaps they chose Switzerland simply because the Swiss also speak French. Or they may have figured, "There's only one big player in Switzerland..."

OID: "And maybe there's room for two."

Lardemelle: Exactly. Perhaps, they thought that the cities might want to have a choice.

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SOGEN FUNDS'
JEAN-MARIE EVEILLARD ET AL.
(cont'd from preceding page)

OID: How big is Decaux?

Lardemelle: Decaux's privately held, so I'm not sure. But I believe they're as big as Affichage or bigger because they not only do all of the billboard advertising, but also all of the street furniture — bus shelters, benches and so forth — in major French cities such as Paris.

BUT AFFICHAGE IS LESS CAPITAL INTENSIVE
AND HAS HIGHER MARGINS AND HIGHER RETURNS.

OID: I see that there are two types of shares quoted.

Eveillard: Affichage has about 750,000 shares outstanding — half of them voting shares and half of them non-voting shares. The bearer shares currently sell at SF550. And the non-voting shares sell at SF528.

For the purposes of our valuation, we simply take a weighted average of the two, assuming that the voting and non-voting shares sell for SF575 and SF533, respectively. So the economics should be slightly worse for the former and slightly better for the latter.

OID: What's the difference between the two issues?

Lardemelle: Really only about 8% and very little else. And to give you some idea of *how* little, many companies in Switzerland are simplifying their capital structure by converting their non-voting shares into voting shares.

OID: So other things being equal, take the discount.

Eveillard: Absolutely. Incidentally, I neglected to mention earlier that based on their current stock prices, American billboard companies sell at 12-15 times EBITDA. For example, Gannett's U.S. outdoor advertising business was sold at between 14 and 15 times EBITDA.

OID: Wow.

Eveillard: And, incidentally, among the reasons why companies in that business sell at such high multiples of EBITDA is that they tend to generate lots of free cash and be unusually stable. And, of course, both of those characteristics tend to make companies in that business prime candidates to be acquired or taken private.

OID: Makes sense.

Eveillard: Anyway, in the case of Gannett's business, the acquirer said, "Yeah, we know we paid a stiff price. But we think we can improve its margins and cash flow."

Well, maybe they can and maybe they can't. However, Gannett is a very well run company. So I doubt very much that it badly mishandled its outdoor advertising business.

OID: And, no doubt, the earnings of Gannett's business were far closer to peak levels than those of Affichage.

Eveillard: Certainly. Again, our analyst compared Affichage to American outdoor advertising companies. And as I mentioned, he noticed that the U.S. companies were much more expensive and that they were growing much more quickly.

Another difference we noticed is that U.S. companies seem to be far more capital intensive. That may be because of the large iron structures U.S. companies build — often near highways — to hold their billboards. There's no equivalent in Europe that we're aware of — in part because of much stricter signage regulation. It's forbidden to build billboards near highways, for example, because they consider it too dangerous. Also, billboards tend to be much larger — and therefore, no doubt, more expensive — in the U.S. than they are in Europe.

It could also be because they get more revenue per measure of capital expended because their posters are generally located in cities and, therefore, seen by everyone. People really can't miss seeing them.

Those are the only explanations we can come up with. But I'm just speculating — because we're really not sure *why* U.S. billboard companies are more capital intensive. Again, that's still something of a mystery to us.

OID: Interesting.

Lardemelle: We also noticed that Affichage seems to earn much higher returns.

OID: Yeah. I noticed that, too.

Eveillard: And we're not exactly sure why that is. Perhaps it's their 80% market share.

OID: Sounds like a major plus to me — and like it's one of the few natural, legal monopolies.

Eveillard: That's right.

Lardemelle: Exactly.

OID: The parallels between Affichage and Edipresse are fascinating. Both are in depressed economies, have depressed earnings and dominate their own market but seem to have expansion potential elsewhere. And both are in what seem to be excellent businesses.

Eveillard: That's right. We've already held Affichage for a few years. And we certainly didn't anticipate that the Swiss economy would still be flat on its back today. But my suspicion is that if the Swiss economy had been growing nicely over the past two or three years, Affichage and Edipresse — which are sensitive to the economic cycle — would be selling at much higher prices than they are.

OID: Absolutely. You have to love low multiples of depressed earnings.

Eveillard: *Yeah.* Something I find intriguing is that when earnings are flat because of external circumstances — in this case because of a depressed economy — I think investors sometimes stop differentiating between good and not-so-good businesses. If there's no earnings momentum, they often just don't want to *touch* the stock.

But whether there's earnings momentum or not, it's important to distinguish between a good business and a not-so-good one. Far too much emphasis is placed on earnings *growth* and not nearly enough on earnings *quality*.

I think that's the primary concern that most investors have with Affichage. In other words, investors see that it already has 80% of the Swiss market. And, so, it's widely perceived that they can't grow.

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SOGEN FUNDS'
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OID: But, assuming you're correct, au contraire.
Eveillard: Au contraire.

WHAT HAPPENED IN JAPAN WASN'T AN *ANOMALY*.
IT *HAS* HAPPENED HERE — AND WILL *AGAIN*.

OID: It's interesting to me, at least, that so many of your best ideas seem to be located outside the U.S.
Eveillard: Yes. In fact, in SoGen International Fund, U.S. stocks account for only 25% of our total assets. In the 18 years I've run the fund, that's the lowest percentage in U.S. stocks I can recall us having — *ever*.

OID: And that's not a conscious decision.
Eveillard: No. It's just a matter of *valuations*. Again, I don't know how high is high. But valuations in the U.S. are difficult for us to cope with.

Rightly or wrongly, (so far rightly), I haven't done what I did in Tokyo in mid-1988 — which was to say good-bye to Japanese stocks 1-1/2 years and 40% early. In part, that's because I don't think the excesses in the U.S. stock market, to the degree there *are* excesses, are as outrageous as those I saw in the late 1980s in the Tokyo stock market. Also, there's greater breadth of choice in the U.S. market than there was or is, for that matter, in the Tokyo market.

OID: And although you left 18 months and 40% early, you seem to be well ahead for having done so.
Eveillard: Yeah. Not only is the Tokyo stock market still 50% lower than it was at the peak at the end of 1989, but it's still quite a bit lower than it was when we left in mid-1988. As I recall, we left with the Nikkei near *30,000*. And today, 9 years later, it's below *20,000*.

OID: Templeton also talks about having left too early.
Eveillard: He may *say* that. But he progressively reduced his exposure. So maybe he didn't own very many, but he still owned some Japanese stocks in the late 1980s. At least he didn't go down to zero like me.

OID: Interestingly, you were both exiting Japan in the late 1980s. And you both have your lowest exposure to American stocks in many years today.
Eveillard: I guess value investors just don't like it when it gets too hot.

OID: Peter Cundill and one of his associates note how mutual fund assets in Japan have declined even more than one might suspect by looking at the Nikkei.
Eveillard: That's right. I understand that the local Japanese mutual fund industry has declined something around 73% in size since the Nikkei's 1989 peak. And the drop in the Nikkei would only account for a 50% decline. So the remainder would seemingly be a function of Japanese individuals redeeming their shares in disgust.

OID: Other things equal, roughly 46% of their assets would have had to be redeemed by my guesstimate.
Eveillard: That's right. And now we've had a proliferation of mutual funds here in the U.S.

OID: And I might worry about the frightening parallel had I not heard statistics about the high percentage of American investors who'll never sell their stocks in a bear market and the huge flows of retirement assets which will be there come hell or high water — i.e., that nearly all are committed for the long term.
Eveillard: Yes. They are *indeed* in for the long term — at least so long as the going is *good*. Of all people, Americans tend to be the *most* impatient.

OID: Except for our subscribers...
Eveillard: You get the *cream*.

OID: We really do. There's no doubt about that. But enough sucking up...
Eveillard: Your subscribers may be the exception. But Americans tend to be impatient with *everything* — from their politicians to their jobs and even their homes. They change their jobs and their homes much more frequently than do people in most other countries. And with financial assets, it's just the same, I think.

OID: But do you think the kind of thing that happened in Japan could happen here in the U.S.?
Eveillard: In the late 1960s, Americans were *also* taken with mutual funds — although not quite to the extent that they are today. But within a few years, the market moved against them — and they lost interest.

And, as you know, Peter Lynch learned to his horror that most shareholders in his Fidelity Magellan Fund during the 12 or 15 years he ran it didn't make money — because they generally bought shares only after the fund had enjoyed a good 12-18 months and then they panicked and sold it whenever it did poorly for six months or more.

OID: In other words, good old human nature.
Eveillard: Yes. And human nature has not changed. Therefore, not only *could* it happen, but it *has* happened and will happen *again*.

OID: Even if it does, I'll bet that most of the ones you've told us about will come through it just fine.
Again, many thanks to you, Charles de Vaulx, Elizabeth Tobin and Charles-Edward de Lardemelle for sharing some truly intriguing ideas with us.
Eveillard: As always, the pleasure was ours.

—OID

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WESCO FINANCIAL'S
CHARLIE MUNGER
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Munger's insights are also highly valued by more than a few *OID* subscribers, contributors (and editors). His speech to the investment management class at the U.S.C. School of Business became an instant classic. Says Buffett, "Every investor ought to read that talk before they invest. I think that's a classic." (Of course, we agree.)

Munger's comments at past annual meetings of 80.1%-owned Berkshire subsidiary Wesco Financial are always replete with witty and piercing insights regarding business investing and the human condition. For example, comments at past meetings have included warnings about the debacles to come in savings and loans and junk bonds years before they emerged into the public consciousness.

Therefore, we're particularly pleased to bring you excerpts from his comments at Wesco's latest annual meeting which was held on May 21st in Pasadena. As always, we highly recommend a careful reading (and re-reading, etc.).

WE WANT ONE NO-BRAINER AFTER ANOTHER. AND HERE'S THE LITMUS TEST....

Our litmus test to separate the wheat from the chaff....

Shareholder: Companies in the restaurant industry and, perhaps, hotels and gaming, don't necessarily have a lot of free cash flow — either because, like McDonald's, they have to buy more real estate, or because they have to outfit new restaurants with fixtures and the like.

So if you're doing a discounted cash flow analysis on those companies where there aren't a lot of "owner earnings" coming through as cash, do you make an adjustment — either in figures or in your head — for that fact?

Munger: Generally, we regard adding to the number of locations as *new* investment, whereas if you're merely taking an obsolete location and replacing it with another equivalent location to do the same volume or a little more, we regard as being like replacing an elevator. So you can't do it just from the gross figures. You have to figure out how much is new and how much is mandatory just to hold what you have.

That's our litmus test: What capital spending is required just to stay in *place*? The capital spending that you *elect* to make to do way better in the future when you're in a high return business, we *love* — *everybody* loves. But you have to separate the wheat from the chaff.

If it's not a clear *no-brainer*, it doesn't happen.

Munger: And it's sometimes hard. Sometimes when you fix up an old business, you're really *transforming* it. So it may *look* like a maintenance expense; but, in fact, the capacity of the enterprise goes up.... So you just have to be able to think through things in terms of their function.

But we do that only very roughly. I've never seen Warren do a detailed discounted cash flow analysis. If he can't do it roughly in his *head* so that it's a clear *no-brainer*, it doesn't *happen*.

Individual subsidiaries may do analyses of various kinds as they decide whether or not to buy a new machine or something of that nature. However, even in those cases, I personally prefer the no-brainer decision.

I've heard Warren say more than once that if you're in a *good* business, it tends to throw up one no-brainer decision after another; and if you're in a *bad* business, it tends to throw up one Hobson's choice after another, (with Hobson's choice being in the modern sense instead of the old sense — which was *no* choice).

We *like* businesses that just throw up one puff ball after another that we can bang down.

IF IT WON'T STAND A LITTLE TROUBLE, THEN IT'S NOT OUR KIND OF BUSINESS.

Assimilation stories have a high percentage of *troubles*....

Shareholder: I've heard anecdotal evidence of horror stories in the assimilation process of Wells Fargo swallowing First Interstate. In your view, how long might that *take*? What's going on? And how do you feel about management now as opposed to when Reichardt was running it?

Munger: Generally speaking, assimilation stories have a high percentage of *troubles* in them. Every once in a while, you have one that works *fabulously*. For instance, when Wells Fargo took over Crocker, that worked wonderfully as it turned out. And that was no doubt what helped them do this last one — which has been much *harder* to assimilate.

One of my favorite stories from business is about Hershey. Way back in the early days, they wanted to go to Canada and make candy. Well, they knew enough to want to keep their own flavor. And that came from some obsolete method of creating the cocoa butter where they used old stone grinders instead of the modern centrifuge. And, so, they were going to go to Canada and wisely use the old stone grinders.

Well, it took them five years to duplicate their own candy flavor in Canada. It's *tricky* moving to a different location — way trickier sometimes than it looks on the *surface*. And it's tricky to meld a whole bunch of new operations in and keep a lot of customers happy at the same time — particularly when the competitors are wisely running commercials on the radio and television saying, "Are you being abused by these monsters? Come into our welcoming little shop."

So that *has* been a tougher assimilation process. [There's] no doubt about it....

Even very *simple* things can be *incredibly* challenging.

Munger: When we moved Wesco's main account from Security Pacific to the Bank of America, it got out of balance. And nobody in the whole Bank of America could ever get it to balance. Well, finally, we just shut it down, let it run out and made some adjusting entry. And that was our accounting.

You'd think you could move your bank account from one bank to another without getting it so gummed up that you had to go back to an old-fashioned stratagem like that.

But if it won't stand mismanagement, it's not the real *thing*.

Munger: But five years from now, nobody will even remember the problems that they're having today. And Wells Fargo will be a big presence down here — as will

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

Bank of America. [One of the *beauties*] of a really good business is that it'll stand some ruin, it'll stand some trouble and it'll stand some bad judgement.

When I worked in the bowels of the mining business as a young lawyer, I had a wonderful, old client who used to say, "Charlie, if it won't stand a little *mismanagement*, it's no *mine*."

And businesses are best for the investor when they'll stand a little mismanagement — a little screw up — from attempting difficult things and having things go wrong.

FREDDIE MAC IS A *MARVELOUS* BUSINESS.
BUT SUCCESS FORGES ITS OWN ANCHOR.

Freddie Mac has the most reliable part of a better system.

Shareholder: For the last eight years, Freddie Mac has been a very, very good business. More recently, it's earned lower returns on capital, albeit still very good ones. What do you think their business will be like in 15 years?

Munger: Freddie Mac is a *marvelous* business. And it and one other company have a very dominant position in a real basic function. Indeed, it was the basic function that Mutual Savings once was *part* of. And that has been *shifted* to a system that really works better.

And not only that, but they've creamed out the most reliable part of it. In other words, by saying, "We'll make loans on single family homes and they'll be limited to a loan of a certain maximum size," that screens out a *massive* amount of trouble.

Freddie Mac's experience was better for a *reason*.

Munger: We recently had, (we're in the tail end of it now in California), the worst foreclosure wave in residences since the *1930s*. And the experience of Freddie Mac, while it was awful compared to their *normal* experience [in Southern California] and other parts of the country, was still a pretty good experience for a lender.

In contrast, the people who made the *$800,000* loans against *million* dollar houses, when the trouble came, their borrowers couldn't just go to their brother-in-law or sister or whomever and say, "Gee. I've got this little $14,000 a month mortgage payment. And these are tough times. Won't you help me out?"

But if the guy had a payment of only *$800* a month or something, why, there was somebody in the family who could help or the wife could go to work or what-have-you. So the experience was just *miles* better.

So there's a lot to like. But success forges its own *anchor*.

Munger: And, so, they've carved out a niche that

(continued in next column)

really *works*. It's a very, very basic type of credit that people really need. And they keep getting smarter and slicker in their procedures. They've got real brute power to discipline the rascals in the mortgage originating network — of which there will be *plenty* if you don't purge it by *using* power.

And the combination makes those two companies have a marvelous business. And that's why we sold our savings and loan and bought the stock in Freddie Mac.

But, as Warren says, great investment records forge their own anchors. And, similarly, great *business* records are constrained by the realities of life. A great big thing *can't* keep compounding at a very high rate indefinitely. Freddie Mac can't grow quite as fast in the future as it has in the past. But we still think it's a very fine business.

OF COURSE, IT'S HARDER FOR US TODAY.
YOU CAN TELL BY SEEING HOW LITTLE WE'RE *DOING*.

Obviously, it's tougher today.

Shareholder: What is the universe of stocks that are still an opportunity for Berkshire — companies that you understand and are basically waiting around to see show up at the right price so you can take a big position?

Munger: Let me answer a question with a question: Are you finding it easier or harder to find things *you* want to invest in?

Shareholder: I'm finding it harder.

Munger: Well, join the club.

Shareholder: There are companies out there I'd find attractive if the *prices* were better. So my universe of maybe 50 potentially good companies to buy is only five now. I'm just wondering what *your* universe is.

Munger: Well, you're at least four ahead of us.... *Obviously*, it's tougher.

It's tougher for a reason — make that *two* reasons....

Munger: People in this room, by and large, were trained in the old school of investment where you really wanted to buy shares at a substantial discount from a liquidating value — assuming the whole corporation liquidated — that was easy to compute.

But a couple of things [happened] to make the lives of such investors much harder. For one, the tax laws changed so that a corporation with appreciated assets including goodwill couldn't sell out in a way that got its shareholders money and gave the buyer a write-up on those assets without imposing a tax at the corporate level. That had a *huge* negative impact on ... liquidating values.

And, then, we got a huge crowd of ever-richer buyers — leveraged buyout operators and so on and, also, other investors who'd had a long run of success — with huge flows of funds going into pension funds, foundations and the like. And buying common stocks has worked very well for people for a long period of years.

And then the rear view mirror kicks in....

Munger: And, then, the process of keeping on buying these things because it's worked in the recent past, in the intermediate past, and maybe even the *long*-term past if

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WESCO FINANCIAL'S
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(cont'd from preceding page)

you want to go back 15 years finally starts feeding on itself. And, *naturally*, that makes it harder for value investors like you and us. It *is* much harder for us.

You can tell by seeing how little we're *doing* at the moment. And that's not because we don't have an aptitude for doing things. It's just getting *harder*.

Our approach works just *fine* — unless you're *wrong*.

Munger: As value investors, we would have gotten in trouble way earlier than you people did because our *size* constrained us way earlier. But, luckily, we developed the habit of mind where we said, "Even though we have to pay a very high price for something, it can still be at a big discount from intrinsic value."

But that involves knowing that something that's plainly a very good business [today] is going to *stay* a very good business for a very long time. That type of thinking was much *scorned* by so-called value investors in the old days. But it works fine — unless you're *wrong*. In other words, if you can correctly sift the Nifty-Fifty for the Nifty-Five that really *are* nifty, that still *works*, at least moderately well.

But *no* business is so wonderful that you can't overpay for it.

Munger: But even *that*, given enough success, could get to the stage where it won't work very well. There is *no* business so wonderful that investing in it can't be ruined as an opportunity by raising the price to *some* point. That's obvious. *No* business is worth *infinity*.

And, so, it's a lot less fun. As I look around the room, I can see a lot of people who are quite comfortable financially based on the old system and the old ways. But if you people just end up very comfortably rich and not having so much fun getting richer, why, I have heard of worse tragedies. And, similarly, for us.

A time to *sow*, a time to *reap*, and a time to just get *through*.

Shareholder: I'm a brand new shareholder. And, therefore, I'm not at all comfortably rich. But I would *like* to be. And you're *scaring* me a little bit when you say there aren't very many opportunities out there now. And I'm just wondering what the future holds for us newbies.

Munger: Well, I think that you newbies as a class — over your full life expectancy — will have your share of opportunities. But if you're anticipating some very easy way to get rich over the next five years, I would guess that you might find it a little *harder* than [it was for] most of the people you see as you look around you today.

That should not discourage you, by the way.

Shareholder: Well, 10 or 20 years, then. I'm young.

Munger: The game is a long-term one for any person your age. There's a time to *sow* and a time to *reap* — and a time to just get through without getting *killed*. It's like the old story about the child who asked his grandfather what he did in the French Revolution. And the grandfather said, "I got *through*."

There are periods like that. And you have to know which is which — or, at least, allow for the probabilities.

WE DON'T LIVE IN FEAR OF ANOTHER 1987.
IN FACT, QUITE THE CONTRARY....

We've paid practically no attention to the Fed.

Shareholder: What seems to be the big unknown is the *Fed*. Nobody in the U.S. has a sense for how the Fed will act 'til they do — which seems different than elsewhere.

Munger: We have nothing helpful to say about the Fed. We have paid practically no attention to the Fed all these many decades. And it hasn't *hurt* us very much. So we're unlikely to start worrying about the Fed *now*.

Higher and higher stock prices would be no blessing for us.

Munger: Of course, you can hardly *help* thinking about market valuations. [But,] for us, with this long-term thinking, our chief terror is not that we're suddenly going to have 1987 over again. We are a net *buyer* of stocks as far ahead as you can see. And we generate a lot of capital. We are a net buyer year after year after year....

And if you're a net buyer, you may care what stocks sell for 50 years from now, but there's *nothing* that would make you want them to keep going up in the *near* term.

And, so, it's not the 1987s that terrify us. What would bother *us* is something that could happen — and that is stocks going up to very, very liberal prices and, with minor fluctuations, *staying* there year after year after year looking a little higher and a little higher and a little higher and a little higher — in other words, just more of what we have *now* with them going on and on and on.

That's what most people *want*. [For example,] if you're running a big mutual fund company or if you're an investment manager or a stock broker, why I've just described an *ideal* world. But that is *not* ideal for us. And it's not ideal for a very long-term shareholder in a place like Wesco or Berkshire.

We're *skeptical* about today's returns, but not *doctrinaire*.

Munger: But it's *entirely* possible that stocks could.... In the *first* place, if American industry is going to continue earning returns on capital like those it's now earning and if interest rates are going to stay at 7%, more or less, on government bonds, it's not at *all* clear that the great corporations of America are horribly mispriced at what looks to you like high prices by historical standards.

And I'm *skeptical* maybe that American business can continue earning these extreme returns on capital. But I'm not *doctrinaire* about it. I'm just mildly skeptical. But I could conceive of stocks going on and on and on with these very low dividend yields and very high prices.

And that would not be wonderful for our shareholders.

Munger: And for a lot of you, that kind of world is not that much fun. You like no-brainer decisions where you can kind of see that there's $3 of assets that you're buying for $2. And the kind of world I'm describing starts making that quite *hard* for you. However, it could go on for a long time.

That scenario is not wonderful in terms of the returns that people would get from holding Berkshire or Wesco for the next 50 years.

High stock prices + easy credit = high private valuations.

Shareholder: Are you experiencing that same kind of

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

frustration as you look for privately held companies? Are they overpriced, too?

Munger: Any private company that can be melded into a *public* company can be transformed, so to speak, into publicly traded common stock. And if the market for publicly traded common stocks goes up and up and up, of *course*, it affects values being paid for private companies. And if the *creditors* of the world get more and more liberal in lending for acquisition transactions, that starts affecting what you have to pay to buy private companies.

It's no *accident* that our recent transactions involved *stock*.

Munger: There was a little group of TV stations and newspapers in the deep south owned by a guy named Park. When he died, his estate decided to sell them. Of course, we looked at it — and [we] passed.

But some guy talked the pension fund of the state of Alabama into putting up virtually all the money at some high interest rate — 10% or 12% or more. And he bought those things at a price that made everybody else in America *blanch*. Well, he paid *off* the loan the other day.

So you're in a market where state pension funds start chunking out the hundreds of millions to help people pay record prices for things. And that affects what Wesco or Berkshire has to pay when we buy things privately.

It's no *accident* that recent transactions at Berkshire have been transactions in which Berkshire issued *stock*. It's *hard* to make cash deals in this kind of a climate.

THE NATURE OF WALL STREET IS SUCH THAT THEY'LL PUSH IT AS FAR AS THEY CAN.

Given the incentives, the Street will charge into insurance.

Shareholder: Wall Street seems to believe that the next great frontier is the securitization of insurance risk. And I was wondering what thoughts you might have about that and how it might affect Wesco's insurance operations.

Munger: Well, that development does affect the insurance operations of both Berkshire and Wesco. The nature of investment banking and, indeed, the nature of all modern finance is that it'll always go any damn place that looks like it may provide a decent return on new money. Indeed, there are second *order* consequences. The promoter or the executive will cause money to go any place he can talk money to go. He gets an *override* — even if it's *bad* for the investor, and this incentive has consequences.

So, *naturally*, Wall Street charged into insurance and said, "We can twist insurance risks into *securities*" — which, after all, is easy enough to *do* with a computer and printer — and then sell the securities.

One piece of insurance that Wall Street *didn't* securitize....

Munger: That happened with the big reinsurance deal Berkshire did with the State of California. Morgan Stanley was in that — and was going to securitize the whole layer that we eventually took. But they took forever doing it and had trouble putting it together. And the State got irritated. In due course, they came to us and said, "Will you do it?" And it took about two seconds for us to say, "Yes." And so much for *that* particular bit of Wall Street turning insurance risk into securities.

But it could have gone the other *way*. So would our business be better if Morgan Stanley weren't out there trying to do that? You *bet*. And how far that securitization scheme will go, I don't know. But I *do* know that the people pushing it will push it as far as they can.

OF *COURSE*, WE USE MULTIPLE MODELS. AND OUR INVESTMENTS *REFLECT* IT.

A few fundamental models will carry a lot of weight....

Shareholder: In the speech you gave at U.S.C., you said that you think in *models* and have several models going at any one time. At Berkshire and Wesco, you seem to be circling around a model of the financial services industry in the future. And the other thing you said in your speech is you say *what* you're doing, *why* you're doing it and *what* you expect from it. Any comment?

Munger: Well, I think it is undeniably true that the human brain *must* work in models. Indeed, semanticists, etc. have pretty well proven it has to work in metaphors, similes and so forth which are one type of model. So the brain works in models. And my brain works like all *others*.

The *trick* is to have your brain work better than the *other* person's brain because it understands the most *fundamental* models — the ones that will do the most work per unit. In science, just a few formulas will correctly make an enormous percentage of all predictions. And, similarly, in messy practical life, certain models will carry a lot of extra weight. So if you know those and use them routinely, why that improves your batting.

Don't ask the man with a hammer about your stained glass.

Munger: Another thing that improves your batting is to have *multiple* models. Many people have only one or two models. And they go through life *forcing* reality into those one or two models. That's why we say over and over again that to the man with a hammer, every problem tends to look pretty much like a nail. That's just the way the mind *works*.

And you have to train yourself *out* of that if you want to think the way we do. You must have *multiple* models and run your reality through them.

Two and two does not always equal *four*....

Munger: And you've got to understand how models *interact* — because frequently two modular implications will be acting in *concert*. And in those cases, two and two does not always equal four — it can be six or even *eight*. Just as you can generate an explosion by simply adding only an extra gram or so of some ordinary material to an existing mixture that happens to create a critical mass, (which occurs according to the laws of physics), sometimes ordinary arithmetic doesn't predict what happens.

And the same thing happens in *reverse*: When you get two or three powerful forces all acting in concert *against* you at the same time, some of the disasters that can result are very large indeed.

Without multiple models, you get some peculiar results.

Munger: I think that is so obvious that everybody

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

ought to know it from an early age. And I think everybody ought to be trained to think that way. I don't think education does a particularly good job. It tends to *balkanize* people's thinking into little territories.

So people learn one or two models from one territory and go around torturing the rest of their experience into the model they already have. That does *not* work very well. If you don't have a multi-modular approach to life, then you're going to get some very peculiar reactions.

I know that sounds *extreme*. But there are all kinds of people who go through life just that way. And that's a *terrible* way to go through life.

Multi-modular folks have more fun. We know....

Munger: And it's *so* much more *fun* to do it [in a] multi-modular [way]. Therefore, of course, if we're buying consumer food and drink items like Coca-Cola Company and toiletry companies like Gillette at the same time that we're buying shipyards like General Dynamics and financial institutions, then, obviously, we must have some multi-modular systems in our heads. And, yet, you'll find that there are some *big* ideas underlying *all* of them — such as high returns on capital.

US AIRWAYS WAS NOT OUR FINEST HOUR. BUT WE'LL PROBABLY COME OUT WHOLE.

Our USAir Preferred deal wasn't our most brilliant hour.

Shareholder: USAir used to be a bad investment. And now it's looking like a good one. I wondered if you'd comment on its economics.

Munger: I'm glad you've given me an opportunity to display my small share of *humility*. British Air just sold part of their holding of USAir Preferred at a big premium to their cost. But US Airways is not yet up to the point where the conversion option of our preferred is "in the money." And, obviously, we did not display our greatest brilliance in getting into that particular investment.

You should remember, however, that we went into that issue as sort of a fixed-income substitute — because we *never* would have bought that security without a mandatory redemption value and a preferred dividend.

(continued in next column)

US Airways took our safety device right to the *limit*.

Munger: But we put a clause into that one that if they ever *defaulted*, they had to pay five points over prime in terms of the accumulating preferred dividend. And, of course, an airline whose business *turns* suddenly looks at hundreds of millions of dollars in the bank drawing *5%* interest and they're paying us 13% or *14%*. Well, it doesn't take a genius to figure out that maybe you might as well pay the preferred dividends.

So we did have enough sense, knowing that more trouble was likely from an airline, to *insist* on a clause that would be particularly useful should stress come. And, of course, stress *did* come. In fact, it took it right to the *limit* of our last *safety* device. And it fluttered for a while with the device *creaking*. But, finally, the device held.

All's well that ends ~~well~~ whole, but it *wasn't* our finest hour.

Munger: And it does look, as though we'll get all of our money back plus the 9% dividend in due course. Plus, who knows? We might even do a little *better* than that.

But, no, that was *not* our [finest] hour.

THERE ARE HUGE OPPORTUNITIES, BUT THEY'RE PROBABLY NOT FOR US.

Commodity businesses & buy/hold style don't mix usually.

Shareholder: Years ago, Berkshire was in some of the metals like Cleveland Cliffs and Handy Harman. Do you have any feeling what the future's going to be and do you have any desire to go back into that area?

Munger: Well, we certainly didn't *do* very well [in natural resource stocks] compared to how well we did *elsewhere*. Generally, those commodity businesses are tough to *do* if you're in the business of buying and holding particular stocks for very long periods.

Actually, there's one mine in the world I'd really like to own. That's a *boron* mine which is a great open pit mine in California. Boron's an *element* — [so] you can't *synthesize* it. They're digging it out of one vast hole — [so] it's a very low cost operation. Of course, it's a nice safe country. Plus, there aren't big environmental problems because boron doesn't do that much harm and, besides, the mine is out in the middle of a very inhospitable desert.

That would be a very nice mine to own. Unfortunately, somebody else already owns it who *knows* it's a nice mine.

There are undoubtedly huge opportunities, but not for us.

Shareholder: Recently there's been a lot of deregulation going on in telecommunications and utilities. Are there opportunities out there for Berkshire and Wesco as far as picking the winners in the years to come?

Munger: Very likely *not*. We have very little aptitude for making predictions in that sphere. And we tend to stick to arenas where we think we've got some special aptitude.

Generally speaking, I am not drawn to the idea of wonderful opportunities where everybody is getting into everybody else's business. That looks to me like more competitive *pressure*. And, generally speaking, we don't like rapid *technological* change because we're not very good at understanding complex modern technology.

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WESCO FINANCIAL'S
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(cont'd from preceding page)

There are undoubtedly huge opportunities *out* there. But they're probably not for *us*.

IF YOU GET THE RIGHT OPPORTUNITY, YOU SHOULD PROBABLY *TAKE* IT.

I *never* want to pay above value — well, *almost* never....

Shareholder: You once said that one should never be afraid to pay a premium price above the intrinsic value of the stock if you fully believe in the fundamentals. How much of a premium should you be willing to pay?

Munger: No. You are *misquoting* me. I *never* want to pay above the intrinsic value for a stock. It may be that some wonderful business has a way higher intrinsic value than a traditional follower of Ben Graham might think. But our game is still buying below intrinsic value.

There is one exception *only*: If the accidents of life gave you the opportunity to ride the coattails of some unusual human being or group of human beings — where you knew they were going to be loyal to you and [so forth] — even though they didn't have a business at *all* yet, if you got such an opportunity, you should probably *take* it.

There aren't *many* such individuals. One was clearly Warren Buffett. And those people who trusted him when he was a young man with *no* business and no assets were, I suppose, paying above intrinsic value because they gave money to Warren to manage and paid him an *override*.

Some relationships may *warrant* paying a premium....

Munger: So I think there are *people* — *very, very* few — and human *relationships* you might pay a premium to get into on the theory there'd be some long-term advantage.

One person thinking that way sent me a check the other day for $50,000. And he said, "Cash this check if you'll let me work for you for *nothing*." I thought that was an interesting approach. Obviously, it didn't work very well because I can't remember his name. But it got my attention at the time.

And I don't think it was *irrational* of him to think that. He got the wrong *person*. But somewhere out there is somebody to whom a $50,000 payment, if that would allow you to work for him, would be a good investment, although I think that's quite *rare*.

And sometimes what *looks* like a premium price may *not* be.

Munger: Generally speaking, our game and yours should still be buying things below intrinsic value. Again, it's just that you have to recognize that the intrinsic values of *certain* wonderful businesses are very *high*.

IF YOU'RE TRYING TO DO WHAT WE DO, I DOUBT IF YOU *NEED* A LOT *MORE*.

I don't think our basic methods will ever become obsolete.

Shareholder: Besides Ben Graham, Phil Fisher and you and Warren, who else could we study in order to become better investors?

Munger: There are *thousands* of brilliant new investment managers out there. And we don't even *know* them. We are from a different generation. I don't think our methods will ever become obsolete. But if you want to do convergence trading between derivatives and British government bonds or something like that, we would not be the ones to come to.

However, when it comes to classic stock picking, I don't think our basic methods will ever become obsolete.

It's *very* basic. And I doubt if you need much more.

Munger: It's very *basic*. What you're trying to do is find mispriced bets available in the public markets. And it's also very basic to say, "I have certain aptitudes for sifting the markets for mispriced bets that will give me an advantage in some areas, but not in others." And, therefore, you search in areas where you have an advantage instead of a disadvantage.

Those are very elementary ideas. And I doubt if you need a lot *more*. I don't think you need a lot of new ideas in addition to the ones we have if you're trying to do what we're doing. Once you learn f=ma and $e=mc^2$ and so forth, you don't need to study alternative formulas.

But that's just the *start*. There's a lot of *work* after you've learned the basic method figuring out what fits and what doesn't.

A classic I picked up some major insights from *re-reading*....

Shareholder: Charlie, last year you were impressed with a book that you recommended to all of us called *The Selfish Gene*. I wondered if there was something else that impressed you outside of your investment reading?

Munger: Well, I come back to a classic that I *re-read* this year, having read it when it first came out — and that was Garret Hardin's *Living Within Limits*. And I actually picked up some minor insights, or even major insights, the second time around that I'd missed in the first.

And he's a very good writer. He was 78 or 79 when he wrote that book. And it won the Phi Betta Kappa award — which is a stunt. *Living Within Limits* by Garret Hardin — he's a biologist.... He's a very, very good writer.

A colorful example to which Warren and I can relate....

Munger: And for you *financial* buffs, he has very amusing examples.... One is about somebody investing the proceeds from the sale of only two grams of gold at 5% per year compounded at the time of the crucifixion of Christ. Of course, that little sum winds up compounding into ... way more gold than the size of the earth by *thousands* or even *millions*.

It's very amusing. And it helps *remind* you how hard it is in any real sense to compound money for long periods.

That's a *very* good book for any thoughtful person to read.... And if you *do* buy it, I'd advise you to read it and then go back and read it again. It's the condensed wisdom of a very smart man's lifetime.

He has some *literary* skills, *too*, with clever examples and wonderful quotations from the greats of the past. And it's *hard* to assimilate in just one gallop through. But I think a lot of you will *hugely* enjoy the book.

—OID

MARK HOLOWESKO, TEMPLETON FUNDS

"Something very exciting and unusual is happening in America. Net inflows going into equity mutual funds as a percentage of GDP is at a record high. As of a couple of months ago, the stock market was [equivalent to] 98.6% of GDP — much higher than it's *ever* been. 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 price-to-sales, the U.S. market would lose 40% of its value.

"If you're worried about bear markets, the best thing to do is to find places where bear markets have already occurred. That's certainly the case with many countries in Asia — like Thailand, Korea, Indonesia and, to a certain extent, Japan. Based on a lot of work we're doing today, I'd anticipate that our Asian exposure will rise — not only because stock prices in that area have declined, but also because the price you pay for the growth in those countries is very attractive. If you look at the growth rates of different economies around the world relative to their P/Es, you'll see that the U.S. is at the bottom. And you'll see that a variety of countries — [including] Thailand, China, South Korea and India — are among the cheapest. We're basically net buyers of all those countries just as we're a net seller of the United States."

Templeton Growth Fund Annual Meeting — July 24, 1997

PETER CUNDILL, TIM MCELVAINE ET AL, PETER CUNDILL & ASSOCIATES

"When I started managing what is now Cundill Value Fund in 1975, there were a myriad of bargain basement issues in the U.S. trading below net, net working capital — below their proxy for liquidation value. Today, there are almost none in the U.S., but Japan is filled with them — with a list I don't think I've seen as full since 1975. And in almost all cases that I've seen, when you can buy a myriad of these securities, as [you can] in Japan today, it is almost always a sign of a market *bottom*. And when you can't find any, [as is the case in the U.S. today], it's almost always a sign of a market *top*....

"From when we started in 1975 to at least 1985 or 1990, I'll bet you we never had less than 50% of our holdings in the U.S. As of today, it's *3%*. We are, in fact, short some securities in the U.S. as a hedge against markets going down....

"The value of net assets invested in Japanese equity mutual funds over the last five years has decreased by two thirds. ...[B]y contrast, 90% of all equity mutual fund assets have been invested in those funds in the last five years. ... [Mutual fund operators] don't expect North American equity assets to decrease by 70% over the next five years. Quite the contrary. I'd guess, though, that our equivalents in Japan probably didn't expect equity mutual fund assets to decrease 70% *either*.

"U.S. unemployment's now at 4.9%. That's the lowest it's been for 27 years. I don't know what full unemployment is. Maybe it's 4-1/2% or 3%. But I'm sure that at 4.9%, the pressures from wage inflation and so on are likely to be higher than they would have been at 6-7%. The conclusion from that is that the markets really have priced in all the good news.

"Don't misunderstand me, though. We're not predicting a crash.... We [simply] think it's overpriced and more likely to stand still or fall. And when it does correct, we'd like to be insulated from it and, hopefully, profit from it.

"We're also in Singapore. We're beginning to do things in Thailand because it's very unpopular. I'd say our focus is shifting to Asia — primarily Japan, but Asia, in general (including India). So we're there. And there are things to do."

Cundill Value Fund and Cundill Security Fund Annual Meeting — May 13, 1997

Dear Subscriber,

We find the unanimity or near unanimity of opinion across half a dozen or so of our contributors striking:

1. (Among five) that U.S. stocks are expensive & risky.
2. (Among all) that bargains are much more plentiful in Europe, (especially France), and Asia, (especially Korea, Thailand and, believe it or not, Japan).
3. (Among four) that central bank sales of gold bullion reserves is symptom of overconfidence in financial assets.

At this year's Morningstar Conference, Paul Stephens of Robertson Stephens noted that two of his "growth golds" — Golden Star Resources and Indochina Gold Fields — had doubled and tripled before plummetting to where they once again sell below his cost. Still an unabashed bull, Stephens observes: "I have no idea when the price of gold is gonna go up. But it's like a coiled spring. It's gonna go up so much at some point that it's going to *shock* people."

We suspect Stephens will prove to be right. As more than one contributor has confirmed, gold is indeed selling below its equilibrium price — probably well below. Unfortunately, the securities are another matter altogether. Few appear to be bargain-priced. And, of course, most mining companies are, (by definition), one of the ultimate commodity, (i.e., low return), businesses.

SoGen's Jean-Marie Eveillard, Charles de Vaulx, Elizabeth Tobin and Charles-Edward de Lardemelle shared some ideas with a combination of multiples, discounts and apparent returns the likes of which we've rarely seen.

Until next edition,

Henry J. Emerson

Your Editor

P.S. Thank you for your patience and your support.

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