Outstanding Investor Digest

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

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Volume XIII Numbers 1 & 2 March 13, 1998

OAKMARK INTERNATIONAL FUNDS' DAVID HERRO AND MICHAEL WELSH
IF THESE WERE BARGAINS BEFORE THE ASIAN MELTDOWN, THEN SOME OF THEM ARE ABSOLUTE *STEALS* TODAY....

David Herro, the highly regarded co-manager of Oakmark International Funds, isn't known for overpaying. Quite the contrary. But in the wake of last year's carnage in Asia, securities that he and co-manager Michael Welsh believed to be attractive bargains in mid-1997 in many cases became much more attractive indeed by year end.

Who better, then, to give us a tour through the wreckage

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CUNDILL INVESTMENT CONFERENCE PETER CUNDILL, SETH KLARMAN ET AL.
"WE HAVEN'T SEEN BARGAINS LIKE THESE SINCE 1975. HOPEFULLY, THE RETURNS WILL FOLLOW...."

The annual Cundill Investment Conference — organized and presided over by Cundill Group founder Peter Cundill — is one of the events which we look forward to most each year. One of the reasons why is its all-star cast. Besides Cundill and his associates, attendees include other notables and quotables including half a dozen or so other *OID* contributors. For example, those attending his latest conference included

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PETER CUNDILL & ASSOCIATES' TIM MCELVAINE & DAVID BRIGGS
"WONDERFUL COMPANIES AT DIRT CHEAP PRICES.... VALUE SEEMS TO MEAN *NOTHING* — ABSOLUTELY NOTHING."

During the 23 years Peter Cundill has been at its helm, shareholders of Cundill Value Fund have enjoyed a compound annual return of 17.6% after all fees and expenses versus 16.6% for the S&P 500 and 13.5% for the TSE 300. However, he recalls his first 10 years with particular relish having earned a compound return of about 26% per year without a single losing year during the period.

So when he mentioned finding bargains as good or better

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WESCO FINANCIAL'S CHARLIE MUNGER WORLDLY WISDOM REVISITED: LESSON #2, PART 2
"MASTER THE BEST THAT OTHERS HAVE FIGURED OUT. NO ONE'S SMART ENOUGH TO DREAM IT UP HIMSELF."

Charlie Munger's lectures on achieving worldly wisdom are considered by more than a few *OID* subscribers and contributors (and editors) to be in a class by themselves. However, in our December 29th edition, limitations of space kept us from bringing you his second lecture in its entirety.

Thus, in this edition, we're very pleased to bring you the second and final installment of Worldly Wisdom Revisited: Lesson #2. The excerpts which follow were selected from a

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— especially since it includes seven or eight casualties of their own — than Herro and Welch. Very conveniently, that's exactly what they do in their most recent letters to shareholders of Oakmark International Small Cap Fund and Oakmark International Fund dated January 8, 1997 from which the following edited excerpts were selected.

WE'RE SIFTING THROUGH THE WRECKAGE AND WE'RE FINDING BARGAINS APLENTY....

The big story in 1997 — unprecedented declines in Asia....

[Last year was] a trying one for international funds, particularly international small cap funds. The currency and equity markets of emerging Asia plunged in particular. Declines in some of these markets were unprecedented: Indonesia, -75%; Thailand, -63%; the Philippines, -55% and Korea, -72% — all in U.S. dollar terms.

Developed markets ... were also big underperformers. Japanese small caps, one of the Fund's biggest weightings, were down 40% ... significantly underperforming Japanese large caps, which were down 20%....

We suggest strategists consider a novel, new factor: Price!

As investors and the media continue to be dominated by widespread after-the-fact-bearishness from Wall Street strategists, it sounds very similar to what these people had to say in the first quarter of 1995 about Latin America. With most Asian markets down over 50% (some down over 80%!!) you have to wonder if strategists ever factor price into their buy/sell recommendations.

Asia will continue to be volatile in 1998. But now that markets have collapsed, the question investors should be asking is, "Are the negatives factored into current prices?" For the companies your fund owns, we believe the answer is a resounding "YES".

Over the past few months, we've spent a great deal of time sifting through the wreckage of Asian markets looking for long-term values. We think we've found quite a few — and this will certainly continue as 1998 progresses.

Two very interesting Korean ideas at 70-80% off....

A number of stocks cut into our performance in 1997, all ... located in Asia. Two of the worst — in part because of the 50% decline in currency value — were from Korea....

Woon Jin, a publisher of mainly educational materials, was down 70%. It remains one of our favorites for its strong free cash flow, modern management and extremely cheap valuation. And Chosun Brewery, which fell 80%, has a dominant market position, brand new production facilities and would make an ideal partner for any foreigner wanting to enter the newly opened Korean market.

Off 90% + below net cash + hi potential = extreme bargain.

In Japan, discount liquor retailer Daimon was a very poor performer, dropping over 60% for the Fund in U.S. dollar terms. Trading as high as ¥6,000 last year, we started to buy it around ¥650 when its market value was at a slight premium to its net cash.

But as it sometimes happens when one is buying out-of-favor shares, we were early. Daimon now trades at a discount to its net cash, has attractive long-term growth potential and remains extremely undervalued by any measure. We have continued to add to our position.

A very well placed, overcapitalized financier at 55% off....

Hong Kong consumer financier JCG Holdings was down 55%, punished along with the financial sector on fears of a devaluation of the Hong Kong dollar, followed by fears of emerging market credit problems due to higher than historical interest rates. The company is extremely well placed to weather any short-term economic slowdown due to its overcapitalized balance sheet and proactive, shareholder-oriented management.

Dominant Thai newspaper fell 60% from our first buys....

We met with a great number of Thai companies on three separate trips. To date, because of heavy debt loads and still too high share prices, we have not found many companies offering a proper return in light of their risk.

The one exception is Matichon — the dominant Thai language newspaper group. It was down 60% from our first purchases in January. And we continued to purchase it throughout the year. Given its sound balance sheet, its conservative management and its excellent franchise, we remain enthusiastic that it will be a rewarding investment over the medium to long term.

THESE THREE DROPPED 50-70% IN 1997 — AND THEY'RE UNDERVALUED TODAY.

Deeper discount + More potential = Our kinda bargain....

A number of stocks cut into the performance of Oakmark International Fund this year. The worst was Malaysian cellular telecom provider Technology Resources, down nearly 70% in 1997 in U.S. dollars, similar to the performance of the devastated Kuala Lumpur market.

Despite the short-term problems Malaysia now faces, we believe the company remains undervalued and have added to the Fund's position at these lower prices. It remains at a significant discount to global comparable companies while having more attractive growth prospects.

Cash-rich, high return & down 50%, Sankyo's undervalued.

One of the developed world's poorest performers in 1997 — down 20% — was Japan. And, unfortunately, our investment in Sankyo was true to that trend — down 50% including an 11% decline in the value of the yen. However, we continue to believe this cash-rich, high return business is undervalued.

And a substantial European global value at 65% off....

In Italy, Fila Holdings was another poor performer, dropping 65%. ...[It] continues to improve its product mix, rebounding from last year's poor product lineup, with an emphasis on performance rather than fashion. We have been actively buying shares at current prices and are convinced of substantial long-term value.

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Baupost Group's Seth Klarman, Deltec's Arthur Byrnes, Kahn Brothers' Irving and Alan Kahn and M.J. Whitman's Marty Whitman — to name just a few.

Another reason we look forward to it so much is that it's always one of the most enlightening events we attend — providing invitees with a sampling of the perspectives and outlooks of Cundill, his associates and selected guests and a smattering of anomalies that they're finding currently.

Even by Cundill Investment Conference standards, however, the most recent event set a new high water mark — opening your editor's eyes to a variety of facts, circumstances and developments worldwide.

Even our format couldn't fully capture the two days of virtually non-stop, in-depth, birds-eye-view briefings. However, we're pleased to bring you selected portions of comments made by Cundill, associates Tim McElvaine, David Briggs and Jim Morton and attendee Seth Klarman of the Baupost Group. We hope you find their comments as illuminating and intriguing as we do.

SEEING SO MANY PROFITABLE NET-NETS BRINGS BACK HAPPY MEMORIES &, WE HOPE, VERY HAPPY RETURNS.

Values remind us of 1975. We hope the *returns* will, too.

Peter Cundill: In a way, today represents the *rebirth* of the Cundill organization. Some of you sitting here invested with us in the early days during the decade from 1975 to 1985 during which time the Cundill Value Fund earned a compound annual return of 26% per year without a single losing year. Longer term, over the 23-odd years since I first began to manage Cundill Value Fund, our compound annual return has been 18.3% or thereabouts. Still, the 13 years following our first decade have not been as distinguished as the first 10.

I'd like to suggest that part of the reason why we earned those very high returns in 1975-85 is that there were lots of net-nets kicking around in 1975. A vast number of securities [in the U.S. and Canada] traded below net-net working capital (current assets less all liabilities divided by total shares outstanding).

Based on the *values*, at least, that we're finding in Japan (and this explains some of the excitement I feel today), there's a chance of us getting back to those kinds of compound rates of return.

As many bargains in Japan *today* as in the U.S. in *1975*....

Cundill: For example, if you adjust for the market value of their share portfolios, today 35% of the 3,000 companies listed in Japan are trading below book value. Roughly 10% are trading below net-net working capital. And many of them trade below net *cash* (which I'll come back and define) and at *big* discounts to their intrinsic value if their businesses are worth 6 times EBIT.

Roughly 150 companies are trading below net-net working capital with market caps of $125 million or more — which is reasonably sizeable. And there are roughly as many in Japan today as there were in the U.S. in 1975 — some of them *very* big businesses indeed....

In 111 or 112 cases, you can pay *less* than nothing....

Cundill: In some ways, they're even *better* than the companies we were finding in 1975. And in other ways, they aren't as good. But one of the ways that they're better is that ... some of these Japanese companies have net cash — cash on *hand* — almost equal to their current market value.

They also have marketable share portfolios. And we've said, "Let's assume they sell their share portfolios and that they're taxed at 50%." And I'm not even sure that we should be tax effecting their portfolios to determine their margin of safety. But, anyway, we do.

Then, we net out the short-term *and* long-term debt. We don't include receivables and inventories ... or payables in the computation. We're not paying anything for them. And when we do that, we still find about 111 or 112 securities trading below net cash. So, in those cases, you're in effect paying a *negative* price for the business.

And they're making money and generating free cash, too....

Cundill: Also, *all* of the companies we're looking at are making money. In many cases, they have no debt. And in *80%* or so of the cases, they're not spending their cash flow — their earnings before depreciation and taxes. So they're generating *free* cash. And that's because they're frozen in the headlights. They are doing *nothing.*

Since 1990, the Nikkei's gone from nearly 40,000 to not much more than 18,000. So roughly speaking, anyone invested in the Japanese market has had a compound loss of about 9% per year (disregarding dividends).

And I think that provides a pretty good explanation of why the Japanese are caught in the headlights today. Certainly, that describes *corporate* Japan right now. And I'd think that it describes *individual* Japan, too.

Anyway, I haven't seen bargains like those in Japan today — in terms of quality and quantity — since 1975 when *America* in some ways was caught in the headlights.

U.S. STOCKS ARE OVERVALUED BY ANY MEASURE — JUST ABOUT AS HIGH AS WE'VE *EVER* SEEN THEM.

It was layup time in the 1970s. Today, it's anything but....

Cundill: What about the U.S.? Well, we do a thing that we call "the see-saw of value". The basic idea came from a guy named Norman Weinger who at that time was with Oppenheimer. And aside from the net-nets back in the 1970s, he did something he called "the Magic Sixes". Those were companies trading at less than .6 times book, (less than 60% of book value), 6 times earnings and with dividend yields of 6% or more. And there were *hundreds* of them. It was layup time. We didn't *know* it was layup time, but it was.

When we run that screen today on 7,000 companies — industrial companies, incidentally, not banks — we find a grand total of *five* companies meeting those three criteria in the whole of the U.S. And one is Semi-Tech Global — which has been in there for a long time. [laughs]

Very few securities today are even *fairly* valued....

Cundill: What about *fair* value? Well, fair value has

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to do with growth and other things. But we fooled around with the idea of fair value being about 14 times earnings, 1.4 times book and a dividend yield of 4% or more. And, believe it or not, there are even very few of *those*....

But if you will grant me that an *overvalued* security — good companies or not — would be over 60 times earnings, 6 times book and a dividend yield of 6/10 of 1% or less, there are *hundreds* of *those* in the United States.

With the exception of the 1968/69 and 1987 markets — which were even *more* extreme — today's stock market is probably as overvalued a share market as we've seen in our professional lives.... So that's how U.S. stocks look on a valuation basis.

Valuation defines *risk*, but has *nothing* to do with *timing*....

Cundill: But does value matter? Is it relevant? Well, I think it *is* — at least in the *long* run. This is a line that Bob Farrell used: "Valuation defines risk. It has nothing — and I do mean *nothing* — to do with timing...."

However, with respect to timing, I'm of two minds. In some ways, because we already have a big position there, I'd like the Japanese market to go up *tomorrow*. On the other hand, we're in the process of raising a lot of money....

I think the change in Japan will happen somewhere between two *days* and two *years* from now.... But maybe I'm being overoptimistic. Maybe the time frames will be longer.... Again, these things can last longer than you'd ever imagine. And if the American market *were* to go bad, I think it would affect every capital market — even Japan which in some ways has historically been uncorrelated....

Investing primarily outside the U.S. is relatively new for us.

Cundill: But in the Cundill Value Fund, we made our bones from 1975 until 1985 with 75% or so of our assets in the U.S. Even as recently as 1989, we had 75% of our assets in the U.S. Well, that's now down to about 3%....

We have lots of cash. We're pushing the button on Japan — and maybe we'll push it *harder*. And we have for defensive purposes S&P futures — if U.S. capital markets go bad for whatever set of reasons.... So our exposure to the U.S. is *less* than 3% net today....

We're just going where the values are....

Cundill: We may also talk a bit about net-nets in Singapore. They tend to be better businesses and have more transparency than those in Japan.... Although Japanese companies give very good financial data in terms of cash and securities and where real estate is located, they don't give you a lot of divisional breakdowns or other material which a good analyst would like to have in order to be able to analyze a business better.

In Thailand, there are a few things we've been doing,

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but I suspect it's still very early to be able to talk about anything specifically. And Malaysia and Indonesia were so overvalued that I don't know whether they're worth commenting on. There are a few net-nets in South Korea, but their *huge*, terrible debt-to-equity ratios are going to make it very hard. And although I don't know for sure, I suspect that when we go back and run our screen, we may find some things to do in Brazil since it's gone through a bad patch in such a short period of time.

So we believe there's *lots* to do *outside* of what you might call the Anglo-American world and *very* little inside.

THE SEVEN YEAR ITCH — AKA TACHIHI WHIZ!
DEEP DISCOUNT TO FAIR VALUE AND BACK AGAIN.

You're going to way too much trouble, Peter....

Cundill: My visits to Japan date back to 1969 — although there was a hiatus between then and 1985 or thereabouts until I began going back regularly again.

But in 1985, we bought a company called Nisshinbo for Cundill Value Fund. And I went into the offices of Jardine Fleming where I'd gotten the original idea from a guy named Patrick Gifford in London. Also working at that office was Colin Armstrong — who would go on to become a slightly infamous fund manager.

And he'd say, "Peter, I don't think you should *worry* so much about all of this value stuff...."

But if you want *discounts*, howsabout an *80%+* discount?

Cundill: "But," he said, "if you're *going* to worry about all of that stuff anyway, there's a company that you'd probably like called Tachihi Enterprise."

By way of background, Tachihi — formerly named Tachikawa Aircraft — made planes during the Second World War in which Kamikaze pilots went off to glory. After VJ-Day, U.S. occupation forces used its facility — which just happened to sit on 225 acres of green land 35 miles west of Tokyo — as a base. And as you may imagine, there isn't a whole lot of green land within 35 miles of Tokyo.

"So," he told me, "they're working on getting approvals to develop their land. And the company has no debt. So if you take the value of that land, Tachihi's real estate alone would make its shares worth ¥13,000 each."

Well, at that time, its shares were trading at *¥2,500*. So, I said, "*Gee*! That sounds like the kind of thing we do. It's not a net-net. But it sounds like it's selling at a mighty big discount to realizable value." And so we bought it.

And trading with my characteristic shrewdness....

Cundill: Well, within six months, Tachihi's shares had risen all the way to ¥4,600. So I said, "Thank you, Colin." And I sell half of our shares because we're good and disciplined.... But along comes March 1987 and I sell the rest of our shares because at this stage, the valuations are getting to be *wild*.

Shrewd trader that I am, by 1990, Tachihi's shares are up to ¥12,800. But, of course, I know you wouldn't want me to make money on overvaluations like that....

Enter "The Seven-Year Itch" — aka round and round we go.

Cundill: But the whole point of this story is "The Seven-Year Itch". Today, seven years later, Tachihi

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still has its land.... And its shares are back down to ¥3,100. So they've gone from ¥2,500 to ¥4,600 and all the way up to ¥12,800 and back again.

There's still no debt. And that, interestingly enough, is one of the characteristics of *many* Japanese companies today. The company still makes money. And it's even a better bargain than when we first bought it because there's a monorail going in that will connect it to the rail system into Tokyo. Also, at least in theory, the zoning is close to being approved. And they're looking for a partner to develop it. So I'm sure that there's ¥13,000 per share of value there. And we own a little....

IN 1990, THE *U.S.* WAS DOING THE SOUL SEARCHING.
TODAY, IT'S THE *JAPANESE* LOOKING FOR ANSWERS.

While Japan thrived, the U.S. dealt with a crisis.

Cundill: Returning to the "Seven-Year Itch" theme, in 1989, the Japanese share market was up near 40,000. At that time, a piece of land in central Tokyo not much larger than a handkerchief was worth $1 million.

By contrast, in 1990, the United States was suffering its savings and loan crisis. There weren't a lot of bargains there then, but there was a fair amount of distressed *debt*. It was clearly a ... time of disquiet and discontent in America. But Americans really do deal most effectively with a *real* crisis — not small, unperceived ones. And they *dealt* with it.

Japan seemed to be in the saddle as U.S. sun was setting.

Cundill: In Japan, on the other hand, there was a paper published by [Akio] Morita, the then chairman of Sony, and a right-wing Japanese parliamentarian entitled "The Japan That Can Say No".

It's really very interesting reading because it's just like reading a research analyst's seven-year old memorandum on an issue in light of subsequent circumstances. It said, in effect, "We are so good at computer chips, etc. that we determine America's destiny — because *our* chips are the only ones that will work in American rockets."

So much for Japanese chips. The Americans seem to have done all right. They won a war. And they've done a whole lot of *other* stuff.

Today, the U.S. is the only superpower in town....

Cundill: And today? Here we are seven years later. America's at the height of its powers — in terms of its imperial power, its economic power, etc. I'm not sure it *gets* much better than this.

Prince Bandar, Saudi ambassador to the U.S. and probably the ultimate arbitrator between the Arab world and the U.S., spoke at an event of the Aspen Institute where he said, "America is the only game in town."

But in fairness, Americans don't get arrogant really. I'm married to one. My two stepchildren are American. I've watched them at work. And they just assume that if they get into trouble, American paratroopers will come in and rescue 'em.... I think that [can-do attitude, only without arrogance] is inherent in the American psyche.

Today, it's Japan doing the soul searching.

Cundill: But when you look at Japan, it doesn't know what route it's going to go. Commercially, it's had a number of bad years. And they've had a bank crisis that the government hasn't been able to deal with as effectively as the Americans.

The Japanese banks look as if they are out of the woods on the *credit* stuff. But they're still *badly* run institutions with no returns on shareholders' equity. So we don't own or want to be near a Japanese bank — at least at this stage.

The non-life insurance companies though are a different kettle of fish.

And Japan *does* have a huge problem....

Cundill: I'm not sure that the position [of the U.S. and Japan] 7 years from now is going to be reversed. However, I believe that there will be some movement toward a reversal of roles — whereby Japan will be *stronger* than it is today and America *less* strong in relative terms. So I expect more parity will come into play as Japan regains its composure.

Where are the seeds of such a reversal? Well, Japan has a big problem — a *very* extreme demographic problem. By the year 2025, 42% of the Japanese will be retired. And although that's true of all developed nations [to a certain extent], it's a much *greater* problem for Japan because a much higher percentage of its population will be retired than that of any other industrial nation.

But raising already high taxes could kill the golden goose.

Cundill: That 42% figure, incidentally, was from an article in *The New York Times*.... And I sat in an office with a senior economist of one of the Japanese banks ... who serves on a committee which advises the Japanese Ministry of Health which, in turn, manages the Japanese pension fund — which is about $1 trillion....

And she pointed out to me the same thing that this article points out — that Japan has three policy alternatives: First, they can tax the young more. Second, they can reduce pensions to older people who are already receiving benefits. But that's not likely since that 42% of the population votes....

So they face a classic political struggle. If they don't do something about it, the young will simply have to pay for the older people. But their tax rates — both individual and corporate — are *already* very high....

IF YOU'RE STUCK BETWEEN A ROCK & A HARD PLACE,
SOME SUNSHINE (EVEN A LOT) MAY NOT SOUND BAD.

Given the other choices, reform doesn't sound so bad.

Cundill: But there's another alternative. Today, Japanese pension funds are invested in JGBs (Japanese government bonds) at an interest rate of less than 2%. So a third alternative is to get their rate of return *up*. And, in fact, the whole thrust of the initiatives happening today is exactly that. They're based on the premise that Japan *has* to get its investment returns up. If they don't, as I've described, they have one *very* big problem.

Therefore, many of the initiatives for change come out of the bureaucracy — which is both MITI (which oversees trade) and the MOF (which is the Ministry of Finance).

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Investments? Nope. Those stakes were admission tickets.

Cundill: Every Japanese company (and this is really quite key) owns pieces of other companies — holdings which are first and foremost about *relationships*. In effect, they're certificates of relationship — as distinct from certificates of *value* — although that practice is also changing. In effect, Japanese companies bought stakes in their suppliers, their bankers and their customers because [the purchase of those stakes was part of the price of admission] to doing business.

Incidentally, Ben Graham always said you could count holdings such as those as extra assets. And that's justified because, in fact, it's always been the case in Japan ... that whenever these companies got into trouble, they could sell their holdings in order to protect themselves — albeit they'd usually be sold to members of their group.

Nearly all of those shares were publicly traded.... And their point [wasn't their investment potential]. The point was that those stakes established *relationships*.

Be they ever so humble, the barest beginnings of change....

Cundill: And that's beginning to change. I sat on a panel two or three years ago where the topic of discussion was corporate governance in Japan. And on that panel was a man named Hideo Ishihara who had been with the IBJ [Industrial Bank of Japan] for many years and is now chairman of Goldman Sachs Japan.

Interestingly enough, he's gone on the board of Sony — which was one of the first Japanese companies to have outside directors. They had an American director a long time ago. I'm not sure any Japanese company has a *woman* director. After all, there are *limits*. But my point is that recent years have seen the barest beginnings of change.

But change has begun to accelerate — *remarkable* stuff....

Cundill: And more recently, there have begun to be *significant* changes. For example, beginning in early 1997, Japanese companies were allowed to buy back shares. And around 75 share buybacks weren't only announced, but *done*. They'd never been done before in Japan....

[Editor's note: In its 1/16/98 edition, *Grant's Interest Rate Observer* reports that the total number of Japanese companies who've elected to repurchase shares is up to 115.]

Cundill: They've also introduced ... share options. And interesting to us, at least, is the fact that to issue share options, Japanese companies are first required to buy in stock in order to avoid the kind of abuse that's happening in *America* with stock options....

Shareholders' rights? What does that mean?

Cundill: And at *major* companies, managements are even talking about increasing returns on shareholders' equity — a heretofore virtually unknown concept. To give you some idea of just *how* unknown, let me quote Hideo Ishihara on shareholders' rights and corporate governance:

"I don't know what you're *talking* about. In a Japanese company, first and foremost comes the employee. Then comes the customer. Third come the bankers and the suppliers."

"At the Industrial Bank of Japan, we owned 4-5% of every publicly quoted Japanese company. And in 20 years at the Industrial Bank of Japan, I never heard the concept of shareholders' rights dealt with — ever!"

Well, that's *changing* — so I don't think he'd make that same comment today.

LOTS TO LIKE ABOUT JAPANESE STOCKS —
PRICES, BALANCE SHEETS & CASH FLOW.

Relative to earnings, Japan is still expensive. But *assets*....

Cundill: It's interesting how we're all products of our experience to one degree or another. One of living legend Sir John Templeton's early coups was to invest in Japan when almost no one else was doing so. And in fact, he even bought puts on the Nikkei and made money on them in 1989 around the same time that we did.

However, I suspect it's been hard for the Templeton Group to go back into Japan. In part, because of Templeton's cultural influence, they focus more on P/E multiples, (although they seem to be changing). And relative to reported earnings, Japanese stocks remain *very* expensive. But on the basis of their *asset* values, Japanese stocks are really *cheap*.

You wanna buy near the lows? Consider Japan today.

Cundill: One of Ben Graham's tests was to buy securities at their lows — ideally near their *all*-time lows, but certainly near their *five*-year lows. And in Japan, plenty of securities meet that test today including the one we're using as today's case study. Tokyo Style's five-year low — which it reached earlier in 1997 — was ¥1,150. At ¥1,290, it's not trading that much above it. And its lifetime high — which it reached in 1990 — was ¥3,040.

In some ways, Japan today is *better* than the U.S. in 1975.

Cundill: But the difference in these companies, as I mentioned earlier, is that on a balance sheet basis, they are *better* in many respects than American companies in 1975. Why? First, many of them have lots of cash and marketable securities. Second, they tend not to have a lot of inventories and receivables. And third, they tend to have no long-term debt — and, in some cases, almost no short-term debt.

For example, Tokyo Style has "Cash and Securities" of ¥123 billion and "Investments and Others" of ¥15 billion. So those two items total ¥138 billion — or ¥1,367 per share — which is more than the current price of the share. You couldn't find many of those in the U.S. today. Actually, you wouldn't even find many of those in the U.S. back in 1975. Tokyo Style is very cheap.

Also, it has long-term debt of only about ¥166 million. So it has virtually no long-term debt [— something less than ¥1.6 per share].

Many of these companies are generating lots of cash.

Cundill: In addition, we look at cash flow. And there, we note that Tokyo Style has gross cash flow of more than ¥5.5 billion. By comparison, its capital expenditures are less than ¥550 million. Therefore, only about 10% of the cash flow that Tokyo Style is generating is required for its

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capital expenditures. So they can do all sorts of things with the rest. They're generating a lot of cash....

And using GAAP, the P/Es are lower than they appear....

Cundill: Tokyo Style's return on equity of only 2.6% is characteristic of almost all the Japanese companies. They have *very* low rates of return on shareholders' equity — partly because they take lots of depreciation. But even if you were to adjust depreciation to American levels, that would still probably only raise their return on equity from 2% or thereabouts to 3-1/2% or 4%. So it would still be very low.

Tokyo Style's P/E is up near 34. But if you adjust the accounting to U.S. GAAP, the P/Es aren't very high. Many Japanese companies sell at 8-9 times cash flow and, again, generate lots of free cash.

And current dividend yields generally aren't so high, but they're a lot higher than a whole lot of *U.S.* companies.

THE RETURN OF TAKEOVERS IN JAPAN IS MUCH NEARER THAN MOST REALIZE.

Not even a *word* for corporate governance — at least yet....

Cundill: When we look at the ownership of Tokyo Style, we see that their major shareholders include Sanwa Bank with 4.6%, Sumitomo Trust with 4.5% and Tokai Bank with 4.5%. That's pretty standard stuff.... But one of the interesting things about Tokyo Style is that although foreign shareholders own 24.1%± of its shares, it won't meet with them.

And now you start to get into the huge cultural divide [between the practice in Japan and that in the U.S.]. There's been a lot of talk about corporate governance.... In fact, some guys — including a number of senior Japanese officials — have had to leave their jobs somewhat involuntarily ... for paying people not to go to shareholders' meetings and ask embarrassing questions.

One of the things they do to prevent shareholders from asking questions is that almost *all* Japanese annual meetings are held on the same day to make sure that these harassers are spread a little thin. And there's not even a Japanese word as yet for corporate governance....

But these companies are more vulnerable than they know.

Cundill: On the other hand, there is a provision in the Japanese commercial code enabling shareholders of 3% or more of outstanding shares for six months or longer to call an extraordinary general meeting whenever they *want*. So foreign shareholders owning 24% of a company's shares could get together, call a meeting and vote in someone new as chairman.... And so foreign shareholders *de facto*, if not *de jure*, control some Japanese companies already.

Morgan Stanley's Alex Kinmont wrote a piece — and there have been a number of other pieces — talking about how Japanese companies don't yet realize how vulnerable they are to all sorts of corporate pressures.

There's no law in Japan to keep shareholders from talking.

Cundill: You used to have to amend a whole lot of 13-Ds in the U.S. if you got a 4.9% position and you began to think about making some kind of unfriendly overture. Well, one of the reasons why Mike Price was able to do what he did with Chase in the way of moving along the process of realizing value was that in America, those restrictions were taken off so that you were free to talk to other shareholders without having to amend your filings.

Because the idea is so off the wall (the concept of a hostile takeover's almost unheard of in Japan), there's no restriction against cross-party talking. So you can *do* it....

Certain provisions come into effect when you get over a 4.9% position: You have to declare. You may have to tender for 51% of a company's outstanding shares. But once you acquire 51% of its shares, there are no *follow-up* provisions. So you can get the *cash flow* with *51%*.

And it's beginning. A few corporate mergers have taken place — nearly all friendly, at least for now.

No hostile takeovers in Japan *today*, but there *have* been....

Cundill: But Japanese takeovers haven't *always* been friendly. There were hostile takeovers undertaken before and after World War II ... as the Japanese system of crossholdings was being established. And there's been the odd proxy contest. So they're not entirely unknown.

During the Meiji Restoration in 1868, Japan chose the German commercial code as their model. But following World War II, during the U.S. occupation, much of the U.S. commercial code and practice generally was introduced.... Then, in the late '70s or early '80s, some Hong Kong groups bought into Japanese companies and, in effect, said, "Here we are. If you're not nice to us, we'll be mean to you."

There were four cases. And in three of the four cases, they got taken out at nice profits. In the fourth, management ran for cover and got the company designated as a national treasure of sorts — similar to the communications business or the Canadian banks. So foreign shareholders could only buy so much. And then the valuations got so [high] that the practice stopped.

A MIND-BLOWING COMBINATION: DIRT CHEAP BARGAINS AND SECURE DIVIDEND YIELDS > INTEREST RATES.

I can sum it up in two words: "mind blowing".

Cundill: Also, I'm sure the kind of conversation that we're having today about potential takeover work in Japan is being duplicated in Hong Kong, the U.S. and elsewhere. The [significance of the] fact that you can actually go off, buy a mess of these things and get your dividend covered [is not lost on everyone]...

Granted there are tax questions that come into play. And they do have very high taxes, special provisions, etc., which impact how you do a lot of the structuring. However, most important is the cost of money. And then the fact that they're trading below net *cash* is nothing less than *mind* blowing!

Dividend yields actually exceed short-term interest rates.

Cundill: Cash is a *terrific* thing to have. But today, Japanese companies earn less than 1% on their deposits — closer to *1/2* of *1%*. In some cases, they're getting *zero*. Also, nearly all of these companies are paying dividends of 1% to 1-1/2%. The last time you could get a dividend yield

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that exceeded the short-term cost of money in the U.S. was during the late '40s or early '50s....

Therefore, if this were Michael Milken-time in Japan, there wouldn't be even *one* of these suckers left by now — because you could borrow the money to take 'em over or take 'em private at between 2% and 3% for *10 years*.

The biggest risk — that some cowboy does it badly (again).

Cundill: I'm not suggesting you do it the *bad* way. Boone Pickens went in and raised hell. And he did it with bad people. And that probably set back most reforms for 10 years. If somebody rides in with a lasso and does it badly and doesn't pay any attention to the Japanese sensibilities — because face is very important — that's, I think, one of the biggest risks. And it *could* result in our having turned out to have engaged in "premature accumulation".

They won't *let* you? They're *encouraging* it! They *have* to.

Cundill: Is it going to happen? I don't know. But frankly, I think so because of *another* element: Consider changes occurring in the investment business in Japan today. Nomura's new president has a doctorate in economics from the University of Chicago. And Nikko's new president went to Columbia....

Also, relationships are forming between SG Warburg and the Long Term Credit Bank. And a whole lot of other strategic alliances are taking place that I suspect will also begin to move the cultural process along as we go forward....

But many would say, "Japan won't *allow* takeovers to happen anyway." But in fact, it looks to me as if the Japanese, [far from not letting you,] are *encouraging* it — because they *have* to implement reforms for reasons I mentioned earlier.

Many Japanese companies are wildly overcapitalized.

Cundill: Tokyo Style, for example, shouldn't *have* ¥123 billion of cash. Clearly, it should distribute *all* of that cash to the shareholders one way or another....

One of the possibilities that scares me a bit is that some of them pay out some really big special dividends. That wouldn't be very tax effective from our point of view given the withholding tax and our limited capacity to offset that tax in some instances.... Repurchasing shares, on the other hand, would be fine. And they are allowed to do that.

Low, low rates make these ideas even more compelling.

Cundill: But one of the *most* important factors here is the rates at which these companies can borrow money. One of my investment friends in Japan tells me his borrowing rate if he wants to do things in Japan is only 3/8 of 1% on a short-term basis....

Or, if you'd like to borrow money for 10 years, the JGB rate — the long-term government rate — is *1.5%*. And the current long-term corporate bond rate for 10 years is about 2%. Obviously, those are *very* compelling rates....

So as an investor, if you could get very comfortable with the valuations and you're in yen and your results are going to be *measured* in yen, why *not* borrow a little money given that the cost of carry is positive — although if you've done that recently, you've lost 20-25% of your money. Anytime you borrow money, there's *always* risk, of course.

Given today's rates, there's an easy way to raise ROE....

Cundill: Or let's assume the company distributes its cash one way or another and borrows money at 2% interest. Wouldn't it be nice to buy a company for less than net cash, get all of your cash back and own a business for nothing?

SG Warburg has written two pieces about how by giving back cash and maybe borrowing a little money, Japanese companies in general can increase their returns immediately — without any improvements whatsoever in their revenues, their margins or anything else.

SHOOTING FISH IN A BARREL CAN BE REWARDING.
AND TODAY, HAPPILY, OUR BARREL'S JAM PACKED.

I feel like Buffett in '74; but talk about shooting birds is *safer*.

Cundill: So again, there are a vast number of companies like this in Japan today.... And as a result, I feel the way Buffett felt in 1974. But it was a different time *culturally* and I'm likely to get myself in trouble saying the same thing he did today. Nevertheless, at that time, Buffett said, "I feel like an oversexed man in a harem."

Well, now we've seen the Japanese harem. But to avoid digging myself into a hole, let me try a slightly different approach: My father was a very good birdshot. And he always said, "Never shoot into the brown." In other words, never shoot into a flock of birds without first choosing a single bird — at least in your mind.

Shooting fish in a barrel is rewarding — when there are fish.

Cundill: But in "The Renaissance of Value" — one of the pieces done in 1974 or 1975 — Ben Graham said that by just buying securities when they were selling below their net-net working capital and not doing any other analytical work whatsoever — and selling them when they rose 50% or, in any case, in three years — that you would have earned a compound rate of return from 1927 to 1957 of 20% per year. That was just by shooting into the brown. You didn't even have to know what the companies *did*.

We began buying plain cheap. Now we're discriminating....

Cundill: To a certain extent, what we *had* been doing was the old Graham stuff — just buying things which were statistically cheap. Now we're trying to determine which are the *best* companies among those trading below net-net — to identify which ones have the best long-term potential.

I'm not sure we'll get that one right. Graham himself felt that was hard to do. But if we can find companies below net-net that have operating characteristics we like, foreign shareholders and no big controlling shareholder, then I think we'll take bigger positions as we go along....

There's *very* little *financial* risk, but a lot of *time* risk.

Cundill: The trick to net-net working capital investing is to avoid losing. If you buy your dollar bills at huge discounts and you're patient, you'll do just fine. There is very little *financial* risk.

But there is a lot of *time* risk. You could wind up having to hang onto these things for a long time. Japan might not work or all of these catalysts I'm suggesting

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could turn out to be dreams.

But I don't *think* so. In Japan right now, there are any number of the North American value investing guys. There's David Winters of Mutual Shares. Tweedy Browne's [Chris Browne, Will Browne and John Spears are] doing a lot of these. Marty Whitman [of Third Avenue Value Fund] is on the record regarding Mitsui Marine. And another major value group, [Southeastern Asset Management], has taken a position in Mitsui Marine....

So I hope you sense the interest we have in Japan.

AN ASIAN-STYLE BEAR MARKET CAN'T HAPPEN HERE? OF *COURSE*, IT CAN. AND IT WON'T TAKE MUCH.

Our four largest buys (and 8 of the top 10) are Japanese.

Cundill: If you look at our largest purchases ... [for the first nine months of 1997, you'll see that our four top purchases were Japanese:] Mitsui Marine, Fuji Electric, [Hitachi Koki and Nissan Fire and Marine]. Our fifth largest purchase — which is Haw Par Brothers — is Singapore-based. Sixth is Tokyo Style which I've already talked about a little. And seventh is Toyoda Auto Loom — the old parent company of Toyota Motor — through which we're buying the car company at a big discount and getting some operating businesses for free.

Eighth on the list is Gakken — which is Japanese. Then, ninth is Times Publishing which is Singapore-based. And finally, 10th and last on our list of largest purchases ... is Shionogi & Co. which is also Japanese....

So in a nutshell, we've gone to Asia and we're out of Europe. And that's basically what we've been doing for the last nine months because that's where the *bargains* are. Also, we've hedged our foreign currency holdings against the U.S. dollar — which has been wise so far.

There was a lot we didn't like about Hong Kong....

Cundill: We've also been short the S&P — which hasn't exactly been a very distinguished thing to do so far. We were short the Hang Seng [Hong Kong], too, at the end of September and had unrealized losses in those puts of roughly $2 million — although, of course, it's better now.

But let me talk about volatility. I have real caution about the U.S. today. I don't know if this story will be instructive or not:

Among the reasons we've been short the Hang Seng is the fact that we don't like the real estate valuations there and the fact that the cost of doing business there is so much higher than it is, for example, in Vancouver which is another quasi-Chinese city today....

Investor enthusiasm for it was virtually irresistible....

Cundill: But the Hang Seng started 1997 at 13,000 and change. Hong Kong Shanghai Bank represents about 17% of the Index. And then Cheung Kong and Hutchinson — Li Ka-shing's company — also represent a pretty big portion of it, too....

On May 27th, I visited Hong Kong and had dinner with one of the most astute investors I know. And, *boy*, was there rampant optimism. Even my very astute friend was carried along by this extraordinary momentum. People said: "What a wonderful thing it's going to be for Hong Kong to get this new parent," and "They're going to throw out the old, bad Brits who have been mean and beat up on those guys and get some nice chaps up north to be able to take over," and so forth.

And in fact, by August 17th, the Hang Seng Index was up close to 17,000. So I'm looking at my shorts and making grunting noises. By October 1st, the Index was still up around 15,000.

Of *course*, it can happen here. It doesn't go on forever.

Cundill: Well, we've closed down half of our shorts — 30% of them at 10,000 — and Mark Stevens, who did a wonderful job, closed out another 20% of them at 8,500.

Just think about the magnitude of the changes that took place in about 20 days. You say it can't happen here. Of *course*, it can happen here — and not just because of *valuations*. Why is it that in Japan or even Singapore or Brazil, you can buy all of these terribly cheap securities — whereas, for the most part, there's an assumption going forward that growth in the United States will continue at 15-20% per annum?

That, I have to tell you, is simply not realistic. It don't *work* like that. It doesn't go on for ever and ever and ever.

It won't take much to make this market *most* unkind....

Cundill: And when it *stops*... All that has to happen is for these companies to make the same amount of money they did last quarter last year — not 15% more. And the U.S. marketplace is most unkind to companies that don't meet whispers, expectations and IBES consensus numbers. It is *most* unkind.

And I think that going forward, there's a lot of possibility of unkindness welling up. So I say to you that if you're 100% invested in the U.S. in common stocks, take some money off the table, do some shorts or hedge your position because you are carrying — maybe without even *knowing* it — a lot of risk. At least you are by our standards....

A STORY WITH A VERY IMPORTANT LESSON — WHICH APPEARS TO HAVE GONE UNLEARNED.

Count your blessings. You coulda sold funds in Japan....

David Briggs: Let me give you an idea of what it would have been like to be a mutual fund salesman in Japan for the last decade. In 1989, Japan's equity mutual fund assets exceeded those of the U.S. — $316 billion vs. $249 billion. Since 1989, Japanese equity mutual fund assets have declined by nearly two thirds — from $316 billion to an estimated $107 billion — while they've grown by a factor of nearly eight times in the U.S. [to $2 trillion].

The net result is that U.S. mutual fund assets today are nearly 19 times as great [as those in Japan].

Famous last words in *any* language....

Briggs: And yet, around that time, you had quotes such as this one from the December 30th, 1989 edition of *The Financial Times*:

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"With the Japanese economy tipped to grow at an annual rate of 4% for the next few years, Nomura Securities confidently predicts that the Nikkei Index will hit ¥63,700 by the middle of the decade; if things go well," the stockbroker says, "the index could touch ¥81,700 by 1995."

With all due respect to Nomura, this is what they were telling their customers and telling the Japanese people — that the bull market would continue on indefinitely.... That's "if things go well". Doesn't that remind you of "if everything goes right" — which is the all-too-familiar refrain you hear again and again regarding the U.S. stock market today.

Once burned badly, twice shy — make that disgusted....

Briggs: So here we are seven years later. Obviously, what's happened in the U.S. is remarkable. But *nobody* wants to buy equity mutual funds in Japan.... I thought that with Japanese stocks rising in the second quarter of 1997 that more people would get optimistic. But, no. Even in the second quarter of this year, they kept *redeeming.*

In every month in 1997, for example, the number of domestic equity mutual funds in Japan has declined.

Buy low and sell high in Japan? They're buying *U.S.*

Briggs: Interestingly, many Japanese investors are buying the *U.S.* market as well as other foreign markets. Ironically, the prevailing view among foreign investment managers in Japan is that opportunity is in U.S. stocks and that it's virtually unprecedented — in part because of a coming surge of capital from Japan to the U.S.

That's one thing the Japanese government is worried about — [the flight of Japanese capital to the U.S. and elsewhere].... And that's one of the biggest reasons why change is starting to happen. There's adequate will — even a consensus — to change. And people who believe Japan will never change are going to be very surprised.

THE REFORMS WON'T BE COMPLETED OVERNIGHT.
BUT IT'S NO LONGER JUST *TALK*. THEY'RE *DOIN'* IT....

If their aim's as true in *returns* as it's been in *operations*....

Briggs: Peter already mentioned some of the long-term positives we believe will characterize the New Japan. First, Japanese companies are increasingly setting targets for return on equity and return on assets. So they're starting to pay attention to managing capital more efficiently.

And Japan's always been very efficient on the operating side. Therefore, we're hoping that as they apply their attention to achieving Western-style returns on equity and assets that they'll become equally efficient with *capital.*

With large companies using stock options, others will, too.

Briggs: Also interesting, stock option compensation, of course, is one of the reasons why U.S. companies have been able to achieve the high returns on assets they have. And we're seeing stock option compensation used more and more within Japanese companies.

We're seeing large companies taking the lead. That's also encouraging because changes in Japan tend to come from the *top* — from companies like Toyota and Sony. And these companies are starting to tie incentives to the achievement of targeted levels of return on equity and return on capital.

So the management, directors and employees of Toyota now have *incentives* to become even *more* efficient. That scares Detroit because Japanese companies are plenty competitive already. And select companies in Japan across many other sectors are doing the same thing.

It's happening slowly. So you have to be patient. But more and more Japanese companies are beginning to *do* it. It's no longer just talk.

Share buybacks are quickly becoming widespread, too.

Briggs: And as Peter mentioned, for the first time in their history, Japanese companies can now repurchase their shares. Over 75 companies have *already* changed their articles of incorporation in order to be able to do a share buyback. And it's spreading.

Increased M&A activity to increase efficiency/unlock value.

Briggs: One of the reasons the Japanese government is trying to reform and deregulate their financial markets is that they figure they'll thereby be able to add about 1-1/2% per year to their GDP growth for the next 10 years.

Therefore, I think you'll see companies teaming up to achieve efficiencies and increase the odds of being the winners in the upcoming, deregulated environment. And usually when you get M&A activity, you get a realization of *asset* value and *hidden* value. And there again, the use of stock option compensation has a large part to play with the successful achievement of U.S.-style restructuring.

[Editor's note: A related point Cundill made in a past conversation with us was that Japanese companies know very well that they can't afford to stand by and leave their financial/legal/regulatory system unreformed given that they believe a near-certain cost of so doing would be the continued inability of their companies to compete.]

We plan to participate in improved corporate governance.

Briggs: We're at the beginning stages of setting up the infrastructure that we'll need in order to have a say in the corporate governance in some of these companies. And we don't want to appear hostile. We simply want to help them as they strive to manage their capital more efficiently and pay attention to their shareholders for the first time.

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There's even serious talk of completely revising the tax code.

Briggs: And the last factor is the key. What will convince people that Japan is serious is the revision of their tax code. Japan's tax code has been very complex and its effective tax rates have been very high. In addition, consolidated taxation, whereby the gains of one subsidiary may be offset by the losses of another, hasn't been allowed. And, obviously, that's very restructuring unfriendly.

But we understand there's a complete revision of the Japanese tax code in process. And among the revisions we expect — some of which, incidentally, have already begun to be implemented — are a lowering of tax rates, the allowance of consolidated taxation and other changes which will give companies more flexibility to pursue M&A activity....

Japanese companies are bloodied, but they're recovering....

Briggs: Many Japanese firms are great businesses. They've been around for 40 years, but they've been humbled for the last seven. They've had their backs against the wall — in part because the yen got so strong.

But the yen peaked in 1995. Since then, many big Japanese companies have begun to recover and feel better about themselves. And that recovery has begun to filter down into most of the other companies in Japan.

"Big Bang" will finally give shareholders a seat at the table.

Briggs: But in effect, we're at the starting point. The "Big Bang" in 1998 will transfer power from capital *users*, who wielded power in the Old Japan, to capital *suppliers*, including shareholders, who'll have a seat at the table, finally, in the New Japan. And that transfer of power should unlock hidden value at many Japanese companies.

[Editor's note: Asked to define "Big Bang", Briggs informed us it was the rolling reform of Japanese financial markets segment by segment starting in 1998.]

So we're buying very attractively priced securities which have what we firmly believe is a big margin of safety. And for all of the reasons we've mentioned, when we look forward to the next several years, we believe that our Japanese investments may be very rewarding indeed....

REALITY AND PERCEPTION NEARLY *ALWAYS* DIFFER. BUT TODAY, THEY ALMOST COULDN'T DIFFER *MORE.*

Why look overseas when you can earn 34% per year here?

Seth Klarman: We couldn't believe more strongly that what Peter's said is correct — that values in the U.S. are *extremely* hard to find. Once in a while, we can find something that's fallen through the cracks, that's legally complex or, for some other reason, people just won't go near. But the great majority of opportunities today are overseas.

What's particularly *confounding* about it is that the conventional wisdom couldn't be more *opposite* — that it's *safe* to buy U.S. stocks. All of you have probably seen the recent survey where investors in mutual funds expect to earn a 34% annual rate of return over the next 10 years.... [Apparently,] the 19% [compound annual returns] of the previous 10 years wasn't good *enough*....

Meanwhile, by contrast, Asian and European markets (and, for that matter, essentially *all* foreign markets) are seen as incredibly *risky*.

We're at a record low exposure to the U.S. — only 11%.

Klarman: However, the values very clearly tell you that the exact *opposite* is true. Our fund is up around $1.3 billion today. We're not accepting new clients and are trying to stay as small as we can. And yet, we have a record low 11% of our assets in U.S. equities. And that 11% is in only a handful of names that seem somehow to have fallen through the cracks.

In contrast, our foreign equity exposure has never been *higher* than it is currently — up around 45%. Then, we own some real estate and things like that which bring the total to about 80%. And the other 20% is in cash.

DISCOUNTS IN FORMER USSR *ARE* HARD TO BELIEVE, BUT DON'T BELIEVE ANYTHING *ELSE* YOU HEAR.

No one says stocks in the former Soviet Union aren't *cheap*.

Klarman: It's seemed to us, at least, that the most compelling valuations have been in the former Soviet Union. The risks there are, of course, very high. However, the opportunity is even *more* compelling. The upside justifies — *more* than justifies — the risks.

The clearest way I can explain it is that nobody has done a net present value analysis and said, "You don't want to buy these Russian stocks or Ukrainian stocks." It's not as if someone has come up with a clear, rational argument that they're not *cheap*.

The argument is more the knee jerk, "Why would you ever want to buy something there? There's no rule of law. Managements might cheat and take some of your money or *all* of your money. The government might *renationalize*."

There are problems, but none justifying a 98% discount.

Klarman: But meanwhile, given their stock prices, oil companies the size of Exxon, Chevron and Arco traded for 5¢, 10¢ and 15¢ per barrel of oil reserves in the ground — which is only about *1%* of Western standard valuations.

Of course, we considered that those valuations might not be a fluke — that they might be based on real problems. And in fact, there are issues. They do regulate how much you can export. And the domestic price is *lower* than the foreign price — although the history of emerging markets is that over time, those prices have tended to converge to world market prices. In any case, that wouldn't come *close* to explaining the [magnitude of the] discount.

There were other issues: For example, people felt that the holding companies might wind up making the money and the subsidiary companies wouldn't.

We paid up for utilities — up to 2% of world standards.

Klarman: However, the valuations were similar in *other* industries. For example, we also looked at the electric power industry. We felt that there were world standards for where utilities should trade, that it takes a certain amount of cost to build a facility and that its returns should be fairly straightforward. And there again,

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we were buying those electric utilities at only about *1/50th* of world standards of valuation.

We focused on oil companies and utilities for a reason....

Klarman: And I could go on and on — although frankly, we focused our efforts on those two industries. The primary reason why, incidentally, was that we felt they were the least subject to interference, theft, obsolescence, mismanagement and the like. For example, even if an oil company's management were able somehow to steal all of the company's production for a year, it may still have 39 years of reserves in the ground where they couldn't be stolen.

Stereotype of rampant corruption conflicts with reality.

Klarman: And my use of the term "steal" is unfair. The Western characterization is that there's been an enormous amount of corruption and crookedness. I think the reality has been different. It's been *vastly* better. There's been, in many cases, enormous insider buying. Managements have bought stock — sometimes openly and sometimes not. And some unfair and unequitable things have been done. However, they've been the exception rather than the rule in our view.

There also seems to be a sense in the West that these companies will do whatever they can to screw you — where *allegedly* investors bought stock and were erased off the share register and that kind of thing. Well, it happened *once* that we know of. And when it did, it was *corrected*. The authorities said, "You can't *do* that. They really own the stock."

So I think that there are actually safeguards — and an increasing *number* of safeguards. All of the processes are improving over time.

And we knew investors couldn't resist Western research.

Klarman: I think that the turning point may have been the entry into the market by Western brokerage firms doing unbelievably high quality research. For example, even though oil companies were at 5¢, 10¢ or 15¢ a barrel, we read a 200-page research report on one company by Salomon Brothers with glossy pictures, detailed analysis — what you would have expected had they written up Exxon.

I think that was a turning point. It was like a bell going off saying, "There'll be similar research reports on other companies. And, therefore, Western investors will have a hard time *resisting* buying these companies unless they slip backwards into communism or something."

VOUCHERIZATION CREATES A HUGE GARAGE SALE
WHICH IS BEING REPEATED AND IS CONTINUING.

The voucher process itself tends to create super bargains.

Klarman: The nature of how these countries came to have stock markets, in many cases, was a *voucher* process whereby vouchers were distributed to citizens which they could tender for shares of companies being privatized.

It would have been a near-impossible task even in a country that's relatively sophisticated financially. But in a country with no history whatsoever of capital, share ownership, stock markets or anything of the sort, citizens were at a complete *loss* what to do. But vouchers were distributed and tendered and stocks started trading. And the results were virtually random.

Almost no Westerners *could* invest. Mutual funds basically couldn't play because their custody rules and transfer rules made it *impossible*. And many other people *wouldn't* play because of their memories, the political risk, the tremendous uncertainty and the very difficult nature of gathering information.... And even today, it remains murky. So there was almost no Western money.

Therefore, stock prices were set at the margin by the very limited capital that *was* available.

Voucher process a big garage sale. And it's being *repeated*.

Klarman: The nature of the voucher process in our view was *compelling*. But Russia, as you know, is up a lot. Through September, Russia's market was by far the best performing market in the world and Russian funds were the best performing funds in the world. They've slipped back a fair bunch with the recent turmoil....

But that voucher process is being repeated today in places like the Ukraine. So the giant garage sale is continuing and being *repeated*....

VERY LITTLE IS *KNOWN* IN VOUCHERIZED MARKETS.
IN CONTRAST, VERY LITTLE IS *NOT* KNOWN IN JAPAN.

Risks in voucherized markets and Japan are *far* different.

Klarman: But it's also important to talk about *risk*. And the risks are *high*. It's not clear how it'll all sort out. It's not even clear yet exactly what kind of society they're going to ultimately have. But it *is* clear, I think, that you're getting paid very well to *take* that risk.

On the other hand, there's no question that investing in these countries is *far* different than investing in Japan. In Japan — which we have started to look at a fair amount, although we haven't bought anything yet — we look at it exactly the way Peter walked through it.

And this is not some backwards country. These companies are *real*. Their management practices are real. They have real assets — which aren't highly leveraged or suspect in any way....

Of course, we could be sitting on our assets for a *long* time.

Klarman: The difficulty for *all* of us is the timing question that Peter raised: If you buy something cheap, but the value's not growing and management isn't doing anything for you, you might be sitting on dead money for a very long time. The same thing, of course, could happen in Russia or anyplace else.

Most frightening of all — the Harvard MBA indicator....

Klarman: But the values are *compelling* overseas, whereas they're the opposite here. I recently addressed the investment class at Harvard Business School — which I'm fortunate to be invited to do every year. And at the end of my lecture, I try to give the students a little bit of advice — which most don't take seriously.

But I just told them, "When I graduated 15 years ago from this place, the Dow was at 740 — basically unchanged

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CUNDILL INVESTMENT CONFERENCE
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for the prior 20 years. Government bonds yielded 13-14%. The prime rate had recently gotten as high as 20%. You could buy great companies for 7 times after-tax earnings. And nobody really cared about *stocks*."

"Today, the environment in this country is virtually the exact opposite in every *way*. So if you're thinking about a career in investing, you better look at that first. That's not to say, of course, that you shouldn't *do* it. But be prepared for a very different kind of environment."

Needless to say, the #1 career choice of graduating Harvard MBAs today is investment management.

When I look at Russia, it raises my hopes for Japan....

Cundill: Thank you very much, Seth. Incidentally, we had a Russia vs. China panel yesterday. And let me mention a couple of facts that are on the *Russian* side: First, 30% of all Russian securities are now owned by Westerners. And second, at 10% of the annual meetings, the directors and/or the management are being replaced — voted out. So the corporate governance practices in Russia are much *better* than they are in China....

UKRAINE PROBABLY 1-1/2 TO 2 YEARS BEHIND RUSSIA.
FIRST RUSH OF WESTERN INTEREST HAS YET TO COME.

The first rush of interest in the Ukraine is still to *come*....

Cundill: James Morton, playing off those comments, perhaps you might talk about your experience in the Ukraine.

James Morton: Most people think the Ukraine is 18 months to two years behind Russia — which it is. And that's an encouraging indication of what stock prices are likely to be doing there [in the next year or two].

Official trading in Ukrainian equities started April 1st, 1996. I hope there's nothing significant about that choice of *day*. It's very easy, by the way, to start a stock exchange in the Ukraine. All you need is two people and capital of UK3 [Ukrainian Kopecs] — which, incidentally, is equivalent to *US1-1/2¢*. Therefore, there are a whole load of regional stock exchanges — most of which you wouldn't want to trade on. So, as you might imagine, 80% to 90% of the trading takes place *off* the exchange.

There are a couple of stock market indices — started about a year apart. Interestingly, they both suggest that Ukrainian equities are up about 100% since prices were first struck. *That's* an interesting indicator, too — because in the first flurry of excitement in these emerging markets in the East, we've normally seen gains of about *450%*. So the first rush of interest in the Ukraine is still to *come*.

The market and its prices have not yet been Westernized.

Morton: And that's reflected in the market itself. Trading has now grown from about US$1 million per week to about US$8 million per week — which is still tiny in a market which has about US$3 billion of capitalization. And that's because the privatization process is still ongoing. The voucher process is still alive and well in the Ukraine.

And unlike comments made about Russian equities yesterday where most companies that would be of interest to Western investors are already listed, well under 50% of the Ukraine's capital stock is in publicly listed companies. And foreign investors own only about 4% of Ukrainian equities at the moment. Again, the privatization process is not nearly so far along as it is in Russia.

THE UKRAINE IS VERY RICH IN NATURAL RESOURCES
AND AN ABSOLUTE *POWERHOUSE* AGRICULTURALLY.

Huge mineral riches — 5% of the world's known reserves....

Morton: However, since the Ukraine is a country that isn't very well known, I'd like to make a couple of points about some of its intrinsic assets:

Something like 5% of the world's total mineral reserves are in the Ukraine — with those reserves very concentrated in certain categories. For example, it has 32% of the world's known manganese ore reserves. And that's especially interesting because the other big player in manganese is South Africa — which is a long way away. Therefore, people who want manganese in that region essentially have only one place to go.

The Ukraine also possesses large concentrations of very high quality coal, iron ore, titanium and mercury. And you can sort of tell what industries would be quite competitive based on those factors of production.

And the Ukraine has very large oil and gas reserves. What they don't have is good modern extraction technology and equipment. But if they could get that together, they could be self sufficient in energy. And since that accounts for well over 100% of their trade deficit, that's kind of an interesting long-term upside.

Bread basket is one thing, but Ukraine's a *powerhouse*.

Morton: The other big category is agriculture. I'm sure that all of you know that the Ukraine was the bread basket of the Soviet Union. But what is perhaps a little less understood is just *how* powerful that resource is. I'm not an agronomist. But I'm told that 33% of the world's most fertile soil — *black* soil — is in the Ukraine. Think about it — 33%!

Also, they have an *incredibly* good growing season — which varies between 150 days in the north and 210 days in the south. This is a country that is larger than France.

Ukrainian citizens and investors could get fat and happy.

Morton: And they were the world's largest producer of sugar in the '80s. They have about 187 sugar refineries, although most of them aren't currently operating.

One of the upsides today for Ukraine's citizens during the transition [to a market economy] is that people don't *starve* in the Ukraine. But the upside for *investors* is that this is intrinsically a very rich country. And they have in place some basic industries such as fertilizer and ferrous alloys which take advantage of their strengths.

MORE RISK AND MORE REWARD THAN IN RUSSIA —
MY FAVORITE'S 97-99% BELOW WESTERN PRICES.

Ukraine's like Russia, but with more risk *and* more reward.

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Morton: But let me reiterate the negative comments you heard [Seth Klarman make about the risks associated with investing in Russia]. They apply to the Ukraine — only probably a bit *more* so. Political stability is lower. Corruption is probably slightly higher. And the accounting is truly an exercise in fantasy.

And yet, there are some very compelling values there.

Ukrainian accounting rules out most traditional analysis.

Morton: But you can't measure those values in the traditional ways. For example, there are no net-nets — because there's no *cash*. Yet, they cash *account*, interestingly enough, which makes life especially difficult because it's still primarily a barter economy.

Thus, you have to question the income statements. And it means that anything which is an *accrual* is not *on* their balance sheets. Therefore, you don't know whether there are massive liabilities or massive assets not recorded.

So you can't do any analysis of market-to-book, return on sales or any of the other normal comparisons that you might like to do when you're trying to figure out whether something is a good company.

But you *can* measure value in terms of what companies' assets *could* do.... And this is where it begins to look *quite* interesting.

For example, fertilizer output at 50% of Russian prices....

Morton: For example, the Ukraine has practically a world class fertilizer industry. Their best firms export to markets all over the world — including the U.K. Yet, at current share prices, you can buy fertilizer output in the Ukraine for only US$160 per ton versus about US$300 per ton for a similar company in Russia and about US$900 per ton in Southeast Asia. And I'm afraid I don't have the figures for comparable North American companies, but I know they're *much* higher still.

So you've got massively undervalued, attractive assets in that sector.

[Editor's note: Morton tells us that the most interesting quoted fertilizer company is Azot of Cherkasy which sells for $140 per ton of output (at just under US$1 per share).]

And beer output at 1/5th to 1/6th of Western prices.

Morton: Or take beer — which is usually very popular in Eastern Europe. You could argue that Western beer is slightly better, but Rogan produces a pretty decent beer. And you can buy Rogan, which is the largest *quoted* brewer in the Ukraine, for about US$32 per 1,000 liters of output versus US$80 in Baltica (which is in Russia) and US$180 per 1,000 liters for the average Western brewer. So there's a differential of 5 to 6 times there.

The prices of utilities have gone up so quickly that the values aren't quite as attractive as they were. However, you can still buy electric generating capacity on a per megawatt basis at a 40% discount to what you'd pay for that same capacity in Russia.

For some reason, I'm partial to cement at 97-99% off....

Morton: Still, my personal favorite today is the *cement* industry because it's always an interesting product. And you can buy cement output in the Ukraine right now for about US$9 per ton. And while that's very, very good, that's *output*. You can actually buy cement *capacity* today for only about *US$3* per ton because cement companies are operating on average at only about 33% of capacity.

By comparison, Russian capacity currently costs twice as much. The average in Asia and Western Europe is about US$79 and US$115, respectively. And in Portugal — which is a popular cement destination for some reason — that same capacity would cost about US$280 per ton.

Granted, the quality of cement production as well as the plant and equipment in the Ukraine are not as good as they are in Portugal. But the difference between US$3 per ton and US$280 per ton is a pretty big difference.

So I think there's going to be some real money made not just by the insiders — who are, of course, very busy feathering their nests — but, also, by people who are out there today buying equities in the Ukraine.

I'D *LIKE* TO HANG OUT IN A HEALTH CLUB, BUT I'M STUCK IN THIS DAMN SAUNA....

If I get hit by a bus, there's an able successor in the wings.

Cundill: Tim McElvaine is my partner in this endeavor on the investment side. And if I got hit by a bus or was removed from the organization chart for any other reason, I have complete confidence that Tim could run all of the portfolios extremely well....

Tim has specific management responsibility for the Cundill Security Fund. By the rules of the game, it has to be 80% invested in Canada. And under his management, it has a remarkably distinguished record — up 20% per year for the past five years despite holding a fair slug of cash. Today, for example, 40% of its assets are in cash. Tim makes me look like an *aggressive* investor.... And he has a little thing called The McElvaine Investment Trust. And in it, he's *60%* cash.

So you're going to get some words of wisdom from a guy who's *really* cautious. And, incidentally, for whatever it may be worth, I'm an investor in both his Investment Trust and Cundill Security Fund. So Tim, why don't you take over.

I'm hangin' out today just inside the door at a men's sauna.

Tim McElvaine: I figure that some of you probably wonder exactly how we go about looking for things to do. Well, we just follow where the prices *lead* us. We go where the decision making is the *easiest* — to be quite honest. And a bad analogy — a *really* bad analogy — is that we're like a heterosexual, young man who's looking for a date: He'll have more luck in a health club than a men's sauna.

And that's exactly our approach to value investing. Japan is the health club of today's financial market. And the U.S. is the men's sauna. But as you know, because we're an RRSP [Registered Retirement Savings Plan] fund, 80% of the assets must be in Canada. Therefore, I spend a lot of time just inside the sauna door waiting for some poor woman to walk in by accident. We're having a hard time finding anything of significant capitalization in Canada....

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We're waiting for a day when there's something to *buy*.

McElvaine: So what does Security Fund look like today? Well, 40% of its assets are in cash, about 1% are in puts and 59% are in equities.

Here's how the 59% breaks down: The majority, as you'd expect, is in Canada. About 12-13% of the invested portion of the portfolio is in Japan. And our Japanese segment was *zero* at June 30th, 1997. That segment has been purchased within the last two months.

[In the next month or two], I'd venture that France, the U.S. and Canada will all be less and Japan could be much *more*. That's just the direction the portfolio is going — although the Fall always gives us stuff to do in Canada. So we'll see. Like everyone else, we're simply waiting for the day when we'll get some stocks to buy.

Today, "investors" have it *reversed*. But they'll learn....

McElvaine: But our approach is to buy on the assets and sell on the earnings. And the thing that symbolizes the Canadian market today is these royalty trusts — which are the *epitome* of selling on the earnings.

We figure we'll be buying a lot of those royalty trusts on the basis of their *asset* values in a couple of years — in many cases from people who paid today's prices and who won't be too happy about having owned 'em. So be careful if you're in that area. I can't say that they're *all* like that, but that'll probably be the result more often than not....

When companies sell below net cash, my job is pretty easy.

McElvaine: One of the recurring themes in the things we buy is that they're selling below net cash. For example, Horipro's a talent agency in Japan that sells below net cash. And among the reasons why we like that theme is that when companies sell for less than their net cash, we don't have to make many decisions about their business — other than, "Are they *profitable*?" and "Will their managers *steal* from us?" — because we're literally not paying for 'em.

So regardless of what's happening at the macro level — which, to be quite honest, I'm not sure I understand altogether anyway — when our holdings are like Horipro, where they're for the most part good businesses and sell below their net cash, it makes me pretty comfortable....

U.S. INVESTORS ARE DROOLING FOR A REASON.
BUT BEWARE OF CONVENTIONAL WISDOM.

All of us are shaped by our experiences — investors, too.

McElvaine: One of the things that Peter talked about which I thought was interesting was how a lot of what each of us think today is shaped by our perception and the baggage that we carry — a bit like Pavlov's dogs which used to drool when the bell rang.

A couple of years ago, my family and I got caught in a hotel fire. And then last night, we had a fire alarm at the Four Seasons. And just as Pavlov's bell caused his dogs to drool, that fire alarm gave me a Pepto Bismol moment.

How does that apply to financial markets? Well, investors are like Pavlov's dogs. When the bell rings in the U.S., the equity investor *drools*. When it rings in Japan, the investor has a Pepto Bismol moment....

The biggest risk in Japan is *timing* risk. And it's not high....

McElvaine: When *we* talk about risk, we're talking about our chance of actually losing capital *permanently* and, perhaps, the time value of money if, as Peter said, these things wind up taking a bit longer than we expect.

However, frankly, the prices we see today in Japan are *so far* below net asset value that although the difference between those values being realized in five years or two may reduce our compound annual return a few percent, our ultimate returns are nevertheless quite likely to still be far better than our alternatives in the U.S....

As Buffett says, there are no called strikes.

McElvaine: Of course, price is what you pay. But value is what you get. And the neat thing about price is that you don't have to do anything if the price isn't right — if it's not *attractive*.

For better or worse, we believe people give us money because they want us to *make* them money. They don't give us money because they want us to invest in equities. So we're very focused on the price we pay for securities. And if something isn't attractive, we just keep the cash.

On the other hand, we know there are opportunity costs.

McElvaine: Ben Graham is kind of dear to our hearts. And he said, "An investor should always remember that market quotations are there for convenience — either to be taken advantage of or ignored."

In the last couple of years, perhaps we've done more ignoring than we *should* have — especially in Canada and the United States. But you have to play the game *you're* comfortable with, not someone *else's* — from our perspective, at least....

When you buy what *we* do, you *better* be focused on price.

McElvaine: People talk about different *spectrums* of value. I don't want to oversimplify what Buffett does. However, as far as we can tell, he prefers to pay a *fair* price for a *wonderful* business. Therefore, he has to be confident that the business is going to *continue* to do well and that he'll get the rewards.

In his 1993 or 1994 letter to Berkshire shareholders, he termed the type of value investing that Walter Schloss and we do as the "cigar butt approach" — which is paying a *wonderful* price for a *fair* business. We're *very* focused on the price we pay — because we have to sell sometimes. Some of these businesses are actually really kind of junky. We just bought 'em cheap.

Finally, a quote from John Maynard Keynes. He said, "There's apt to be great confusion ... between depreciation arising out of fluctuations and depreciation arising out of serious mistakes in the choice of individual securities."

It's obviously the *former* that we're most interested in....

Be patient and prosper....

Cundill: Well, I think that pretty much covers it all. Here's where we are today: Buy Japan. Short America. Maintain quite a lot of cash. Be patient. And prosper....

—OID

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TIM MCELVAINE & DAVID BRIGGS
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than those he was finding in the U.S. in 1975 today in Japan and elsewhere, we thought it was time to give him a call and see if he might be willing to share some of them with you.

Long-time *OID* subscribers know that Cundill and long-time cohort Tim McElvaine have never disappointed. In past interviews, they've told subscribers about one extreme value after another. Since we last spoke, however, Cundill added additional depth to his staff and suggested that we might want to speak with one or more of them — a motion, incidentally, seconded by McElvaine.

So after speaking with Tim about a couple of fascinating ideas, we took their advice and spoke with their resident Asia specialist — David Briggs — about a couple of markets and a dozen or so situations which have them smacking their lips in anticipation and shaking their heads in disbelief. And, but for a shortage of time and space (believe it or not), we could have brought you others still.

The following excerpts were selected from a series of conversations with McElvaine and Briggs which occurred between January 14th and shortly before we went to press. We hope that you will find some of their ideas and insights as intriguing as we do.

WE THINK THESE IDEAS ARE COMPELLING —
EVEN WITHOUT THE TYPICAL TRAUMATIC EVENT.

OID: I thought your comment about U.S. investors having been conditioned to drool at the mere mention of "stocks" while Japanese investors have come to wince in pain and the resulting valuation anomalies were fascinating. As you know, we agree with you — and we've been wrong, too.

Tim McElvaine: We don't *mind* being early. In fact, we're *usually* early. Fortunately, one of the great things about investing the way we do is that you really don't have to be a rocket scientist to do it.

In the case of most U.S. stocks today, you'd *better* be right about the underlying business, future returns and pretty much everything else because, as Peter says, given current valuations, investors are ultimately likely to be very unforgiving of anything but the best-case scenario.

In contrast, to do what we're doing in Japan, all you need to be able to do is read and perform very basic math. Generally, all you have to do is add up the cash and marketable securities, divide by the shares outstanding and make sure the current stock price is well below that. You don't need to estimate growth, forecast cash flows, discount 'em to any present values or anything of the sort.

OID: As you said at your meeting, if a company is selling for less than its net cash per share, all you need to know is that it isn't likely to lose money and that management isn't going to steal from you.

McElvaine: Exactly. Some would argue — and they may very well be right — that lousy corporate governance is reason enough for these things to be as cheap as they are, if not *cheaper*. After all, they might say, these managements haven't generally operated their businesses in a very shareholder-friendly fashion. But we believe that's partly because they haven't had an incentive to do so. And as you know, we believe that's changing quickly.

OID: In which case, if you're right, the onset of U.S.-style corporate governance could even provide a very nice tailwind for your Japanese investments.

McElvaine: That's what we expect. Peter believes that it may move much more quickly than people expect. In fact, he believes that 1998 will probably even turn out to be the year of the deal in Japan.

OID: I was shocked to hear about the introduction of reforms such as share buybacks and stock options and the seriousness with which the Japanese are undertaking reform — at least in your view.

McElvaine: It really *is* pretty wild. And we think that it represents a trend that's just beginning.

Many Japanese companies sell at deep discounts to their intrinsic value. And, of course, they are subject to recessions and the like. But the values are *compelling*. And when companies that sell below their net cash repurchase their shares, the impact is far more dramatic and far more accretive to shareholder value than it would be for most U.S. companies undertaking the same repurchases.

OID: Amen.

McElvaine: Therefore, the only real issues are corporate governance-related. That's different than what we and other value investors usually contend with. Usually, when we buy things, a traumatic event has *made* them cheap. In the case of our Japanese securities, the trauma generally revolves around corporate governance.

VALUATIONS IN MANY CASES ARE NO-BRAINERS.
BUT SOME HAVE GROWTH & HIGH RETURNS, TOO.

McElvaine: Still, the timetable by which reform ultimately unfolds is unknowable. Our biggest unknown, in fact — and, we believe, the biggest single determinant of our ultimate returns in our Japanese equities — will be time. For example, if the underlying values are recognized in three years or less, our returns will probably be excellent. If those values aren't recognized for five years or more, then our returns may be mediocre.

OID: But isn't that generally so — whether you invest in Japan, the U.S. or anywhere else?

McElvaine: Usually, it is. But here's the difference: We generally try to bottom fish. Therefore, we tend to deal in buying at a discount to net asset values. And the concept of net asset value isn't a precise figure to me, but just a rough range around reasonable value. And the market may ultimately agree with our estimate or not.

But the first question is whether that net asset value is constant or growing — because if the net asset value is

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relatively constant, then time is your enemy because that's all you're going to get. If it's growing, you don't have to be as concerned because time is your ally.

OID: And the higher the percentage of net asset value which consists of cash earning 1% or so interest...

McElvaine: The more likely its value isn't growing very fast. Exactly. And the more that's so, the more we'd like to see its value recognized as quickly as possible.

OID: I assume that's why you're flaunting these things so shamelessly?

McElvaine: In some ways, the stuff we're doing in Japan is more the kind of thing Tweedy, Browne is known for buying than it is to any kind of in-depth analysis. That's in part because their valuations in so many cases make them such no-brainers and in part because we're unable to obtain the information that would *enable* us to perform that type of in-depth analysis.

I'VE ALWAYS PREFERRED TWO LEGS TO ONE:
SURPLUS ASSETS *AND* BUSINESS VALUE.

OID: Although, as I recall, you and David Briggs mentioned that the underlying returns of some of these things are respectable, if not downright high.

McElvaine: That's right. In some cases, the value *isn't* very static. KFC Japan, for example, although it isn't a great business, produces free cash flow that *is* growing. It isn't growing 20% a year, but it is growing. So if its value takes longer than we hope it does to be realized, that could be helpful.

Something else we like about KFC Japan is that it has *two* legs to stand on. It's trading today at about ¥1,100. And depending on how you value its receivables, it has surplus assets of ¥1,100 or ¥1,200. Then, KFC's business is probably worth *another* ¥800 to ¥1,500 per share. So even if its surplus assets evaporate entirely, its business is probably worth more than its current stock price.

OID: And ditto if the business goes away...

McElvaine: Exactly. We're particularly partial to ones like that.

OID: Us, too. But how did you come up with your ¥1,100-1,200 estimated value for surplus assets?

McElvaine: Very simple. KFC Japan has cash and marketable securities net of all debt of ¥20± billion plus deposits with their landlords (what they refer to as "Long-term Guarantees") of ¥10 billion, more or less. Granted, they probably aren't worth 100¢ on the $1. But when we include them at 50% to 100% of their face value, we estimate that KFC Japan has total surplus assets net of all liabilities of ¥25-30 billion.

So when we divide the ¥25-30 billion of surplus assets by KFC Japan's 23.4 million shares outstanding, we arrive at ¥1,100-1,200 of surplus assets per share.

OID: More like ¥1,100 to ¥1,300, but who's counting? So you get net cash and securities of something between 1 and 1.2 times the current stock price.

McElvaine: Not including its business. That's right.

CORE BUSINESS VALUE AIN'T CHICKEN FEED EITHER —
PERHAPS ANOTHER 1 TO 1-3/4 TIMES TODAY'S PRICE.

OID: And you think KFC Japan's core business is worth something, too?

McElvaine: It's worth a fair amount. KFC Japan is simply shorthand for Kentucky Fried Chicken Japan which is the exclusive licensee for Kentucky Fried Chicken and Pizza Hut for Japan. In other words, they pay a royalty to TRICON International — the recent spinoff from PepsiCo — for the exclusive right to establish, own and operate Kentucky Fried Chicken and Pizza Hut restaurants.

Incidentally, there are two different businesses here: (1) the business of operating restaurants that they own, and (2) the business of being the sublicensor — of collecting royalties and franchise fees from other restaurant owner/operators. However, in both instances, they send a portion of the revenue back to TRICON.

OID: But shouldn't KFC Japan's returns be higher, possibly much higher, in the sublicensor business than in the restaurant business — in part because of greater capital outlays in the latter?

McElvaine: That's a very good question. Unfortunately, like many Japanese companies, KFC Japan doesn't provide very good disclosure. But you're right. Although its restaurants are mostly leased, the business of owning and operating restaurants probably is inherently much more capital intensive than that of being a restaurant sublicensor. Remodeling restaurant facilities, for example, can be extremely expensive. KFC Japan is, in fact, remodeling its owned and operated restaurants today. And even in the restaurants that they sublicense, they offer their sublicensees incentives — such as breaks on their royalty payments — to assist the ultimate owner/operators in funding their capital expenditures.

But when we look at the fees that KFC Japan earns from its sublicensees net of the cut that it pays to TRICON, we conclude that its business is quite profitable. And it's easy to understand why that might be so. Think about it: KFC Japan collects a royalty check, deposits the check and, finally, cuts a check to send a portion of its royalties to TRICON. To my way of thinking, the business of being a sublicensor essentially involves clipping coupons — which has always sounded like a terrific business to me.

OID: Except for the check to TRICON anyway.

McElvaine: All told, we estimate that KFC Japan is

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earning a very nice return on the assets it has invested in its core business — which come to about ¥10± billion net of payables generated in the normal course of business. And its pretax earnings in 1996 were about ¥2.6 billion. So KFC Japan's earning 25%± pretax on invested assets.

OID: And while 25% pretax may not sound like anything to cluck about, it sounds plenty respectable given the current state of affairs in Japan.

McElvaine: That's right. And it has been far *higher*. But it's still producing relatively steady free cash flow. And, therefore, anyone considering a leveraged buyout of KFC Japan would assign some value to its business — possibly a fair amount.

OID: And I'll bet that you just happen to know where some shares might be available...

McElvaine: How'd you guess? KFC Japan's sales, incidentally — which are comprised of royalties paid by its 700 or so franchised restaurants plus revenues from its 300+ owned and operated restaurants — total something around ¥83.5 billion.

OID: That doesn't sound like chicken feed.

McElvaine: Not at all. It's around US$650 million. And KFC Japan had operating income of ¥2.7 billion last year — although it will probably be lower this year.

As you know, I'm no fan of EBITDA. But KFC Japan's depreciation is roughly another ¥2.5 billion. Therefore, KFC Japan's EBITDA is something like ¥5.2 billion.

OID: Which would be EBITDA of about ¥220 per share.

McElvaine: That's right — and operating income of about ¥115 per share. And I figure KFC Japan's business should be worth 10 times operating income or more. If so, then its value would be at least ¥1,150 per share. Then, adding its surplus assets of ¥1,100-1,300 per share would suggest a value between ¥2,250 and ¥2,450.

And I think that's being quite reasonable. That's not assuming you get in there and reduce capital expenditures, close non-performing stores or anything of that sort.

OID: I'm out of my element with EBITDA...

McElvaine: Aren't we *all*. But as long as the people who *buy* the stock from me at the end of the day are thinking in terms of EBITDA, I'm happy.

OID: Wouldn't this type of business typically sell for 8 times EBITDA or more in the U.S.?

McElvaine: It and everything else.

OID: If so, that would imply a value closer to ¥1,800 per share.

McElvaine: That could very well be so. But I don't want to feather the story. And whatever the figure may be, a buyer could run this business to generate more cash. A well positioned restaurant chain with lots of goodwill could be very interesting as a potential (forgive the term) LBO.

KFC JAPAN'S MOST SIGNIFICANT RISK
HAS NOTHING TO DO WITH JAPAN.

OID: But isn't one risk always that TRICON overplays its hand or even cancels KFC Japan's license outright? Isn't it even bound to happen at some point?

McElvaine: The relationship between TRICON (the master licensor of both Kentucky Fried Chicken and Pizza Hut) and KFC Japan isn't very good. I understand that the managements of KFC Japan and TRICON don't think very highly of each other. And KFC Japan's licenses — both for Kentucky Fried Chicken and Pizza Hut — come up for renewal in 2004 and 2007, respectively. Therefore, it is probably true that KFC Japan's biggest risk has nothing to do with Japan.

OID: How charming. KFC Japan is living on the edge. And its relationship with those it needs most are foul.

McElvaine: It's not as big a risk as you might think. Much more likely is the possibility that TRICON wipes out KFC Japan's profitability by hiking its fees too much during an upcoming license renewal negotiation.

OID: True enough. But couldn't KFC Japan wind up losing its franchise altogether?

McElvaine: In theory. But that would be *extreme* — and highly unlikely.

OID: Because TRICON would lose its existing locations and its existing market position potentially — or maybe even probably — to one of its competitors?

McElvaine: Exactly. TRICON would risk losing its existing market position *completely*.

OID: But don't licensors have more leverage generally — given that they typically have lots of franchisees, whereas franchisees have only one or two franchisers?

McElvaine: What you're saying is generally true. But there's actually leverage on both sides. Again, the franchisees have the locations and the relationships.

OID: On the other hand, if TRICON doesn't value the relationship, might they not want to bite the bullet and force KFC Japan to pass it along to a licensee they think they might prefer?

McElvaine: Let's suppose that's true. In that case, what could they do? If they want to compete in Japan, but they don't keep their franchisee, they risk suddenly going from having a huge market share to being the small guy against an entrenched competitor.

OID: In which case TRICON buying out KFC Japan would be the more likely scenario in that event?

McElvaine: I'd think so. Anyway, I trust 'em enough to wing it.

OID: Knowing that it could be a recipe for disaster...

McElvaine: There's a kernel of truth to what you're saying. But you shouldn't pan KFC Japan on that basis for at least two reasons. First, your disaster scenario is quite a longshot in my view. And second, even if TRICON were to do what you say — and KFC Japan's core business,

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PETER CUNDILL & ASSOCIATES'
TIM MCELVAINE & DAVID BRIGGS
(cont'd from preceding page)

therefore, had no value at *all*...

OID: That certainly sounds like a disaster scenario.

McElvaine: In that case, at today's price, KFC Japan may have been undervalued or not. However, it's hard to see how it would be *overvalued* because, again, we're standing on *two* strong legs — one being the business and the other being its surplus assets. And the odds of *both* getting fried...

IT'S EASY TO ARRIVE AT SILLY-SOUNDING NUMBERS. HOWEVER, WE'RE CONTENT TO BE ROUGHLY RIGHT.

OID: But you said that KFC Japan's earnings would probably be lower this year?

McElvaine: That's right. But I don't think last year's results were abnormally high. In fact, their KFC segment has about 1,050 locations. So it's relatively mature. They should probably even *close* a few of those.

On the other hand, their Pizza Hut division, although it's growing rapidly, has fewer than 300 locations today. I'm not saying they'll have 1,100 of those any time soon. But they should certainly have a lot more than 300. And it's still *losing* a little money today.

OID: So KFC Japan's ¥235 per share of EBITDA understates the earnings from its KFC segment since it's net of a small loss from its Pizza Hut operations?

McElvaine: You've got it. And certainly, that segment isn't worth a *negative* amount — which is what's implied if you don't add back something for its value.

Given KFC Japan's current stock price, you're not paying anything for the KFC segment or the Pizza Hut segment. But the Pizza Hut segment's growth potential may make it worth a lot more in the eyes of some prospective buyers than you might think — or, at least, a lot more than its current sales and negative earnings might suggest. In fact, one interesting potential catalyst here is the restructuring of KFC Japan's balance sheet by someone in order to reflect the substantial value in its Pizza Hut segment as a result of its growth potential.

Today, KFC Japan's Pizza Hut restaurants generate less than ¥13 billion of its ¥83.5 billion of sales — and none of its earnings.

OID: That is interesting — especially if Pizza Huts outside the U.S. are being revitalized the way that they are in our area. Their pizza is really awesome — especially their Chicken Supreme...

McElvaine: My daughters love Pizza Hut, too. Its new menu is a vast improvement over what they had up here, too. That's one of the benefits of owning restaurant stocks: I can go eat pizza with my kids and be working. It wouldn't be nearly as much fun investing in IBM...

OID: So long as you keep the intriguing ideas coming, Peter need never know...

McElvaine: Again, less than ¥13 billion of their sales last year came from their Pizza Hut segment. Therefore, more than ¥70 billion of their ¥83.5 billion of total sales — the lion's share — was generated by its KFC operations. And of that ¥70 billion, approximately ¥45 billion comes from the restaurants they own and operate and the remaining ¥25-30 billion from sublicensed restaurants — from franchise fees, supplies sold to sub-franchisees, etc.

OID: You said KFC Japan had ¥83.5± billion of sales last year — or nearly ¥3,600 per share. Is there such a thing as a typical profit margin that someone might be able to scratch out in this type of business?

McElvaine: I think typical pretax margins in this business if it were well run might be up around 10% — both on revenue from their owned restaurants and for the revenue that they receive from their sublicensees.

OID: Which isn't that far off from the margins earned by NPC International — which Value Line says is the largest franchisee of Pizza Huts in the world.

McElvaine: Like I said.

OID: And NPC International's sales per unit appear to be similar to those of the units KFC Japan owns and operates — although NPC doesn't appear to sublicense any of its restaurants. And yet NPC appears to have regularly received a valuation of 75-150% of sales.

McElvaine: I'm always wary of price-to-sales ratios. But since I'm not paying anything for it...

OID: If KFC Japan were to warrant the same multiple, its business would be worth nearly ¥3,600 per share. And including surplus assets, the implied value would be about ¥4,800 — or more than 4 times today's price.

McElvaine: That's right. I don't think your ¥4,800 figure is necessarily that far off from reality though for several reasons: I mentioned the growth potential in their Pizza Hut segment earlier.

Another factor which enhances its value, at least in my judgement, is that KFC Japan's ¥83.5 billion of sales doesn't include the sales of its sublicensees — only the royalties that those sublicensees pay KFC Japan.

OID: That sounds impressive, all right.

McElvaine: It impresses *me*. It's hard to imagine the business of being sublicensor not being better than that of being a restaurant owner and operator — both because it should have higher margins and, as you've pointed out, lower capital expenditure requirements.

I'm a little embarrassed to tell you this. However, the range of value that I've set in my mind for KFC Japan is between ¥2,400 and ¥4,500 per share — depending on how things evolve and what happens with their own operations. Obviously, that's a pretty wide range. But I don't know what to tell you about that other than to acknowledge that our pencil isn't as precise as some people's.

OID: In Charlie Munger's words, you'd rather be roughly right than precisely wrong.

McElvaine: We just turn it around and ask ourselves if we have asset protection when we pay ¥1,100 per share. And the answer there appears to be yes. It looks to us like it's definitely worth more than that.

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OID: Since you're paying less than cash and marketable securities, I would say so. It's kind of like getting the business for free and being paid to take it.

McElvaine: True. How *much* more? I don't know. But I think it's clear that we're getting some positives that we're not paying for. As long as the range is significantly higher than today's price, I'm happy.

So I don't think your ¥4,800 figure is unreasonable, although it does assume that someone either comes in and sells off the pieces or dramatically enhances its returns.

OID: Standard investment publishing assumptions...

McElvaine: But long-term interest rates in Japan are down around 2-3%. So even if a potential buyer were to go out and borrow the purchase price at 4% — even assuming no improvement whatsoever in KFC Japan's margins which, again, are down around 3-1/2% — it's hard for me to imagine them not being able to borrow a multiple of the current stock price.

OID: Now you're talking.

McElvaine: But whenever I do that exercise, I start to arrive at what seem like silly-sounding numbers...

OID: What's wrong with silly-sounding numbers? Isn't that what we're after?

McElvaine: If it's silly-sounding numbers you're after, consider this: I mentioned that KFC Japan earned about ¥3 billion last year, but that they'd earned much more. Well, their peak earnings — which occurred in the year ended November 30th, 1992 — were north of ¥5 billion.

OID: That's not so shocking. If it could ever achieve the kind of margins you think it can — margins, again, similar to those NPC International is earning today — its normalized pretax earnings could be ¥8± billion. But, of course, who's counting?

McElvaine: That's exactly right.

OID: And that would be close to ¥370 per share — which given the multiple of 10 or more that you mentioned earlier on KFC Japan's operating earnings would imply a business value approaching ¥4,000 per share and a total value up near ¥5,000?!

McElvaine: That's right. But, again, we just figure it's worth more than today's price. And it's funny — when sentiment finally does change, it's amazing how far prices can go the *other* way. Pete describes it as a pendulum. And I think that's a good analogy: The price swings down well below any reasonable estimate of fair value and then it swings the *other* way. It doesn't stop at a specific number — whether it's fair value or anything else — along the way. Usually, it swings right *through* it.

So even though it's hard to imagine KFC Japan and our other Japanese stocks selling for well *over* fair value, you can rest assured that sooner or later they will.

THERE'S QUITE A LOT TO LIKE AT HORIPRO. IT'S *EASILY* WORTH DOUBLE TODAY'S PRICE.

McElvaine: Horipro is another Japanese company that you can buy today for less than its net cash plus marketable securities. When we add up its cash and other liquid assets net of its debt and its pension liability, we estimate that it has net cash and marketable securities of over ¥1,000 per share. Yet, you can buy it for ¥800± today.

OID: Not including anything for its business.

McElvaine: That's right. And most of its ¥1,000+ of cash and marketable securities is *cash*. It has ¥11 billion of cash and ¥4 billion of marketable securities. So what is that — nearly 75% cash?

OID: That sounds about right. And how many shares are there outstanding?

McElvaine: About 13-1/3 million.

OID: Isn't that more than ¥1,100 per share of cash and marketable securities — more than ¥800 of which consists of cash?

McElvaine: I guess that's right. And Horipro doesn't have such a bad business either. It's a talent agency. And about 30% of its revenues come from performance fees for appearances by performing artists on radio commercials and so forth.

OID: It gets a percentage of fees earned by its clients.

McElvaine: That's right. And another 30% of its revenue is derived from concert and music production where Horipro puts together the production, collects the box office revenue and pays the talent and so on.

OID: Where Horipro takes the business risk rather than the performing artist or anyone else.

McElvaine: Correct. And then the final 40% or so of their revenue comes from fees that they receive for producing commercials plus royalty and airplay fees they receive on copyrighted songs, radio programs and so forth.

OID: Horipro has intellectual property, too!?

McElvaine: Yep. They own Horipro Entertainment which receives royalties and air play fees on approximately 3,500 copyrighted songs in Japan. And then, another wholly owned subsidiary — Emerald Forest — owns another 9,000 music copyrights in the U.S.

OID: Before I put you on hold and call my stockbroker, let me ask you how much of that last 40% of revenues are derived from royalties and airplay fees?

McElvaine: We'd *love* to know that. Unfortunately, Horipro isn't quite as forthcoming as we'd like. As Peter says, Japan has good accounting, but lousy disclosure — better than Russia, but by no means as good as the U.S.

OID: What about Horipro's business? Could you give us some sense of what it's worth?

McElvaine: Horipro is a much smaller company than KFC Japan. Its pretax earnings were ¥1.05 billion and

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¥650± million for the years ended March 31, 1996 and March 31, 1997, respectively — and will probably be something around ¥600 million this year and next.

So with about 13-1/3 million shares outstanding, they'll have pretax earnings of something between ¥45 and ¥50 per share. So if you were to just take that ¥50 of pretax earnings and apply a multiple of 10, you'd arrive at a valuation of about ¥500 per share for its business.

And then, adding back the ¥1,000+ of cash and marketable securities that I mentioned earlier, we conclude that Horipro is *easily* worth double its current stock price.

EVEN THAT'S IGNORING HORIPRO'S REAL ESTATE, ITS EARNING POWER, ITS LIBRARY AND MORE.

OID: You say it's easily worth double today's price?

McElvaine: Easily. Horipro may be worth *much* more. For example, I've used its recent earnings in my valuation. But its earnings have been declining since 1992 — when its pretax earnings were ¥1.9± billion. And that would be equivalent to more than *¥140* per share.

OID: Wow! On the other hand, if that trend is set to continue, Horipro may be worth less — maybe far less. You don't think those days are gone forever?

McElvaine: I don't see any reason they *should* be. Again, about 30% of Horipro's revenue is comprised of what they refer to as concert and music — meaning musical box office revenues from the production of shows.

OID: In other words, theatrical?

McElvaine: That's right. And that earnings stream can be quite volatile depending on the number of shows they do and their success — whether they're hits or flops.

Volatility aside, however, this is an excellent business. For example, Horipro only has about ¥3 billion of assets employed in its business today. And pretax earnings on a normalized basis are probably at least ¥750 million. If so, it's currently earning close to 25% pretax on those assets.

And, obviously, its returns would be far higher using the ¥1.9 billion of peak earnings that I mentioned earlier. But we're not relying on it getting back to peak earnings. Again, quite the contrary.

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

McElvaine: Also, in the case of KFC Japan, unless you make a conscious effort to run the business to generate free cash flow, capital expenditures will probably more or less equal depreciation. In Horipro, you can be relatively sure that depreciation will exceed recurring capital expenditure requirements.

OID: Because of the nature of the media business.

McElvaine: Exactly. So that 25% pretax return pretty much entirely consists of real earnings or free cash or whatever you want to call it.

OID: For whatever it may be worth, what are we talking about here in terms of sales per share?

McElvaine: Horipro's sales are around ¥9-1/2 billion — which divided by its 13-1/3 million shares outstanding gives it a little over ¥700 of sales per share.

OID: So 10 times its ¥140 per share of peak earnings would be equivalent to 1-3/4 times sales.

McElvaine: That's right. And I don't think that sounds so unreasonable. Plus, I haven't included anything in my valuation for their intellectual property either.

OID: Although it sounds like you have included the revenue/earning streams they generate and, therefore, incorporated them into Horipro's business value.

McElvaine: That's true. However, the prices that those kinds of properties are assigned in the marketplace are probably a *multiple* of any value I include in that way. I'm always amazed at the prices people are willing to pay for copyrighted recordings and similar properties.

I'm not saying Horipro's song library is like that of Polygram or Columbia. For instance, Emerald Forest — their wholly owned subsidiary that I mentioned earlier — owns copyrights from KISS, The Byrds, Hall and Oates and the like, the kind of thing you and I might be familiar with from our teen years.

And don't ask me if that's a positive or a negative because I don't know. But Horipro's song library is probably worth something. And I've basically ignored it.

OID: Perhaps I wasn't clear about the ground rules...

McElvaine: Furthermore, some people argue that because Japan is going to have many more channels thanks to new technologies such as digital cable and satellite broadcasting, the demand for content such as Horipro's library is going to increase and, therefore, that Horipro will be a beneficiary.

But, honestly, I don't *know* how it's going to play out or exactly what it's likely to mean to Horipro in terms of revenues and earnings. However, I certainly don't think it's going to be a *negative*.

Our whole point on Horipro is that we paid nothing for its song library or anything else for that matter. Again, we paid a *negative* number. It's like we were *paid* to buy it. So, hopefully, we didn't overpay.

OID: Unless the assets, your math or its management leave a lot to be desired, that sounds hard to imagine.

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(cont'd from preceding page)

BUT HORIPRO HAS ITS NEGATIVES:
FOR EXAMPLE, LIMITED LIQUIDITY.

OID: But what then could turn Horipro into a mistake?

McElvaine: Like you said, bad math, bad assets or very bad management — and not much else.

As Peter and David mentioned, the main issue in Japan relates more to corporate governance than valuation — because valuations are clearly *very* attractive. Therefore, were these companies located in the U.S., their values would have already been unlocked by now.

And I told you that I liked the shareholder dynamics at KFC Japan. Well, here's what I meant: At KFC Japan, there are two players with stakes of around 30% each. Therefore, it's much easier to imagine the company going into play or, at least, having the status quo changed.

By comparison, Horipro has one large shareholder. Therefore, nothing's going to happen without his approval. We have no reason to believe his intentions aren't good. But any action the company takes will be at his discretion.

OID: Gotcha. Any other negatives?

McElvaine: Horipro's market cap at its current price is only a little over US$80 million. So it's pretty small. And, therefore, you may not even want to talk about it. However, its size is fine by us.

OID: I assume you already have a pretty full position?

McElvaine: Yeah. We do. But you should caution your subscribers about most of the stocks we talked about: If people are interested in any of these ideas and follow up on them and decide to actually buy 'em, they should be very, very careful on what type of limits they put on their bids.

OID: Because they're so thinly traded and, therefore, could be bid up very easily.

McElvaine: Exactly. And that wouldn't serve anyone's purpose.

OID: Aside from any newsletter editors who might just happen to own call options...

McElvaine: Also, Japan's Over-the-Counter market — like the OTC market in the U.S. — can involve players who may not always have your best interests at heart.

OID: In other words, similar to all financial markets — only more so.

McElvaine: Absolutely. So we're very careful with the type of orders we place. And I'd urge anyone who reads about it and decides to deal in that market to do the same.

OID: This edition and always. Amen.

McElvaine: That's right. Small cap stocks in Japan are very thinly traded. So an aggressive buyer or aggressive seller can move a stock price around quite a bit.

OID: And what gets bid up on the buying probably gets sold down just as much on the selling.

McElvaine: That's exactly right. And, therefore, it's particularly important to tread lightly.

OID: Peter says you're hedging your currency risk. But do you have any thoughts there?

McElvaine: Several years ago, General Electric's Jack Welch wrote an editorial in *The Wall Street Journal* suggesting some of the things you said in your last letter. As he put it, "Let's not mistake a weak dollar for productivity growth."

I agree with your contributors in your last edition [Valuevest's Mark Bakar and John Burbank] who talked about a weaker dollar having provided a tailwind for U.S. companies and the likelihood of a stronger U.S. dollar turning that tailwind into a headwind.

OID: With the wind presumably blowing the other way in each case for Japanese companies.

McElvaine: That's the way it looks to me. But most important are the valuations. I think the stocks will do well enough to compensate for whatever the yen may do. We're just going short expectations and long fear and worry.

OID: With the expectations that you're shorting being in the U.S....

McElvaine: And the fears and worries being in Japan. That's right. Obviously, there are plenty of fears elsewhere in Asia — for example, in Indonesia, Malaysia and Korea. And you can probably find companies in those countries cheaper than the ones we're finding in Japan. In fact, we're buying the occasional stock in those countries. However, I believe the fears you face in those countries are a lot more real and the risks a lot more dangerous, too.

And I think these ideas are *plenty* cheap.

AND IF YOU BUY OUR RATIONALE FOR JAPAN,
HERE'S A WAY TO BUY IT AT A *DISCOUNT*....

McElvaine: More important than the specific ideas, however, is the concept — the developments underway in Japan that Peter and David talked about and the fact that valuations within virtually the entire spectrum of small cap stocks are so attractive. I definitely think your subscribers might find it worth their while to take a look.

OID: Any suggestions for the less adventurous types?

McElvaine: People who don't want to invest directly in Japan might want to consider another alternative that we think is pretty good. It's a closed-end mutual fund based in the United Kingdom that invests in Japan — Henderson Smaller Companies Japanese Investment Trust. For individuals who for some unimaginable reason prefer not to put their money with us, it's another way to participate in smaller cap Japanese stocks.

OID: Go figure.

McElvaine: It's trading at a discount of about 15%. However, then, of course, you're buying a portfolio.

OID: Are the holdings very well selected?

McElvaine: The manager has a different approach than we do. But there's more than one way to get to

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heaven. He looks more for growth stocks at a discount. But there is overlap. For example, he owns Horipro and KFC Japan.

OID: Really!?

McElvaine: And its net asset value, as you may imagine, has steadily moved lower the last three years. So we think that he's fishing off the right dock. And we're buying it at a discount of about 15%. His management fee is relatively low. And I have confidence in his approach. So that's another way to do it.

OID: And the biggest negatives?

McElvaine: The only one I can think of really is that he owns about 100 securities. So it might not have the same pop as a handful of well-selected holdings.

OID: Or downside volatility, I suppose.

McElvaine: We'll see. It's an *easy* way to participate.

OID: Does he have tax losses in his portfolio?

McElvaine: I wasn't thinking about it from that point of view. But you're quite right. He *must.*

FOR THE POOP ON SOME OTHER INTRIGUING IDEAS,
YOU SHOULD SPEAK WITH OUR SPECIALISTS.....

OID: I gather you're finding little or nothing in the way of bargains in the U.S.

McElvaine: On the long side, that's right. Of course, we are shorting S&P futures and buying S&P puts. However, on the long side, only about 3% of our assets are still in U.S. stocks — and we're selling some of those.

OID: Your colleague, James Morton, described finding some pretty extreme sounding values in the Ukraine? Are you doing anything there?

McElvaine: No. I'm not trying to find ideas so cheap that I'm going to make 10 times my money...

OID: Please feel free to pass those along to us.

McElvaine: I'm just looking for sensible businesses with low risk. And Japan fits that criteria. I think the odds are excellent that if we look back two or three years from now, we'll be very happy that we bought KFC Japan and Horipro and some other Japanese stocks today.

Fortunately, in these securities, we're more toward the end of our purchase program than the beginning. But we are actually out there in the market buying these ideas. And I know that you'll be pleased to hear that we're putting our money where our mouths are.

OID: Very much so — and even more appreciative about you sharing your ideas and thoughts with us.

McElvaine: I suspect some of your contributors, quite honestly, are better analysts than we are. We just deal in situations where the sentiment influences the price far more than any analysis.

OID: That sounds very similar to what Marty Whitman told us recently — that people frequently ignore the obvious and don't pay enough attention to price. And, interestingly, he was talking about Japan, too.

McElvaine: It looks like a no-brainer to us. We don't think there's any question about it. But, again, we hope so — because that's how we try to overcome our limitations.

However, frankly, I'm an observer on some of the stuff that Peter and Dave do. I play my game on my court kind of off to the side. I get involved in their game sometimes. But mostly, I just play my own.

OID: And Japan is their game.

McElvaine: That's right. So you really should talk with David about Japan. And Singapore's interesting, too. For example, you should ask David about Haw Par. I think you might find it particularly intriguing. Frankly, I suspect that some of the things he's finding are better bargains than the ones that I'm buying.

And I'm sure that James Morton or Mark Stevens would be happy to tell you about some of the things that we're doing in Europe. They seem pretty compelling, too.

OID: Super. Subject to constraints of time and space, we'll give 'em a call. However, first, thank you again for taking time away from the men's sauna to share two or three intriguing ideas.

McElvaine: My pleasure.

THESE STOCKS ARE PRICED LIKE FUTURE DISASTERS
— VALUE SEEMS TO MEAN ABSOLUTELY NOTHING.

OID: Tim told us about a couple of ideas in Japan that sounded very attractive and then informed us that if we wanted real bargains to call you.

What do you think that was about?

David Briggs: Well, I handle Asia for Peter Cundill & Associates. And I think it's the greatest job in the world. However, I've learned the hard way that it's possible for me to be 100% diligent and true to our style and still have what I believe are very cheap stocks decline by half or more in what seems like the blink of an eye.

OID: Or even 80%....

Briggs: That's right. I thought the Valuevest guys, [Mark Bakar and John Burbank], hit the nail on the head in your December 29th edition. I don't want to tell you how many times I've turned to my wife for reassurance. Looking after Asia is a totally different world.

When I see a stock go from 60% of book to 40% of book on no news, I tell myself, "It's just 'Mr. Market'. When we paid 60% of book, after all, we thought that it would be worth 1-1/2 to 2 times book at some point. And the fundamentals are the same. So it's time to buy more."

But it's hard not to get fazed.

OID: I can relate.

Briggs: But Asia's good that way. If you maintain a long-term time horizon, you can take advantage of the kind

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(cont'd from preceding page)

of weakness its markets have had recently in order to build positions in wonderful companies at dirt cheap prices.

OID: Similar to what Valuevest's Mark Bakar and John Burbank told us.

Briggs: Yes. And, again, there's little or nothing that they said that I don't agree with. However, one of the countries they talked about was Korea. But when Korean stock prices plunged, it seemed like every idea I looked at had so much leverage that I couldn't find very many net-nets. And we *looked*. We looked aggressively. But we were able to find *very* few.

In contrast, around 40% of Japanese companies have little or no debt. In fact, the capital structures of the Japanese companies we're looking at are so strong that most have net *cash*. So as prices fall and the price of $1 bills went from 60¢ to 50¢ — even 40¢ — that $1 bill is *intact*. So you can average down with conviction.

OID: You guys talk about net-nets a lot. Might you very briefly define the term for us?

Briggs: Sure. By net-net, we mean a situation where the sum of the company's current assets plus its long-term marketable securities less all of its liabilities divided by its shares outstanding exceeds its stock price. In effect, if we liquidate the business, we get the money we paid for the stock back in full or more without allocating any value to the company's fixed assets or its business, etc.

OID: And when you say something is selling for less than its net cash, that sounds obvious enough...

Briggs: I think so. When we say something is selling for less than its net cash, we mean that its stock is selling for less than the total of its cash and marketable securities less all of its interest bearing debt divided by its shares outstanding.

OID: No business liquidation required.

Briggs: Exactly. So, anyway, one reason why these companies survived such a prolonged, severe recession is that they had the capital structure required to survive. Also, because there has been such a prolonged severe recession, they weren't in a hurry to deploy capital in their business. Thus, for both reasons, many of these Japanese companies tend to be very cash rich.

And so, watching these markets fall, you can't help but wonder whether we could have the same kind of sentiment in the U.S. or Europe at some point where value seems to mean *nothing* — absolutely nothing.

OID: Like 1974-75.

Briggs: That's right. Peter keeps his notes and selected research from those days. And it makes for fascinating reading. There were hundreds of net-nets then — in all different types of businesses.

And that's exactly what we're seeing in Japan. Because of the weak yen and restructuring, the earnings of the big exporters have begun to surge. Therefore, those stocks have already rallied sharply from their 1995 lows. But when you go down in market cap, prices drop off a cliff. Stocks sell at 1984/85 prices and at big discounts to book. It's as if people assume that all of these companies are going to go bankrupt — despite the fact that so many are hugely overcapitalized and that they generally possess very large net cash positions.

Investors — and I don't even like to use the word because I think it gives them too much credit...

OID: How about financial market participants?

Briggs: That's better. It's almost humorous. But you can't help asking yourself whether you're missing something. We believe we've done our homework though and that's what keeps us positive.

Also, we're under no time pressure — which is great. But it's hard to get used to the downside. I thought a stock was cheap trading at a 20% discount to net cash. And the next thing I know, it goes to *half* of net cash.

OID: Let's be sure to talk about that one.

Briggs: In fact, Japan and Singapore are giving us an opportunity to overlap Buffett and Graham — to utilize Buffett's principles without sacrificing Graham's criteria. Today, we're able to buy great businesses — broadcasting businesses among others, believe it or not — with wonderful franchises for less than their net-net and, in some cases, less than their net *cash*.

OID: The best of both worlds.

Briggs: Yeah. It's funny. Would someone in Japan know newspapers or broadcasters are great businesses? Not necessarily. So within Japan, you can find publishers — very stable companies that are very integral parts of Japanese culture — that few foreigners know about that perhaps aren't being managed properly, but which are great businesses. And you can buy those great businesses at prices meeting the very strict criteria Graham espoused.

But among the things you *can't* control is the economy. One risk always is that the macro situation continues to deteriorate. But as Tim says, if you've got a margin of safety based on assets *and* business value — you have two things to fall back on. If the asset deteriorates, you have the business. And vice versa. I think that makes sense.

OID: Both when it comes to preserving capital and maximizing prospective returns — what you might call double-barreled bargains.

Briggs: That's right. That's exactly what they are. And we're finding lots of those, too. We're getting the opportunity to do it in Singapore where there's been a virtual free-fall in share prices. Just as so many U.S. stocks seem to be anticipating doing super-fine forever, many stocks in Japan and Singapore seem to be discounting 5-10 years of severe recession. Therefore, both countries are very good hunting grounds for us today.

U.S. BASHING IS OUT AND JAPAN BASHING IS IN.
BUT CHANGES ARE DRAMATIC, IMMINENT & REAL.

Briggs: But whenever we invest outside of North America, we're dealing with a different culture and a different legal/regulatory environment, among other things. Therefore,

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we believe it's especially important to be plugged in and establish relationships with local partners on the ground — because that's how we learn what's *really* going on.

OID: In the terminology of Warren Buffett, to learn who the patsy is and try to make sure it's not you.

Briggs: That's the idea. So we've focused on building the right infrastructure. But even then there's no way that we can know what's happening long distance. Therefore, we make a point of traveling to Tokyo each quarter.

OID: Since most of our subscribers have day jobs, could you save us a trip by just giving us the poop?

Briggs: At the Cundill Conference, we talked about Japanese equity mutual fund assets, how they exceeded those in the U.S. as recently as 1989, but were now only about 1/19th of those in the U.S.

OID: An incredible statistic.

Briggs: It really is. But it's gotten even lower since. Now they've fallen to less than *1/25th* of those in the U.S.

And that's another thing that makes Japan attractive. *So* much money there — *huge* pools of capital — aren't invested in equities.

OID: Although it sounds like momentum investing remains in vogue. And given their relatively elderly population, they'll need to draw down those savings all too soon — particularly if, as Peter points out, savings continue to earn microscopic returns.

Briggs: True. But it's the second largest economy in the world. The country's very highly developed. Its citizens are highly educated. And although corporate governance leaves much to be desired, Japan is serious about change.

OID: Although that is a contrary opinion.

Briggs: Very much so. But that's one of the things we believe wholeheartedly — that we have conviction about. Japan is changing. There are signs of it everywhere.

And yet 99.9% of people are *negative* about Japan. We can find virtually nothing positive written about the Japanese stock market — by anyone anywhere.

OID: You may be able to call us nobodies, but when Marty Whitman reads this, you're gonna be in trouble.

Briggs: A few of us are in it because we see value. And, therefore, that makes us positive about it because it meets our investment criteria. But there are *very* few. And we like that very much.

Instead, just as it was popular during the late 1980s to bash America, what's in style now is *Japan* bashing.

OID: Very much so.

Briggs: However, anyone who thinks the Japanese are stupid is in for a very rude awakening. They adapt, but they do it quietly. And the next thing you know, they've taken your market share. Ask Kodak about Fuji.

OID: And risk our PG rating?

Briggs: That's a terrific case study. In the summer of 1995, with Fuji Photo's share price at ¥1,900, I tried to find anyone with positive feelings about Fuji. I couldn't. There was virtually no one.

OID: Aside from SoGen's Jean-Marie Eveillard and Brandes Investment Partners' Charles Brandes....

Briggs: That's right. And the weak yen helped. In 1992-93, the exchange rate was about the same as today. But in between, Fuji suffered the shock of the yen strengthening all the way to ¥80 to the US$1.00. Still, Fuji just kept quietly building, researching and developing. And they very quietly laid the groundwork in the U.S. So when they were finally released from the shackles of a strong yen — as it moved up towards ¥1268 to the US$1 — they took away serious market share from Kodak.

And I'm no expert on photographic technology...

OID: Feel free to call anytime.

Briggs: And Fuji's been very aggressive on pricing. But I believe it also has some terrific technology.

OID: Jean-Marie told us that photographers in the know swear by Fuji film — that it's clearly better.

Briggs: I've paid attention to what Jean-Marie's been saying about Fuji. And I think he's right.

But, once again, I think it goes to show that when Japan has a serious problem, they don't react with *words*, but with *deeds*. Eastman Kodak even resorted to relief from the World Trade Organization. But Fuji won there, too.

And it's funny. Again, we bought Fuji around ¥1,900. Here it is 2-1/2 years later. Its stock is up around ¥4,800. And every place I come across any kind of reference to Fuji, it seems to be "Buy, buy, buy."

OID: And you're hoping Fuji's experience will turn out to be more the rule than the exception.

Briggs: I don't see why *not*. Japanese managements finally have the tools they need to do a relatively painless restructuring. They can reduce their net cash position by distributing cash to their shareholders via dividends or share buybacks. Japanese companies can now implement stock option plans to incentivize management to achieve ROA and ROE targets. Shareholder-oriented capital allocation won't become the norm in Japan overnight. But stock options will no doubt help that process along.

Similarly, one fear associated with investing in Japan is the overhang of crossholdings where shares are owned for reasons regarding relationships and not returns — reasons which will no longer be valid in the "New Japan". In other words, people figure that some shareholders will want to get rid of their shares. That's a classic reason why people say the Japanese market *should* be cheap — because of this huge overhang of shares.

OID: Because people worry that those shares will be sloshing around for awhile.

Briggs: Exactly. But shareholder composition is changing fast — from the hands of banks and the like who have been very passive and who don't really care so much about shareholder value to pension funds and others like us who care about it a *lot*. And there's no question that the

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changing shareholder composition will make a difference.

That overhang of shares will need buyers. And the companies know it. Thus, more and more representatives of these companies are coming to the U.S. to find shareholders with a long-term perspective — shareholders like us who won't take the shares and flip 'em.

Meanwhile, the Japanese pension funds are totally *under*-invested in equities.

IN THE INSURERS, WE'RE NOT PAYING FOR THE SIZZLE. IN FACT, WE'RE NOT PAYING FOR THE STEAK.

Briggs: As you know, one of the industries in Japan on which we're most focused and in which we're most active is the property and casualty insurance sector.

OID: And, as I recall, both Peter and you agreed that it was the most undervalued industry in Japan.

Briggs: That's right. For example, in aggregate, all of the Japanese property and casualty insurance companies combined have a total market cap of a mere US$45 billion versus around *US$500* billion for Japan's banking industry.

OID: Less than 1/10th the size?!

Briggs: You've got it. And here's a better comparison: The largest property and casualty insurance company in the U.S. is Allstate with a market cap of US$40 billion — all by *itself* — versus a US$45 billion market cap for Japan's entire property and casualty insurance industry.

OID: Wow.

Briggs: Making that comparison more stark still, that US$45 billion of total market cap for Japanese insurers includes Tokio Marine — which is by far the largest and most expensive Japanese insurer of all. If you exclude it, the figures would be far more striking.

OID: Amazing.

Briggs: It is. Japan's property and casualty insurers are *very* undervalued. And their total market cap is not so low because Japan's insurance industry is tiny — quite the contrary. In terms of premium volume, it's second only to the U.S. So it's a massive, massive industry. Those market cap disparities are primarily the result of the Japanese insurance industry's dramatic undervaluation. For example, excluding Tokio Marine, the average non-life insurance company in Japan probably trades at about 50% of U.S. GAAP book.

OID: That sounds mighty cheap, all right.

Briggs: I think it very clearly *is*.

OID: I understand that Third Avenue Value Fund's Marty Whitman would agree.

[Editor's note: See our December 29, 1997 edition.]

Briggs: Marty Whitman is pretty heavily invested in these Japanese non-life insurers, too. In fact, we helped each other get up the curve on these things about a year ago.

OID: No wonder he said you guys know that area well. I just figured you might be related by marriage...

Briggs: His commitment to the sector is every bit as serious as ours.

OID: That sounds like a mighty good sign to me. Marty seems to have a habit of being right...

Briggs: It's true. Besides Marty, we've been working with Staley Cates at Southeastern Asset Management. And his rationale, by the way, was simply that some of these insurers trade at around 5 times economic earnings and at very attractive discounts to net asset value and that most of the net asset value consists of holdings of companies which themselves have depressed share prices and depressed margins and very good balance sheets.

I could also make the case that these businesses have potential and that they're worth a fair multiple of earnings or, at least, a meaningful premium to book. But since we're not paying anything for that potential — or their insurance businesses, for that matter — why bother?

OID: Well, it's sorta customary in our interviews...

Briggs: In fact, since we're usually paying less than 50% of U.S. GAAP book value, we're even getting the *assets* at a discount. So it's sort of a *double* margin of safety.

LIES, DAMN LIES AND BOOK VALUES — AT 40% OF PRETAX BOOK, MITSUI'S A STEAL.

OID: Among the insurers you're not paying for, might we ask you which ones are the best bargains today?

Briggs: Sure. But to understand these companies, first you need to understand that Japanese accounting is very conservative. For example, Japanese GAAP doesn't allow insurers to mark their portfolios to market. Therefore, they stay on the books at their historical cost. Also, Japanese GAAP allows companies to include a "catastrophe reserve" as a liability against their book value. Therefore, book value under Japanese GAAP is usually only one-half or one-third of book value under U.S. GAAP.

Today, only Tokio Marine and Mitsui report in U.S. GAAP. But we expect more and more of these Japanese companies to elect to report using U.S. GAAP. And we're pretty accounting-intensive, as you know.

OID: Nobody's perfect.

Briggs: So one of the things that makes these Japanese insurers so neat is that all it takes is a few simple accounting adjustments to see that these things are trading at enormous discounts to intrinsic value.

But you asked which were the best bargains today. The *cheapest* non-life insurers — at least on the basis of price to U.S. GAAP book value — tend to be the *smallest* ones. Unfortunately, the smallest ones tend to be the least well managed and least efficient ones, too.

OID: No problem. One learns to live with that...

Briggs: For example, in part because it's the largest,

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Tokio Marine has the lowest expense ratio in the industry — less than 35%. But it's also the most expensive member of the group at more than 1 times U.S. GAAP book. So all of these insurers are very cheap, but they tend to be priced more or less appropriately relative to each other — given their respective efficiencies.

But there are exceptions. For example, Japan's four largest non-life insurers are Tokio Marine, Yasuda, Mitsui and Sumitomo. Those four have a combined market share of nearly 50% — 20% held by Tokio Marine and about 10% held by each of the other three.

As you might expect, because those three don't have the same market share as Tokio Marine, they don't enjoy the same economies of scale either. Therefore, their expense ratios range between 36% and 40% — which is not as good as Tokio Marine's, but better than those of most of their smaller competitors.

And the cheapest of the three by far — the greatest inefficiency among the largest insurers — is Mitsui.

OID: Based on your comments at the Cundill events, it sounds like you think it might be a bargain.

Briggs: Mitsui is *definitely* a bargain. Absolutely. Mitsui's U.S. GAAP book value is nearly ¥1,300. And today, it's trading at less than ¥700. So it's trading at a discount to book of more than 45%.

OID: That sounds cheap, all right.

Briggs: It is. But here's the kicker: Implicit in the calculation of a company's U.S. GAAP book value is the assumption that it realizes the gains in its portfolio and creates an account called "deferred taxes" to account for taxes which would result from those gains being realized — in other words, which would be due on sale.

But Mitsui and most of these other Japanese insurers *aren't* going to be selling their core holdings any time soon. Therefore, in Marty Whitman's words, those deferred taxes amount to "quasi-equity". After all, they count in judging a company's capital strength and in estimating its capacity to write insurance and enter new financial businesses.

OID: As long as those positions aren't sold.

Briggs: Which it's not going to do any time soon. And the cost basis of these holdings tends to be minuscule for two reasons: First, those positions have typically been owned not for years, but decades — since they usually have more to do with relationships than returns.

Also, because the holding periods of these positions most often include that of the Japanese Economic Miracle — decades during which most Japanese stocks experienced remarkable growth — their cost basis tends to be a tiny fraction of their price today.

And, by the way, the effective tax rate on capital gains in Japan today is approximately 50%.

OID: No wonder they've had a prolonged recession...

Briggs: Our thoughts exactly. And one of the ways we expect Japan to begin treating capital providers better is by lowering its effective capital gains tax rate.

[Editor's note: In Charles Adams' remarkable book — *For Good and Evil: The Impact of Taxes on the Course of Civilization* — Adams points out (1) that the savings rate in prewar Japan was no greater than in the prewar U.S.; (2) that the high propensity for saving which the Japanese are known for today occurred only after tax rates on interest income and capital gains were lowered following the waning of influence of U.S. postwar occupation forces; (3) that such "incentive[s] for growth ... accounted for much of Japan's economic miracle"; and (4) that "In 1989, ... Japan replaced its low capital gains withholding tax with a high American style tax. As soon as this happened, the Japanese stock market collapsed. Just a coincidence?"]

Briggs: So for all of the reasons I've mentioned, the deferred taxes in these insurers tends to be *enormous*. Mitsui, for example, has total deferred taxes approaching ¥350 billion. Therefore, when we divide that figure by Mitsui's 726 million shares outstanding, we estimate that it has deferred taxes — "quasi-equity" or whatever you want to call it — of about ¥477 per share.

Granted, those positions may be sold one day. And, therefore, even though I think any such sale would very likely occur only during a time when the effective tax rate on long-term capital gains in Japan is lower than the current 50%, one should probably not add back 100% of Mitsui's deferred taxes. But depending on how much of that ¥477 per share you add back to its ¥1,300 of U.S. GAAP book value, you can arrive at an adjusted book value of up to *¥1770*.

OID: So Mitsui could be selling for as little as 40% of adjusted book value — or pretax book, in any case?

Briggs: Exactly.

A PORTFOLIO OF (MOSTLY) GLOBAL COMPANIES WITH THE WIND TO THEIR BACKS AT 40-60% OFF.

Briggs: And one could argue that Mitsui's portfolio is *better* than the portfolios of other insurance companies because its holdings are mostly international companies — even global. For example, it owns 91 million shares of Toyota Motor. That stake alone is worth ¥425 per share of Mitsui. Plus, Mitsui owns stakes in companies like Denso (a big Japanese auto parts company), Fuji Photo, Sharp and Suzuki Motor. So the nature of those holdings gives them a little extra margin of safety, too.

OID: Particularly, I suppose, if you believe that a cheap yen gives them a competitive advantage.

Briggs: Exactly. When the yen got strong, the big Japanese exporters had to cut their costs and lower their break-even. In 1995, when the yen strengthened all the way to 80 yen to the US$1, I recall hearing things like, "We must be prepared to make money with the yen at 90 to the US$1."

So these big, international companies were the first to aggressively restructure, cut costs, etc. And they're now well into restructuring American-style as a result of the yen crisis. Sony, Canon and Fuji Photo and all of the major companies rationalized and reduced their break-even. For example, Toyota Motor drove its break-even point down by 28%.

OID: I get the picture.

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Briggs: So they prepared to compete with the yen at 90 to the US$1 and here it is today up around ¥128. So, as you'd expect, their earnings are beginning to surge.

OID: On the other hand, you mentioned that stocks of the exporters have already rallied and had gone from being the cheapest sector to being less undervalued than the domestic companies.

Briggs: That's right. They aren't as cheap as they once were. And on average, they sell at higher multiples of book than domestic Japanese companies. However, I don't think they sell at a higher percentage of their intrinsic value. They *deserve* a premium valuation. Besides being much further along in the process of reforming and rationalizing themselves, the large international players are the most likely beneficiaries of globalization and rising living standards in Asia.

OID: In other words, invest as I say, not as I do?

Briggs: That's not how we invest. But Japan's global companies tend to sell at lower multiples of cash flow than do similar companies in the U.S. and even Europe. And Japan's been in a recession for seven years. So they're selling at lower multiples despite being based — more often than not — on more depressed results.

For example, on *paper*, Toyota Motor is arguably the most expensive automobile company in the world.

OID: So you only do the figures in your head?

Briggs: But for a variety of reasons, it's not as expensive as it looks. For example, Toyota plans to obtain a U.S. listing — in the year 2000, as I recall. As part of that process, they're expected to switch to U.S.-style financial disclosure. And it's been hiding a lot of earnings — which you'll see when they make the switch.

Also, they're the largest auto company in the world as measured by market cap without a large credit subsidiary. At Ford, for example, a big part of their earnings and value is derived from those credit subs. How many times have you heard the argument about how cheap the automobile areas of those companies are — 5 times earnings or whatever — when you back out the value of those credit subs? They're *hugely* profitable — way more profitable, in fact, than their auto business.

OID: Everything's relative.
But how does that help Toyota?

Briggs: Toyota's carrying around a huge cash position — and earning next to nothing on it. So Toyota's only earning 7-8% on equity today. But between the release of its hidden earnings, the building of a major credit sub and the reallocation of its cash, it could increase its return on equity up to the 20% that the U.S. auto companies are earning today.

Finally, although Toyota is a force in the U.S. and elsewhere outside Japan, slightly over half of its sales are derived within Japan. And Japan's automobile market is on its back today. It's virtually bombed out.

Also, Toyota's making substantial inroads in the U.S. They're taking away market share from the Big Three. The U.S. companies have earned enormous profits from the sale of light trucks and vans. Some have even said that those sales were their salvation in recent years. Well, Toyota's never been a serious player in those segments. But now it's begun to make significant inroads in that area. And those should be very high margin sales.

OID: At least until the field gets too crowded.

Briggs: And we've already talked about the cheap yen providing Japanese exporters with a powerful tailwind. So Toyota isn't nearly as expensive as it looks. And Toyota accounts for less than a quarter of the value of Mitsui's portfolio. So even if you were to give that holding a 50% haircut, Mitsui is still extremely compelling. I don't think there's any question about it.

But whether it's expensive or not, the other 77% of its portfolio is not. For example, Sharp is near a 5-year low. Fuji Photo doesn't look expensive.

OID: Jean-Marie Eveillard apparently doesn't think so. It's one of SoGen International Fund's top purchases according to Portfolio Reports.

Briggs: And another Mitsui holding — Ito-Yokado, the Japanese supermarket chain — is one of Jean-Marie's favorites, too...

OID: Even without a 50%+ discount and an insurer thrown in for good measure.

Briggs: Exactly. But he may like the package, too — since he's also buying the insurers.

HIGH MARKS FOR BUSINESS MANAGEMENT,
NOT SO HIGH FOR CAPITAL ALLOCATION.

Briggs: Another reason why Mitsui's discount may be larger than the other similar-sized Japanese insurers and other Japanese stocks generally is that it recently issued shares at a discount to its U.S. GAAP net asset value — which is clearly dilutive.

OID: Yeah. Marty says that they issued US$320 million worth of shares at a 57% discount to net asset value.
But to whom were those shares issued?

Briggs: It looks like 75% of the new shares were offered to foreign shareholders — not to anyone in particular, just a straight issue to build up its Japanese book value. But we believed that Mitsui was ahead of the curve in terms of looking after shareholders. Issuing shares at a discount to book value is clearly a step backwards.

But as part of the process of selling that issue, Mitsui had its first-ever dog and pony show in the U.S. And as you might expect, there were some unhappy shareholders in attendance. Besides yours truly were Marty Whitman, Mason Hawkins and Staley Cates. And among those representing Mitsui was its president.

Needless to say, one question that Marty, Mason and I all had was *why* they were doing it.

OID: A good question. Did they have a good answer?

Briggs: Not really. They were overcapitalized to begin with. The president's stated rationale was that most of

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Mitsui's capitalization consists of latent gains within their portfolio holdings. And U.S. GAAP assumes those positions are sold and the taxes paid on those gains. But they're forgetting to think in terms of U.S. GAAP. They're still thinking in terms of Japanese GAAP where those positions are carried at their historical *cost*.

OID: Did you suggest he tie a string around his finger?

Briggs: He's not off base entirely. As he pointed out, "These big latent gains aren't real capital because we won't sell those positions. And one reason why we won't is that we'd lose those companies as customers if we did. Thus, since we can't realize those gains, we need *real* capital."

OID: Pray tell what does he need the capital for?

Briggs: Nothing. He just figured that excluding the latent gains, Mitsui's ratio of equity-to-assets is lower than that of Tokio and Sumitomo. And he wanted Mitsui to be on par with them by that measure. But don't ask me why.

OID: They just want to keep up with the Sumitomos.

Briggs: That's about the size of it. It's really bizarre because including those gains, they're *way* overcapitalized. And the gains are real since they're marketable securities. Basically, he *couldn't* rationalize it.

So Mason, in effect, told him, "We're supportive of management, but we can't figure out why you're doing this. It's unquestionably a step backwards. Instead of *issuing* shares at this price, you should be buying them *back*."

Mason told him, "Based on your economic earnings, we figure your cost of capital at your current stock price is up around 20%. So it's a bad deal all the way around." That 20% figure, by the way, is based on Mitsui selling at about 7 times economic earnings — flow-through earnings the way Buffett calculates it for Berkshire.

OID: When Mason says economic earnings, what does he assume for the earnings on Mitsui's portfolio?

Briggs: I'm not sure. But from what I've seen of Staley Cates' work, he's probably assuming a 4% return on the current market value of Mitsui's equities.

OID: That sounds pretty conservative, all right.

Briggs: It sounds pretty conservative to me. Then Mason and Marty suggested the president discuss the concept of flow-through earnings in its next annual report.

OID: Awesome idea.

Briggs: It really was, although it's hard to imagine them doing it this year. So, anyway, we just told him that we were supportive of management and went on to make a couple of suggestions...

OID: Such as not issuing any more shares as though they were toilet paper?

Briggs: That was one suggestion. Another was that they implement an incentive compensation plan with awards of stock options based on achieving certain targets. And they said they're considering changing their articles of incorporation this year — in the year ending March 1998 — to enable them to do that.

One director even suggested that they might consider doing a share buyback — although that's kind of bizarre since they'd be doing it on the heels of a share issuance.

OID: When it comes to learning, late beats never. Speaking of which, did you learn anything else?

Briggs: Not really. We just confirmed what we knew — that they're very good at running an insurance business and that they have an opportunity to grow the business and gain market share. Mitsui's #3 today. And they expect to take share away from smaller, less efficient players — thanks in part to their greater economies of scale — and become a bigger player in Japan, which we expect as well.

And they're doing other things, too. For example, they've entered the financial guaranty business in the U.S. in partnership with a company called Cap Mac. So we believe that the president's very credible from that perspective.

Unfortunately, in terms of looking after shareholders, this management has failed miserably. They need to clean up their act in that category. So far, at least, they seem to be horrible capital allocators.

OID: More shareholder-oriented corporate management in the U.S. wasn't built in a day either.

Briggs: True. And, hopefully, they'll come around. Who knows? Maybe they'll even redeem themselves by announcing a share buyback and begin to take care of shareholders. In any case, they do need to behave in a more shareholder-friendly fashion — because if they don't, they may find themselves replaced by a management that will. We were just trying to convey to them that relative to comparable companies around the world, they're already hugely overcapitalized. They need to recognize that.

The president understands that doing business based on owning stakes of other companies will disappear in the New Japan — that success will be based on service, not ownership. But not yet.

On the other hand, subsequent to Mitsui's new issue, foreign shareholders own more than 24% of its shares.

OID: That sounds like a plus to me. But, presumably, you're putting your money where your mouth is at today's price?

Briggs: Our average cost for Mitsui is about ¥600. But we've paid up to ¥750. And, again, it's trading at less than ¥700. So it's *definitely* still compelling in my view.

KOA'S AVAILABLE AT A SMALL INSURER PRICE, BUT WITHOUT THE SMALL INSURER BAGGAGE.

Briggs: Another Japanese non-life insurer that we think is mispriced — one of the smaller non-life insurers — is Koa Fire and Marine. Its GAAP book value is near ¥1,000. And yet, it's selling at just over ¥600 — or only about 60% of U.S. GAAP book.

And that book is net of deferred taxes of about ¥400 per share. So if we apply the same methodology to Koa that we did to Mitsui, then Koa's adjusted pretax book could be ¥1,400 — or well over 2 times today's price.

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OID: A mighty fine start.

Briggs: And Koa isn't likely to sell very many of those positions any time soon either — at least until the tax code is changed. And those discussions are already underway. For example, we understand that they're talking about allowing companies to utilize consolidated taxation — whereby holding companies utilize losses in one subsidiary to offset gains in another.

OID: And I imagine that there are plenty of tax losses these days...

Briggs: You better believe it. There's still a lot of uncertainty about how that's going to unfold. But I think there's an excellent chance of Koa's gains and the gains of other insurers being taxed at a rate far lower than the 50% assumption used to calculate their U.S. GAAP book value.

Koa's largest corporate shareholders, incidentally, are Nippon Express and the Sanwa Bank — the largest general transport company and the largest and one of the strongest retail banks in Japan, respectively. We view their involvement as a big plus. Koa management tells us that it plans some form of joint marketing effort with Sanwa. And Koa's already begun to market its policies to Nippon Express customers. Also, needless to say, it's hard to imagine either firm turning to anyone else for insurance that Koa can write.

So the strategic benefits of having Sanwa Bank and Nippon Express as large shareholders are a major plus.

OID: At least until Sanwa Bank and Nippon Express dispose of their unrelated holdings.

Briggs: That's right. But as I said, when you forego the larger insurers, you forego their greater market shares and their greater economies of scale. Therefore, with the Japanese insurance industry on the eve of deregulation, those kinds of strategic relationships may prove to be particularly important today. In fact, they could literally turn out to be the difference between success and failure.

I don't know yet what form any such joint marketing effort between Koa and Sanwa will take. Sanwa could buy Koa out in whole or part or form a financial entity Koa and Sanwa own jointly. So picturing what Koa will look like in a few years is hard to do. But it'll probably look different.

OID: I can't help but notice that Koa's expense ratio is north of 40%.

Briggs: Again, the smaller insurers' combined ratios tend to be higher and their managements weaker — although Koa's management may be average. So that's probably just a function of Koa not having the same economies of scale as the larger insurers.

OID: And Koa's portfolio?

Briggs: You do get a large holding in Sanwa Bank.

OID: One of the dreaded Japanese banks...

Briggs: Exactly. But Japanese banks are interesting. They are expensive based on their current earnings and adjusted book value. But relative to their normalized future earnings — especially after Big Bang — it's not at all clear that they're expensive. They may even be cheap. And Sanwa only accounts for 7% of Koa's portfolio anyway. So I don't think it's really much of a factor.

OID: May I ask what you've paid?

Briggs: Koa is the one we've owned the longest. We've had a small position — on and off — in it dating back to the 1980s. However, we bought the lion's share of our position roughly two years ago. We probably paid ¥480 to ¥670 for it. And, again, it's trading at about ¥580.

AND NISSAN IS NOT WITHOUT ITS SERIOUS FLAWS,
BUT OH WHAT A DISCOUNT (TO A DISCOUNT).

OID: Might we trouble you to tell us about one more?

Briggs: One thing you get with the smaller insurers — except for Koa (which has strong partners already) — is a much greater likelihood of some kind of deal. Again, that's one of the potential catalysts that could unlock the values in these things.

And in that vein, another one that's intriguing is Nissan Fire and Marine. It's also relatively small. Mitsui, Sumitomo, Nippon and Yasuda are in one tier in terms of market share (10-20%) and market cap (US$3-4 billion). With Nissan — like Koa — you've left the realm of the top-tier insurers and entered the realm of the smaller ones. By smaller, I mean markets shares closer to 5% and market caps down around US$1 billion.

And like most of the smaller ones, it doesn't seem to be very well managed. In fact, it seems to be relatively *poorly* managed. On the other hand, the smaller insurers tend to sell at 40% to 50% of U.S. GAAP book value. Nissan Fire and Marine is trading at about ¥460. And its U.S. GAAP book value is up around ¥1,000 per share. So it's selling at slightly over 45% of U.S. GAAP book.

OID: Management schmanagement...

Briggs: And if you add back its ¥475 or so per share of deferred taxes, then Nissan Fire and Marine's adjusted book is nearly ¥1,500. So Nissan is selling down around *30%* of adjusted pretax book.

OID: Flaws notwithstanding, how can you resist?

Briggs: We *can't.* Our average cost in Nissan is about ¥520. But we've probably paid as little as ¥400 and as much as ¥600. So we've been averaging down.

Also, Nissan Fire and Marine is part of the Hitachi and Nissan groups. But it has no exposure to the failed Nissan Life. Nevertheless, when Nissan Life failed, confusion in the mind of the public led to a decline in Nissan Fire and Marine's premium volume — its first, incidentally, in many years, if not decades — and a decline in the price of its stock.

Also, Nissan Life owned a chunk of Nissan Fire and Marine shares. And although Nissan Life was liquidated, we still don't know where those shares are. However, their potential availability, in our view, makes Nissan Fire and Marine an even more likely candidate to be bought by some foreign partner — either in whole or in part.

As for Nissan having a lower expense ratio than Koa, I'm not sure what that's about. However, let me just say that we have confidence that Mitsui and Koa will reduce

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PETER CUNDILL & ASSOCIATES'
TIM MCELVAINE & DAVID BRIGGS
(cont'd from preceding page)

their expense ratios going forward. And we know that they're aggressively preparing for the Big Bang. We don't have that confidence in Nissan's management — at least not yet. But that may just be a function of our being less familiar with Nissan because it's a newer holding.

OID: How do Koa's and Nissan's portfolios compare? Are there any major pros or cons of one vs. the other?

Briggs: Both are widely diversified. Nissan Fire and Marine's portfolio consists primarily of companies from the Hitachi and Nissan groups which are themselves related. Hitachi group companies tend to be overcapitalized and undervalued. But the reason why they're undervalued is that they tend to have *horrible* corporate governance. They're classic "Old Japan".

The Nissan Group is more of a mixed bag. However, the Nissan Group's flagship — Nissan Motors — is a very highly geared auto company that's been losing share in Japan. Still, it's probably half the price of Toyota Motor on the basis of enterprise value to EBIT.

OID: So that Nissan Fire and Marine is more of a play on Japanese reform...

Briggs: That's true. On the other hand, because Nissan Motors has much more debt than Toyota and most of Mitsui's holdings, they're also more likely to go bankrupt in the event that there is continuing, prolonged distress in Japan. Still, Nissan Fire and Marine's portfolio is much more diversified than Mitsui's. So even if some of its holdings go bankrupt, you may be getting a greater discount anyway.

THE COZY OLIGOPOLY & RIGGED MARKET MAY GO.
HOWEVER, THE MOAT AIN'T GOIN' NOWHERE.

OID: I get the impression that you think these Japanese non-life insurers are good businesses.

Briggs: I do. I think they're *very* good businesses.

OID: Insurance isn't a commodity business?

Briggs: It is. But these insurers — with very few exceptions — operate with combined ratios below 100.

(continued in next column)

OID: Marty Whitman also told us these insurers had consistently earned an underwriting profit. But how could that be? Didn't most of them report underwriting losses as recently as 1992 and 1993?

Briggs: Marty's right. The 1992 and 1993 results are misleading. Japanese property and casualty insurers have pretty much *always* earned underwriting profits. In fact, they've tended to have combined ratios closer to *90%*.

What you're seeing is the impact of the typhoon — which I believe hit in 1992. Except for that typhoon, they've virtually *never* had an underwriting loss.

OID: That sounds impressive. But why? And what makes you think they'll be able to do it in the future?

Briggs: Historically, property and casualty insurance in Japan has pretty much been a rigged market. In effect, it's been a protected market. You could even argue that the Big Four — Tokio, Yasuda, Mitsui and Sumitomo — have maintained an oligopoly whereby they've managed the insurance market almost by collusion to keep prices high. It looks to me like they could take additional market share anytime they want. However, by keeping prices higher, they more or less maintain the status quo — by gaining *some* share, but not *too* much — and keep profits higher than they would be otherwise.

OID: But aren't the same reforms you expect to enable these insurers to earn higher investment returns, repurchase shares and incentivize their managements also very likely to eliminate their cozy oligopoly?

Briggs: Absolutely. That's one of the risks. But since we're buying 'em at a huge discount...

OID: And why won't low-cost players from the U.S. and elsewhere who are already much more efficient come in and take over the Japanese market?

Briggs: That fear is one reason why these insurers are so cheap. But I think it's overblown. In my view, foreign insurers *can't* take over this market. It's even hard for them to enter Japan and grow. Hank Greenberg's been able to grow American International Group organically. But it's the exception. And it took him 30 or 40 years.

Some people suggest that foreign companies will be able to sell insurance direct. But even the direct business is going to be a very slow process.

OID: Why do you say that?

Briggs: Japanese auto insurance is very interesting. Listen to this statistic: In terms of *total* premiums paid, Japan is the second largest market in the world — second only to the U.S. However, in terms of insurance premiums per *capita*, Japan ranks only 7th. And they rank 28th in terms of insurance premiums relative to GDP.

OID: So?

Briggs: In Japan, there's very little crime, very little theft and very few accidents...

OID: And very little litigation.

Briggs: Yeah. Because there are very few lawyers.

OID: Now there's an enormous plus. But your point?

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Briggs: Therefore, auto insurance rates are very low — averaging no more than US$400-500. And the difference between different insurers' rates may only be US$40-50. That's not enough of a difference to justify the hassles associated with changing providers for most people.

Therefore, price is a far less important factor in Japan than it is, for example, in the U.S. The most important reason why people stay with their auto insurer — and, therefore, the most important competitive element in Japan — is *service*. It's all about claims servicing, customer service, etc. — about the ability of companies to have representatives come out and look at their cars when they have an accident and so forth.

To be successful in Japan, insurance companies need distribution, claims service and relationships with agents, etc., that would take any foreign entrant *years* to develop. So without strategic relationships with local insurers, foreign insurers don't have a *prayer*.

OID: You say that with such conviction...

Briggs: Therefore, it makes sense for foreign insurers to *buy* into these Japanese insurers — maybe even buy 'em outright. So some of the more aggressive global players will probably do deals with some of the smaller companies.

And although we doubt that those deals will be hostile — at least right away — when it *does*, you can imagine what'll happen to the prices of these stocks. Some of them are so cheap that even if acquirers pay a big premium, they may be able to buy 'em at a discount to net asset value.

FOR JAPANESE NON-LIFE INSURERS,
BIG BANG COULD MEAN BIG BUCKS.

Briggs: As Marty Whitman says, they have huge "surplus surplus". Their bad debt problem is negligible. They never even came to that party. They're selling at dramatic discounts to their net asset value and at low single-digit P/E multiples of their economic earnings — even assuming modest returns on their equity portfolios. What else could you ask for?

OID: A bright future and long-term financing?

Briggs: I think their future is likely to be *very* bright. It's easy to forget that these things aren't closed-end funds. They're insurance companies. They're so cheap that you don't need to consider the value of their businesses. However, they have very *substantial* value.

OID: I imagine you wouldn't care to hazard a guess about what kind of returns on equity and the like that those businesses are likely to earn...

Briggs: Their current earnings are depressed right now for several reasons. First, they're writing nowhere near the level of premium volume that their surplus allows them to write. So there's significant untapped earning power there. Second, their investment earnings are depressed by the extremely low investment yields prevailing in Japan today.

OID: Which you expect to change with the Big Bang.

Briggs: Exactly. And because the accounting that these insurers use is extremely conservative, their reported earnings are very understated. As I said before, they maintain something called a "catastrophe reserve". And each year they write off an allowance for it.

OID: Like many European companies — just in case a huge meteor should come down and destroy millions of cars or some other equally improbable contingency.

Briggs: Exactly. In addition, they expense all of their commissions in the first year rather than amortizing them over the life of the policy. So all of these companies are trying to understate income. But if you adjust their earnings to U.S. GAAP, despite all of the factors we've talked about (with the exception of Tokio Marine which trades at a huge premium to the rest of the sector), their P/Es are relatively modest even today — with most trading for between 11 and 15 times earnings.

And if you add their look-through earnings to their U.S. GAAP earnings to arrive at economic earnings — the way Buffett does at Berkshire — aside from Tokio Marine, they're probably trading at around 5 times very depressed earnings, probably less on average. Even Tokio Marine is probably selling for about 11 times economic earnings.

But that's Japan. One of the great secrets of Japan is the number of overcapitalized, cash-rich companies. It's quite remarkable actually. There's so much potential. So much could happen with these overcapitalized companies.

For instance, there's a *huge* amount of savings — an estimated US$12 trillion of household savings alone.

OID: That's incredible. Unless my math is mistaken, that would be over US$100,000 per U.S. household. And Japan's population is half the size...

Briggs: It's an incredible statistic. And very little of that US$12 trillion or so of household savings is being serviced properly — at least yet. But as Peter said, one of the big forces driving reform is the need for those savings to earn higher returns. So accompanying the Big Bang — you might even say a component of it — will be enormous growth in the investment management business.

Meanwhile, these insurers have decades of experience managing their own assets. And since the mid-'80s, they've also offered GICs — Guaranteed Income Contracts — to their policyholders guaranteeing them a fixed return on a portion of their premiums. So they already have their toe in the water managing assets for retail clients.

I see no reason why some of them shouldn't be able to expand their retail business by offering mutual funds, enter the institutional side and expand into other niches in the financial services business.

OID: You say that like it's a positive. However, isn't it di-worse-ification?

Briggs: Investment management, run properly, is a fine business. That's one of the primary areas that insurers are going to focus on once the Big Bang arrives. And we think they have a very good chance to garner a meaningful piece of that business.

OID: Through a combination of existing infrastructure, goodwill and enormous financial muscle.

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Briggs: Exactly. And because they are so enormously overcapitalized and have so much financial muscle, you don't have to worry about them lacking the resources to survive or the wherewithal to muscle their way into whatever businesses make sense.

OID: There you go again sounding like Marty Whitman.

Briggs: These insurers are the healthiest institutions in Japan. They're starting from a position of great strength. And for all of the aforementioned reasons, they're uniquely well positioned to be major beneficiaries of the Big Bang and major players in the Japanese financial services sector post-Big Bang.

And with Japanese savings up around US$12 trillion and the total market cap of these insurance companies currently only around US$40 billion, it's easy to figure out that even if these insurance companies are *half* smart and things were to go *half* right, a tiny piece of that market could be a coup for at least some of these insurers and their shareholders.

Therefore, in addition to earnings from their core insurance segment, some of these insurers could find themselves with substantial income from other sources — similar to non-interest income earned by banks.

OID: So these insurers should earn decent returns — even if we can't pin you down as to how decent.

Briggs: Exactly. So much change is underway and in prospect that I really couldn't even begin to guess what kind of return on equity these insurers will ultimately earn. But for all of the reasons we've discussed, I see no reason why their ROEs shouldn't be *plenty* respectable. However, since they're freebies anyway...

THE RULES IN JAPAN ARE CHANGING —
MOMENTUM FOR CHANGE IS VERY STRONG.

OID: What then could turn these ideas into mistakes — aside from a wide variety of geopolitical events or yours truly buying a few shares?

Briggs: Peter, Tim and I have talked about that. Given the assets and the business values and so forth, really the only thing that we can think of is the timetable. How long will it take for the changes we expect to occur? Therefore, much of the work we do is along those lines — evaluating whether things are indeed changing.

OID: What do you say to those who are skeptical about the odds of real reform in a country unable even to acknowledge its crimes against humanity during World War II, much less teach its children about it — except that the beastly Americans dropped the Bomb?

Briggs: That's a tough question — and a good point. There's definitely a history of denial.

OID: I strongly resemble that remark...

Briggs: But Japanese companies have had to deal with a severe hangover from the excesses of the late '80s — and they've had to do it in the context of an economy that's gone nowhere since 1990. So Japanese have felt worse and worse about themselves as time has gone by.

And it's coincided with a period in which North America has thrived. So why is Japan changing? It's not because foreigners *told* them to change.

OID: Or because it's the right thing to do.

Briggs: That's right. Japan's changing for one reason — because they *have* to. Their system's *broken.*

For the past 30 years, if you ran a Japanese company, you were friends with your banker. You may have been related by way of interlocking ownership interests. And you probably exchanged gifts with him. Perhaps your family even exchanged gifts with his. Those relationships were enormously important — perhaps more important than your capital structure or anything else.

But given the economic stresses of recent years, your banker had no choice but to begin looking out for himself. It became "every man for himself." That's what's causing the change. They didn't really have the luxury of whether or not to implement reforms. The writing was on the wall.

OID: It was either change or become sushi.

Briggs: That's right. So it took a crisis. However, as a result of that crisis, the rules are changing. And during the last year or so, things *have* indeed begun to change — and *dramatically* — in a variety of ways. We've talked about many of them. But let me give you one last example:

A lawyer I know who's based in Tokyo told me that he went out to lunch recently with some guys from MITI [Japan's Ministry of International Trade and Industry].

OID: Which most observers used to believe gave Japan such an advantage that we either had to copy it and out-MITI Japan or become a permanent has-been.

Briggs: Exactly. And this attorney said he made the mistake of paying for everyone's lunch with his credit card. Well, these four guys got so upset. They told him, "You have to change that bill. We can't accept your paying for our bill — because it'll look like you're bribing us."

OID: They prefer cash?

Briggs: That was within the last couple of months. Only a year ago, taking government officials out to lunch was standard business practice.

OID: And then they'd return the favor by being out to lunch when it helped you?

Briggs: Something like that. My friend wasn't trying to bribe 'em — either then or now. However, it gives you some idea of how much the normal ways of doing business are changing.

Here's another example: In the Old Japan, authorities would never have been able to go in and raid the Ministry of Finance without the authorization of the Prime Minister. They were totally untouchable. In fact, you couldn't even *criticize* 'em. But recently, prosecutors were able to walk right in through the front door of the Ministry of Finance and arrest two high officials. So today, they can arrest 'em, send 'em to jail and embarrass 'em all they want.

OID: That part certainly sounds like U.S.-style reform.

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Briggs: Now the Japanese are actually going after corruption in their central bank.

OID: Are they vilifying the prosecutors in Japan, too?
Briggs: Things are changing *fast*. So here we have this environment where the economy's shaky. And this lawyer used a line that I've been using. But it was good to hear him use it, too. He said, "The rules are changing. And the momentum [for reform] is very strong."

Incidentally, he also represents Japanese companies with investments in Canada and Asia — trading houses, brokers and everything else. And he says they're aggressively buying into companies throughout Asia — in Korea, Thailand and other markets which are flat on their backs. And Japan has huge interests throughout Asia already. But I believe when you look back — after these markets have recovered — you'll see that the prices they paid today were terrific.

A 50%+ DISCOUNT ON A PACKAGE OF ASSETS
WHICH ARE THEMSELVES VERY CHEAP.

OID: Tim suggested we also ask you about Haw Par...
Briggs: I think Haw Par Brothers International — Haw Par for short — is a *terrific* bargain. As of year end 1996, Haw Par had a stated book value of S$3.37. And you can buy it today for less than S$2.00.

OID: That sounds good. But is this a case where the book has been written up and is therefore misleading?
Briggs: Not at all. The only part of Haw Par's book that's been written up is a couple of their office buildings — which they revalued in fiscal 1996. And it was written up by only about S$.50 per Haw Par share. Everything else is carried on their books at historical cost.

In fact, when we adjust their largest publicly-traded equity holdings to current market prices — using what we believe are conservative assumptions — we estimate that Haw Par's net asset value is closer to *S$4.50*.

OID: It's sounding better and better.
Briggs: We began buying Haw Par at about S$3.00. However, it's come down quite a bit in the last few months — along with many other Singapore stocks. So we've been buying it quite aggressively.

OID: A 50%+ discount to net asset value sounds cheap. But what does Haw Par's net asset value consist of?
Briggs: It's *very* cheap because its net asset value consists of assets most of which are *themselves* very cheap. For example, the biggest component of its net asset value consists of a 6% stake in United Overseas Bank [UOB] — the fourth largest bank in Singapore. Each share of Haw Par owns one-third of a share of UOB — which is trading at about S$6.70 today. So each share of Haw Par owns about S$2.25 worth of UOB — more than Haw Par's current price all by itself.

And UOB is selling at a discount to *its* net asset value. UOB's book value as of year end 1997 was around S$6.00. But that's carrying its property portfolio at historical cost. Its current market value is easily S$1.50 more. So we estimate that UOB's net asset value is at *least* S$7.50.

OID: So valuing its stake in UOB at net asset value, Haw Par owns about S$2.50 per share of UOB.
Briggs: Exactly. And, frankly, I think it's safe to say that UOB is worth a lot *more* than its net asset value.

AND I GIVE HAW PAR'S REAL ESTATE A HAIRCUT
AND INCLUDE ITS LEISURE OPERATIONS AT BOOK.

OID: Before I ask why you say that, might you give us a thumbnail on the rest of Haw Par's net asset value?
Briggs: Sure. In addition to Haw Par's S$2.25 to S$2.50 worth of UOB, each Haw Par share also includes S$1.00 worth of real estate, S$.70 worth of leisure operations and S$.30 worth of Haw Par Healthcare — their Tiger Balm business.

And I think each of those valuations are conservative. I arrive at my figure of S$1.00 per Haw Par share for its real estate, for example, by adjusting its stated book *down* by a third.

OID: That doesn't exactly sound wild-eyed.
Briggs: And then Haw Par has leisure operations — including a Sea World-style oceanarium in Singapore and Spain, a bowling joint venture with Brunswick, golf ranges and a 20% stake in Sony Singapore.

[Editor's note: As we went to press, Briggs mentioned that Haw Par had just sold its 20% stake in Sony Singapore (at a premium, he believes, to its carrying value).]

Briggs: I assign those operations a net asset value of S$.70 per share of Haw Par — which is their carrying value on Haw Par's books.

OID: That doesn't sound too fishy at first glance either — unless those businesses are underwater or your assumptions are all wet.
Briggs: Not at all. The businesses are relatively new. But Haw Par has a hurdle rate — an ROE target — of 15% for the businesses in its leisure segment. And they say that they've achieved that target the last couple of years.

OID: So that your valuation of 1 times book is less than 7 times trailing earnings?
Briggs: You've got it. And management believes that they're good businesses,

OID: What do you think?
Briggs: I'm no expert on the leisure industry. But they seem to tend to be attractive, high-margin businesses with relatively high free cash flow.

OID: Is that because they tend to have high margins, low recurring capital expenditure requirements and little or no need to finance receivables?
Briggs: Probably so. Furthermore, they're plays on

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PETER CUNDILL & ASSOCIATES'
TIM MCELVAINE & DAVID BRIGGS
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rising disposable income in Asia — although given what's going on in the region today, leisure spending is likely to decline temporarily. But it's hard for me to imagine that disposable income and standards of living won't continue to rise over the long term. And if so, these people are going to want to do what we do. And that's going to include going to oceanariums, bowling, playing golf, etc.

HAW PAR MEDICAL'S A BARGAIN IN ITS OWN RIGHT
A FRANCHISE SELLING NEAR ITS NET CASH.

Briggs: Finally, last on the list of things that we're getting for free when we buy Haw Par is a majority stake in Tiger Balm via Haw Par's 75% stake in Haw Par Healthcare — until recently named Tiger Medical.

And Haw Par Healthcare's very cheap, too. It's selling at S$.90 — right at its net-net of S$.90, not much above its net *cash* of S$.77, at a discount to its year-end 1996 book of S$.98 and 7-1/2 times depressed 1996 earnings. So we think it's definitely a bargain in its own right.

OID: And may I ask if you're buying it directly, too?

Briggs: We are. But we're also buying it for nothing indirectly through Haw Par. Each Haw Par share owns roughly 1/3 of a share of Haw Par Healthcare — which, at current prices, is worth about S$.30 per Haw Par share. And since I'm valuing that stake at its current price in this analysis, I'm assigning no contribution whatsoever to its stake in the Tiger Balm franchise.

OID: I certainly don't mean to rub you the wrong way, but what's that?

Briggs: Tiger Balm is a menthol ointment that people use to treat a variety of ailments. For example, some use it as a deep heating rub for sore muscles. Others use it as a cold remedy by applying it to their nostrils. And still others rub it on their forehead to treat general discomfort.

OID: Does it help with the heartburn investors have gotten from owning Haw Par?

Briggs: I'll give it a try and let you know. Incidentally, Tiger Balm is an old Chinese medicine developed early in this century — 1911, I believe.

OID: In one presentation, you said it was a franchise that Buffett might love? What did you mean by that?

Briggs: It's a product with a huge consumer following — particularly in Asia.

OID: Based on Haw Par Healthcare's annual report, it appears that tennis player Michael Chang endorses it.

Briggs: That's right. It's a strong consumer franchise within Asia. The family that formulated Tiger Balm and founded the company — the Aw family — is very famous.

And the product is relatively inexpensive. It only costs a few bucks.

OID: In Asia, maybe. But at the drug store we called, it costs $5. I guess their target market isn't editors...

Briggs: Really?! In Vancouver, it's right on the shelf. And it only costs about C$4-5 — or about US$3.50.

OID: What makes it different than Mentholatum or any other deep heating rub — the advertising?

Briggs: A 70-year tradition. It's *very* different in Asia. There, *everybody* knows Tiger Balm.

OID: But doesn't it face the inevitable onslought of global pharmaceutical firms?

Briggs: That's a good question. For now, it's growing. For example, its revenues grew from S$36 million in 1992 to S$64 million in 1996.

OID: And 15% per year sounds healthy. Alas, the rub is that its shares outstanding appear to have grown 20% over the same period — so that sales per share have only increased about 10% per year.

Briggs: And its earnings have been flat for the last couple of years because of its higher advertising outlays. But we're not paying anything for the Tiger Balm franchise either — both because we're buying Haw Par for less than the value of its stake in UOB and because I incorporate Haw Par's stake in Haw Par Healthcare at its current price (and it's trading at its net-net).

UOB'S RETURNS HAVE BEEN NOTHING TO SNEEZE AT
AND ITS RISKS ARE LESS THAN YOU MIGHT THINK.

OID: You mentioned earlier that you think UOB is worth more than the S$6.75 its stock trades for today or its S$7.50 net asset value. Why?

Briggs: Lots of reasons. First, it's very well managed as demonstrated by its double-digit earnings growth and its 15%+ return on average equity. But take a look at UOB's annual report and judge for yourself.

OID: It looks like UOB's earnings per share grew 17% per year compounded over the last 10 years and that its reported ROE, after having been in the single digits, has trended up to 16%± the last three or four years.

Briggs: That sounds about right.

OID: And what sounds like book value — what they call "Adjusted Net Tangible Asset Backing Per Share" — appears to have compounded nearly 10% per year during the last 10 years despite their having paid out nearly 50% of their reported earnings on average during the period.

Briggs: Exactly. Does that sound like a company that deserves to be selling at less than its net asset value and less than 7 times normalized earnings per share?

OID: Whether we think so or not, this management's been happy to issue new shares. What's that about?

Briggs: UOB has 990± million shares outstanding — double the number outstanding 10 years ago. But I think shares have always been issued at a premium to book.

OID: Although based on the math it's hard to imagine that they were issued at much over 1-1/4 times book.

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PETER CUNDILL & ASSOCIATES'
TIM MCELVAINE & DAVID BRIGGS
(cont'd from preceding page)

Briggs: That's probably about right. Frankly, these guys are more concerned with improving their capital ratios than they are with maximizing shareholder value.

OID: Given the combination of credit risk of U.S. and emerging markets risk, that doesn't sound all bad. But isn't emerging markets credit risk off the chart?

Briggs: One risk in UOB and, therefore, Haw Par is always going to be that of a large surge of bad loans. That's just the nature of the beast in banking.

Korean banks have very low equity ratios — equity as a percentage of assets. So it wouldn't take much in the way of loan losses in order to wipe out their capital. And it's similar with Indonesian and Malaysian banks. Even Japanese banks have relatively small capital bases relative to their assets.

But United Overseas Bank is a *Singapore* bank — which are the best capitalized banks in Asia. Singapore is *very* strict with banks. Its minimum capital adequacy ratio is 12% versus a minimum of around 8% internationally. And equity-to-assets ratios of Singapore banks tend to be over 20%. For example, UOB's is more than 22%.

So you're right — you can never be sure with a bank. But from everything I know about this bank, it has to be one of the least risky banks on the planet. For example, Morgan Stanley says UOB has one of the most conservative regional portfolios among the Singapore banks.

OID: Regional portfolios?

Briggs: That's right. They have loans outstanding to companies in Indonesia and elsewhere in Asia. That's one of the reasons why the prices of Singapore bank shares have declined so much — by two-thirds in some cases.

But based on our analysis, Singapore banks could take far bigger hits on their loan portfolios than we think they've suffered to date and not take any hit on their equity whatsoever. They're extremely well provisioned. So Singapore banks can get through almost anything.

There are even rumors that there are reserves that don't show up on the balance sheets because Singapore encourages banks to build up an extra margin of safety — just in case.

OID: A disaster reserve, if you will.

Briggs: Exactly. And Singapore companies typically don't like to write their assets up. They tend to have portfolios of stocks and real estate which they carry at historical cost. Singapore's good that way. It has good accounting policies, too. Generally, it's only the real estate companies that write up their investment properties.

OID: I thought you mentioned earlier that Haw Par had written up its real estate?

Briggs: Haw Par is unique in that way. It did write up a couple of its office buildings. However, it didn't write up its gains on UOB and Haw Par Healthcare which, after all, dwarf their property gains.

WE THOUGHT HAW PAR WAS CHEAP BEFORE.
TODAY, WE THINK IT'S AN ABSOLUTE *STEAL*.

Briggs: Still, Haw Par might write up its UOB stake this year — because last year, for the first time, Haw Par announced its net asset value. Management informed shareholders that its net asset value was up around S$5.40 per share in order to try and attract new investors.

OID: So much for that approach...

Briggs: And a story in *The Singapore Times* read as follows: "Estimates of the revalued ... [net asset value] range ... [between] S$6.00 ... [and] just under S$6.50...."

OID: So you've been holding back on us, eh?

Briggs: That was *last* year. Let me try to explain the difference in sentiment between then and now:

UOB has two tranches of shares — local and foreign. And foreigners are absolutely forbidden to buy local shares. In fact, you go to jail for even *trying* to do that.

OID: And take your chances with cigarette smokers, gum chewers and other such unsavory sorts....

Briggs: Exactly. And early last year, the local shares traded at S$12. At the same time, the foreign shares traded at S$17 — thereby incorporating a huge premium. Even then, many money managers were excited enough about the prospects of Singapore in general and UOB in particular to pay that S$17.

At that time, you could buy Haw Par at S$3±. And because each Haw Par share owned one-third of a share of UOB, you could, in effect, buy shares of UOB for S$9 — or roughly half the S$17 price we'd otherwise have to pay.

OID: Not to mention a few goodies thrown in for free.

Briggs: Exactly. When we were buying Haw Par for S$3.00, its stake in UOB covered our cost by itself. And, arguably, UOB's local shares were hugely undervalued. Therefore, we figured that we were getting all these other good businesses with their growth potential plus a portfolio of real estate for free.

And it's fortunate that these good businesses and the real estate are free because we're rarely willing to pay up for good businesses — and as a general rule, we usually don't like to pay for real estate.

OID: I can relate. That's how I feel about publishing.

Briggs: So here we were buying UOB's local shares — *legally*, may I add — at half the price of the foreign shares without even factoring in all of those other goodies. And that seemed okay to us.

And it's easy to understand why people could get excited about buying UOB at that time. After all, as you pointed out, its earnings had grown at something around 17% per year dating back to the mid-1980s — which was the last time that Singapore experienced a recession. And its earnings appeared set to continue growing nicely in the decade to come. Basically, everything seemed fine.

Today, on the other hand, there's lots of uncertainty about their regional portfolio and fears about how that's going to impact UOB's earnings. Also, there are fears about what's happening domestically. Many investors worry that Singapore is on the brink of another recession.

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Property prices have also fallen 25% over the last six months. And many worry that Singapore banks will suffer serious loan losses in their *domestic* loan portfolios. And, of course, that's the worst nightmare for *any* bank. So there's lots of uncertainty.

OID: As Peter has pointed out, it's interesting how dramatic change can happen so quickly.

Briggs: Amen. And the foreign shares have been hit especially hard. UOB's foreign shares which traded at S$17 trade at less than *S$7* today.

But when we were buying Haw Par at around S$3.00, we estimated that its net asset value was close to S$5.30 — versus something between S$4.25 and S$4.50 today.

The main reason why Haw Par's net asset value was so much higher then, of course, is that UOB was trading for so much more. Obviously, Haw Par's net asset value is very sensitive to the valuation of UOB. Plus, we're giving an extra haircut to Haw Par's real estate assets to reflect the recent slowdown in the property market. So that's what's different.

OID: So you're getting a greater discount on a basket of assets which are themselves cheaper.

Briggs: You've got it. Our average cost in Haw Par is a lot higher than the price we're paying today. And we thought Haw Par was cheap back when we were paying S$3.00 for it. A lot of our investment rationale then, incidentally, was based on UOB being cheap at the *S$9.00* we were effectively paying for it.

OID: Nobody's perfect.

Briggs: But it's even cheaper today at close to 1 times book value. Incidentally, the all-time high for Haw Par was S$6 in 1987.

OID: So it's fallen by nearly 70% in local terms.

Briggs: That's right — although the highest it traded since the Crash was S$3.54 last year.

And I wouldn't be at all surprised if we were to ultimately accumulate a big position both in UOB and Haw Par Healthcare directly. We think that both of those are very attractive today. And, therefore, we've been buying Haw Par right through the decline.

OID: Reading between the lines, I get the impression that you think Haw Par may be a bargain.

Briggs: At today's price, I think it's an absolute *steal.*

THERE IS INVASION RISK HERE,
BUT NOT THE KIND YOU THINK.

OID: It sounds like it. But what are we missing?

Briggs: I don't think we're missing anything. Singapore stocks generally have been sold off. Lots of very high quality companies have been absolutely hammered. There was a virtual absence of buyers.

So Haw Par Healthcare, for example, is down from S$2.10 to S$.90 since early 1997. And it's a terrific company. It shouldn't be priced at S$.90. And Haw Par's fallen from S$3.54 to S$1.95 during that same period.

OID: Any invasion risk — as in the People's Republic of China deciding they want to expand?

Briggs: I don't think so. Some people worry about that in the case of Taiwan. But that's not going to happen with Singapore. Lee Kuan Yew wouldn't *tolerate* it.

OID: Singapore has a Godfather?

Briggs: He's the guy who developed Singapore. Singapore is the home of the offshore Chinese. They broke away from Malaysia. So it's always possible that there could be conflict between Singapore and Malaysia, but not the PRC.

OID: I'll bite. What's the risk there?

Briggs: It could happen. But I don't know enough about the history of Singapore to tell you for sure.

One risk Singapore *does* have is competition from Malaysia, especially since the Malaysian ringgit fell by almost half — from 2.50 to the US$1 to 4.50 — last year before recovering a bit to 3.73 ringgit to the US$1 today.

So Kuala Lumpur is now far more competitive. And people are crossing the causeway into Malaysia to shop.

OID: You're saying that the biggest risk of invasion is an invasion of Singapore's shoppers into Malaysia?

Briggs: And Malaysia siphoning off business activity generally which would otherwise occur in Singapore because it's viewed as a cheaper place to do business.

But Singapore's a great place to do business — a terrific place — and a first class location for banking and high-tech services. For instance, it seems like virtually every U.S. high-tech company chooses Singapore for its regional headquarters — whether it's Seagate, Quantum or anyone else. Singapore is the preferred location in Asia. They may locate their *production* facilities in Southeast Asia, but they put their *headquarters* in Singapore.

Kuala Lumpur, Malaysia's capital, is building itself up to that, but it's not there yet.

OID: What can you tell us about the Singapore dollar?

Briggs: When we first began to buy Haw Par, US$1 was equivalent to S$1.40. Today, US$1 is equal to S$1.60. So Singapore's currency has declined nearly 15% against the U.S. dollar since early last year.

OID: So Singapore stocks have declined even more than it might appear based on their local stock prices — at least to a U.S. dollar-denominated investor.

Briggs: That's right. Fortunately, we hedged our currency risk so we avoided nearly all of that decline. But because interest rates are higher in Singapore than they are in North America, it costs us something to hedge — unlike Japan where, again, we get paid to hedge.

OID: What can you tell us about interest rates?

Briggs: Interest rates in Singapore are around 8%. Most people view Singapore as a safe haven. And that's how we viewed it, too. But when the Hong Kong dollar came under pressure and Hong Kong raised its interest rates, Singapore also raised its rates — to as high as 15% — to

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deter further selling of the Singapore dollar.

So declines in the Malaysian ringgat have also put pressure on the Singapore dollar. But a lower currency wouldn't be a bad thing for Singapore. Actually, it's just the reverse. If the Singapore dollar gets too expensive, they risk pricing themselves out of business.

OID: My thoughts exactly. But might they not be in line to have their own currency meltdown?

Briggs: Singapore's currency was sold off along with the rest of the region. And even though it's only down about 20% versus the U.S. dollar, a 20% drop is a big drop for Singapore. This currency has gone up for the last 10 years versus the U.S. dollar. And just about anyone will tell you that the Singapore dollar is considered to be one of the strongest currencies in the world. In part, that's because Singapore has absolutely *enormous* reserves and a huge trade surplus.

So I think you're right. I think the Singapore dollar probably will get weaker in the *short* run. However, over the long term, the Singapore dollar is more likely than not to be one of the *strongest* currencies in the world.

OID: What, then, could turn Haw Par into a mistake — aside from management waking up on the wrong side of the bed and a myriad of geopolitical possibilities?

Briggs: I suppose one risk is that leisure spending drops off a cliff and stays there for five or ten years. If so, Haw Par would be left with bowling alleys and aquariums that nobody ever visits.

And there's always the risk of a surge of bad loans. However, as I mentioned, we don't think that's very likely to happen because we believe that UOB is reserved sufficiently to weather all but the most severe of storms.

OID: And I'm sure they'll have the opportunity at some point to demonstrate whether you're right or not.

Briggs: No doubt. Another risk probably is that these new ventures they're going into don't work. However, they seem like good ideas to me.

NOT ALL OF OUR SURPRISES WILL BE NEGATIVE.
WE COULD HAVE VERY PLEASANT SURPRISES, TOO.

Briggs: I believe we're more likely to get positive surprises in Singapore stocks than we are negative ones. For instance, I ask myself, "What could go right?" And what could go right? Singapore's had annual GDP growth of 8% per year for many years. But it's only so big. So Haw Par Healthcare must expand outside of Singapore.

It's in 100 countries today. But as it advertises the Tiger Balm brand in more and more countries and diversifies into other product lines, its growth could surprise us. The Tiger Balm franchise could begin to grow like crazy throughout Asia — in China, India, etc. Therefore, Haw Par Healthcare could really take off.

OID: I didn't realize that Peter hired optimists.

Briggs: And here's something else that could go right: UOB could recapitalize a lot of these regional banks and other financial service companies that are short on capital while things are horrible and there's blood in the streets and so forth. Then, when things return to normal, it could find itself with far more of a presence outside of Singapore with wonderful assets it bought for a song. So there are a couple of things that could go *right*.

Frankly, that's probably the way things *will* unfold. Meanwhile, we get a big margin of safety. Something's free here — either Haw Par's stake in UOB or the other stuff. Take your pick.

OID: And you think they all have bright futures, too.

Briggs: That's how it looks to me. Haw Par Healthcare is obviously a good business. Among the things it owns is the largest generic drug manufacturer in Singapore — believe it or not called Drug Houses of Australia. By the way, I think the rationale for Tiger Medical changing its name to Haw Par Healthcare was to convey to investors that it offers a broad range of health care products. And Haw Par owns the leisure operations I mentioned earlier. So it owns some pretty decent businesses.

Also, one of the things that's changed in Haw Par over the last couple of years is that they've started to focus.

OID: I can't tell if you're being sarcastic or not.

Briggs: I'm quite serious. They still have their fingers in a lot of different pies. But at least they're focusing on boosting their core operating earnings in only two areas — leisure and health care — which is particularly important since investment earnings can be so volatile. And we think that management's efforts have only begun to show up in higher core operating earnings. That's another reason why we want to own Haw Par — because we think that those higher earnings will become increasingly visible and cause it to get rerated upward over the next few years.

HIGH MARKS FOR WEALTH GENERATION —
CORPORATE GOVERNANCE, ON THE OTHER HAND...

OID: What can you tell us about this management — without getting into too much trouble?

Briggs: UOB is run by Wee Cho Yaw who's chairman of the various companies within the UOB group. And besides UOB, Haw Par and Haw Par Healthcare, the group includes Singapore Land and United Industrial Corporation. Needless to say, the Wi family is one of the key families in Singapore. And Haw Par is his trading company.

OID: So you're piggybacking on his margin account?

Briggs: Yeah. That's not too far off. And Singapore is another country that leaves a great deal to be desired when it comes to corporate governance. It's often criticized for being unfriendly to shareholders.

OID: Aside from majority shareholders, I guess.

Briggs: That's right. Many of these companies are family-controlled and look after family interests first. However, as in Japan, there is a slow change underway. For example, Singapore is going to permit companies to repurchase their shares. And many of these companies

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have been overcapitalized. Therefore, share repurchases are likely to lead to higher stock prices and better returns.

So they're trying to move in the direction of better corporate governance. But you're right — in effect, today, these companies are part of this family's personal empire, which just happens to be listed on an exchange.

OID: So there's still a lot of "crony capitalism" where the government picks the winners and losers.

Briggs: There is.

OID: So couldn't you wake up one day and find out that there's been an enormous amount of misallocated capital and a bunch of businesses that can't cut it?

Briggs: You could in Korea. But Singapore has Confuscious Capitalism — overseas Chinese capitalism. These guys are very good at generating wealth. They're very conservative and debt-averse. For example, if they want to go into a business, then somebody in Malaysia will contact five overseas families — one each in Hong Kong, the Philippines, Singapore and so forth. And they'll all come in to reduce the overall risk for each of them.

And they can do it with one phone call. It's a very tight network of businesspeople who are unusually conservative — each of whom run family operations.

I understand that in Malaysia and Indonesia, the overseas Chinese with 5% of the population control something like 90% of the economy. Those are the sort of numbers we're dealing with. And that's led to enormous resentment on the part of the ethnic Malaysians and ethnic Indonesians. So if you're an overseas Chinese, you had to have bodyguards because people were taking shots at you.

OID: They haven't perfected the art of manipulating public opinion using the media?

Briggs: This is sweet revenge for a lot of the locals who resented their success. They're humble anyway. They're not given to flaunt their wealth. But it's been an extremely humbling experience.

So part of the investment rationale hinges on whether or not you think they're going to come back. Right now, they've been beaten back in a big way. I think they will. For example, Li Ka-shing lost about 50% of his wealth measured by the market cap of his listed flagship companies in the last three months. Is he going to come back? You bet.

And there's one risk you *don't* have in Singapore.

OID: Just one?!

Briggs: The scariest risk in Hong Kong is that of the PRC coming in and changing the rules. And that's one risk you *don't* have in Singapore.

SOME OF ITS BUSINESSES ARE FINE,
BUT GAKKEN'S PRICE IS *SUPER* FINE.

OID: That's a hard act to follow. But feel free to try.

Briggs: Gakken is a very complicated story, but it's also very good — and very educational, too.

OID: As long as it's a very good bargain...

Briggs: Definitely. Gakken's a famous company that among other distinctions is the leading publisher of educational materials and consumer magazines in Japan.

OID: That sounds like it could be a very fine business — at least outside of investment publishing...

Briggs: It is. In part, that's because everybody in Japan has grown up using Gakken's educational materials. So there's an enormous amount of goodwill and tradition associated with the Gakken name. *Everyone* in Japan knows the name.

And besides its educational publishing division, Gakken also has a stable of leading consumer magazines. For example, it publishes leading magazines for housewives, teenagers and children.

And both divisions are getting *better*. Gakken's discontinuing titles that aren't profitable and focusing on the hot ones. So the publishing business is doing well and continuing to progress and improve.

OID: So far, it doesn't sound like a business that would sell below net-net.

Briggs: It's not standing still on the educational side either. Education, of course, is very important in Japan. And parents work very closely with their children as they prepare for their exams.

Gakken introduced a new test preparation service last year that Japanese consumers are very excited about. It's a fax-based testing service. It's usually administered by the child's parents and faxed in, graded by computer and returned with feedback about the specific areas that the student needs to work on in order to be as prepared as possible for his placement exams.

That business has been taking off and doing very well.

OID: Interesting.

Briggs: And Gakken has another good business — Gakken Credit — a credit subsidiary whose primary activity to date has been to finance purchases of Gakken products. They're trying to build it into a finance company people use to finance *other* products. But it's already very profitable. And Gakken's management wants to take it public.

So Gakken has two or three excellent businesses. And it has a wonderful database as a result that we think has enormous value itself.

OID: So far, so good.
But, presumably, the price is just as good?

Briggs: Gakken's book value today is nearly ¥700. And its net-net is at least ¥500 — roughly ¥325 of which consists of net cash and marketable securities. I say at least because I've given the marketable securities a haircut of 50% because they're bank shares. (That's house policy around here.)

Meanwhile, Gakken's trading at less than ¥300 — or less than 60% of net-net, not much over 40% of book and below its net cash.

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IF YOU AREN'T DISGUSTED WITH GAKKEN TODAY,
YOU MUST NOT HAVE BEEN PAYING ATTENTION.

OID: Why is this thing so cheap!? What's the catch?

Briggs: Several reasons: First, although Gakken has two or three wonderful businesses, it isn't focused. Besides the businesses that I mentioned, it also has some lousy businesses — including, believe it or not, a division that sells furniture to schools.

OID: And here I thought you might be exaggerating about the lousy business part...

Briggs: Unfortunately not. Its diamonds are hidden by its garbage. Second — and this is the kicker — there's quite a bit of disgust on the part of investors about this company. Management has a serious credibility problem — a problem which isn't altogether undeserved. As of last March, Gakken's book and net-net working capital were ¥886 and ¥750, respectively. Again, today those figures have declined all the way to ¥700 and ¥500, respectively.

OID: How did they lose so much ground so fast?

Briggs: Very simple. Gakken owned a big slug of Yamaichi paper. Therefore, when Yamaichi went bankrupt late last year, Gakken was left holding the bag.

OID: Yamaichi got the money and Gakken got the education...

Briggs: Exactly — and a very *expensive* education. In 1989, Gakken invested ¥9 billion in Yamaichi's Worldwide Growth Investment Trust. Yamaichi took the money from Gakken and four other investors under the guise of the aforementioned Worldwide Investment Trust and promptly invested 100% of the trust's proceeds into some can't-miss warrants on a construction company called Shimizu.

OID: Using the term "invest" and "trust" very loosely.

Briggs: *Very* loosely. To put it into context, this was 1989 very near the top of the Japanese bubble.

Anyway, in the first half of 1990, the Nikkei corrects. It fast becomes obvious that the warrants are worthless. But Yamaichi, in order to preserve its client relationships, provides Gakken with an IOU promising to restore its original ¥9 billion investment. Bear in mind that most Japanese investors think the downturn is temporary.

OID: Everything's relative.

Briggs: Therefore, Gakken carried its ¥9 billion stake in Yamaichi's Worldwide Investment Trust at face value until Yamaichi announced that it was going bust this past November — at which point they got in line to collect on their IOU and finally wrote down its value to zero.

OID: That might explain a quick drop in Gakken's book value and net-net.

Briggs: But what we found most discouraging was Gakken neglecting to mark its portfolio to market for all of those years. Of course, their auditors signed off on it. However, they kept it on their books at 100¢ on the $1.00.

Worse, we even asked a Gakken representative about those assets during the course of our normal due diligence. We even specifically asked whether any of Gakken's assets were suffering any hangover from the bubble years. And he said no — that they were essentially fine.

OID: Maybe he thought you were asking if he had a hangover from chewing too much bubble gum...

Briggs: I don't think so. I asked him the same thing when I visited with the management in Tokyo in September — and he said no *again*.

OID: So much for that theory...

Briggs: Therefore, that's what I used in my net cash calculation. So you can understand why Gakken might have a very serious credibility problem with many investors — us included. By the way, Tweedy, Browne owns it, too.

OID: Slinging mud won't help you at this point — unless you're in politics or legal warfare, of course.

Briggs: Finally, Gakken had been enjoying a bit of an improving trend. So it reestablished its dividend. But now it looks like it's going to have to cancel it again. So the improving trend has been abruptly halted — for now, anyway. And there's a kind of scandalous smell to the company today and an enormous amount of disgust.

INVESTORS ARE FOCUSING ON THE AGONY TODAY,
BUT THESE BUSINESSES WILL GENERATE ECSTASY.

OID: And yet it's not three strikes and you're out.

Briggs: Management has struck out credibility-wise. But fortunately, we bought Gakken cheap enough that we *still* enjoy a substantial margin of safety.

OID: May we ask what you've paid?

Briggs: We've paid up to ¥600 and as little as ¥160. Our average cost is about ¥400. But the ¥9 billion Yamaichi fiasco allocated over Gakken's 102 million shares outstanding comes to less than ¥90 per share. And, again, very conservatively, it has net cash of ¥325 per share. Incidentally, even that figure excludes its credit sub — which we deconsolidate to avoid muddying the water.

OID: Which, I imagine, may explain why the decline you related earlier in Gakken's book value and net-net far exceeded the ¥90 per share that it invested in Yamaichi's Worldwide Investment Trust.

Briggs: Exactly — that and the 50% haircut we apply to Gakken's marketable securities that I mentioned earlier.

And whether management's lost its credibility or not, Gakken's clearly worth a multiple of its current stock price. Its consolidated sales for the year ended March 1997 totaled around ¥150 billion. Of that ¥150 billion, roughly ¥75 billion was books and magazines, ¥15 billion was its fax-based testing service and ¥10 billion was its credit sub. Then, the other ¥50 billion was school furniture, toys and a hodgepodge of other very loosely related businesses.

So Gakken's publishing and educational divisions have total sales of around ¥90 billion — or ¥882 per share. So you're only paying 33% of sales even if you disregard

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the fact that you're already getting reimbursed for 100% of your purchase price in cash.

OID: Wow.

Briggs: And it's hard to imagine that those segments aren't worth at *least* 1 times sales. A similar U.S. company — Scholastic — has typically gotten a valuation including net debt of 1-2 times sales. And I suspect that Scholastic may not have quite the same degree of brand recognition in North America that Gakken has in Japan.

OID: Are sales in those good segments growing?

Briggs: Gakken's magazine segment — the so-called popular publishing division — is growing. However, its educational sales are falling. And a broad bear argument is that the number of children in Japan is declining. Therefore, Gakken won't be needed. So its future is grim. The average person on the street would probably say that.

OID: Super. A terrific franchise that's out of favor, viewed as a dying business and buried in disgust.

Briggs: You've got it. Within the disgust are some terrific assets. So this company's lost its credibility. But there are definitely some good businesses within the mess — on the educational side, the magazine side and, possibly, even the credit side.

OID: In an analogy Bill Ruane often uses, within the pile of manure is a pony — maybe even two or three.

Briggs: Exactly. And it's also interesting because for the first time we're seeing shareholders take stakes and demand changes — not just outsiders, but insiders, too. For example, a former Japanese politician has taken a 3% stake in Japan Airlines and is demanding major changes — including divestitures of non-airline businesses and dramatic reductions in the number of flight attendants.

I think Gakken is another company where you could see a big shareholder coming in and demanding changes. But there's no question that there's still a margin of safety.

OID: And presumably some very good assets at an extremely good price.

Briggs: No question about it. Given the nature of its businesses, run *properly*, it could do *very* well.

OID: I get that impression. It looks like Gakken was selling at ¥3,880 per share in 1989.

Briggs: That doesn't surprise me. In part, that was a function of the Japanese stock market bubble. But Gakken had operating earnings for the year ended August 1989 of more than ¥70 per share.

All it needs is the right focus on the good businesses — the publishing, the educational testing and, possibly, the credit subsidiary. It *will* be run properly one day. The only question is when. And one hopeful development there is that Gakken's management is currently being replaced. So we'll see.

A GLOBAL BRAND AT 2-4 TIMES EBITDA, TWO THIRDS OF BOOK AND NET-NET!?

Briggs: And if you like Gakken, you'll probably like Descente. It's another example of what you might call the best of all worlds — a net-net of a company with a wonderful business run by a management with an excellent track record.

Descente's a great sportswear company with a couple of top brands. It's most famous for its skiwear — which it sells under its flagship Descente brand. If you visit skiwear stores in Canada, you'll see its jackets retailing for US$600 or more. And of that US$600, the retailer earns a 50% margin. So it won't surprise you to hear that the retailers I've spoken with love Descente because it's one of very few brands that allows them to earn very high margins.

And they come out every year with *new* jackets — obviously very high-end stuff.

OID: Either very high-end, very overpriced or both — although I suspect I know your opinion there.

Briggs: The Descente brand is very strong. If you ski or if you're involved in athletics, then you know Descente. You know its brand is highly regarded and its products are first rate. For example, Descente was an Olympic sponsor — sponsoring the Canadian Olympic team and the Japanese ski jumping gold medalists, among others. All of them had "Descente" displayed prominently on their outfits.

OID: I understand people even watched the Olympics in Canada.

Briggs: And besides its flagship brand, Descente licenses the Adidas name in Japan and owns the Munsingwear trademark worldwide, although I believe their sales of Munsingwear products rank a distant third after sales of their Descente and Adidas products.

OID: On the other hand, isn't brand loyalty in fashion notoriously fickle?

Briggs: Maybe. But Descente is a long-lived brand with goodwill that they've built up over many years.

OID: How widespread is Descente's distribution?

Briggs: Most people don't even know it's from Japan. They think it's French.

OID: Nobody's perfect.

Briggs: But Descente's definitely global — in markets throughout Europe, North America and Japan.

And yet, despite all of those positives, Descente is trading at less than ¥340 per share — below its net-net of around ¥350 per share. And it has ¥144 per share of cash net of debt. That's one of the best things about Descente — that it has so much cash.

OID: Rich or poor, it's good to have money.

Briggs: My thoughts exactly. And when you net out its cash, you see that its enterprise value is only about ¥186 per share. And then when you divide that figure by its ¥90 per share of trailing EBITDA, you see that it's selling at only a tiny fraction over 2 times trailing EBITDA.

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OID: Sign me up.

Briggs: So even if earnings drop in half this year, today's price would only represent about *4* times EBITDA.

And Descente's book value is ¥530. So it's selling at less than two-thirds of book and 8 times trailing earnings. Granted, earnings are likely to decline. So its prospective P/E multiple will be higher than its trailing multiple — perhaps even twice as high.

On the other hand, Descente's earnings last year didn't exactly rely on extraordinarily high profit margins. Its net profit margin was less than *3%* per year.

OID: It's hard to imagine those being peak earnings.

Briggs: Exactly. And again, that's one of the things I love about investing in all of these Japanese companies — that their margins are *so* depressed.

THIS MANAGEMENT DIDN'T WAKE UP STUPID ONE DAY.
MORE OF THE PAST WOULD BE FINE, THANK YOU.

OID: But did I read in Grant's that Descente may be losing its license to produce one of its main products?

Briggs: That's right. Adidas has told Descente that it wants to terminate the joint venture through which it designs, manufactures and distributes Adidas products. And the market is pricing Descente as though it's official. However, it's *not* official.

Our friends on the sell side have been writing reports downgrading Descente's earnings.

OID: That's pretty amazing all right. Having friends on the sell side is one thing. But admitting it...

Briggs: I've seen research reports looking out to the year 2001 and saying that Descente will be toast — that Descente's earnings are going to collapse.

And if you think Descente will go from doing everything for Adidas to doing absolutely nothing and that management's going to do nothing, then they may be right — or at least partially right.

But I don't think that's realistic. It's true that Adidas wants to go out on its own in Japan. But Descente designs, manufactures and distributes Adidas products — the whole shebang. I think there'll be some sort of relationship going forward. At the very least, I expect Adidas to rely on Descente for distribution — because distribution is the key and it's the hardest thing for foreigners to do.

So the relationship will be changed in terms of form. Therefore, it won't be as profitable for Descente as it was. But it's not like the relationship is *over*.

OID: In other words, it's a negative, but not the disaster that the market seems to be discounting.

Briggs: Exactly. So I don't expect the relationship to end entirely. But even if it did, Descente's management would have to deal with it and grow their business anyway — which is exactly what they've done in the past. Will they be able to adapt to the changed relationship with Adidas? I don't see why not. Is Descente some flash in the pan? Not at all. It has a long track record suggesting otherwise.

They've always been able to grow Descente's profits historically. They've had a tough time lately — in terms of sales anyway. But they've nevertheless managed somehow to keep their profits growing even then. So management's track record is pretty good.

And the Japanese sportswear market is in absolutely horrible shape. Even NIKE just recently blamed Japan for its earnings shortfall. Yet Descente earned 7.9% on equity last year...

OID: Which I'm told is a sky high return in Japan.

Briggs: Yeah. Especially when you consider that Japan's been in a long lived recession and they're carrying around so much cash.

OID: So you hope that there's nowhere to go but up?

Briggs: That's right. And our view is so *what* if it takes two or three years for Descente to get back on track?

OID: Other things being equal maybe.
However, what percentage of Descente's sales were associated with Adidas products?

Briggs: Roughly 40%.

OID: So given that Descente's total sales for the year ended March 1997 were around ¥100 billion, their sales ex-Adidas would have been about ¥60 billion?

Briggs: Yep — which given Descente's 77 million shares outstanding comes to about ¥779 per share.

OID: So that even if Descente's relationship with Adidas were to disappear and it flushed its cash, you'd only be paying about 45% of sales.

Briggs: If you ignore Descente's cash and marketable securities, that's right. And Descente is working on other products — including electric thermalwear which is skiwear that's heated electronically.

OID: That explains why it's cheap.
Getting long enough extension cords alone...

Briggs: So I think it's foolish to think that the end of the relationship with Adidas will lead to Descente's demise or even huge losses. I think these guys will do what they always have — which is to manage their way out of it and find other ways to grow their sales and earnings.

And as they do, its earnings will reflect that success. People will start to buy their stock. And it'll start to trade at the same kind of P/E multiple that it did before — growth multiple and all.

OID: That doesn't sound so bad. I understand that Descente sold for as much as ¥2,460 back in 1977 and that it's still not earning what it did in 1982.

Briggs: Really!? I don't look back that far. Usually, we think looking back 10 years to the 1988-89 bubble is far enough. But maybe I should look back further.

OID: At CNN, Ted Turner used to observe, "If it bleeds, it leads". At OID, it's, "If it's hype, we type."
But what'll keep Descente from becoming gristle on NIKE's tracks?

(continued on next page)

PETER CUNDILL & ASSOCIATES'
TIM MCELVAINE & DAVID BRIGGS
(cont'd from preceding page)

Briggs: Just its brand name and its relationships with retailers. NIKE doesn't really compete so much in the premium skiwear segment anyway. I can't recall ever seeing NIKE products in a ski shop. Actually, Descente's main competition is FILA.

OID: You don't expect NIKE to expand its presence in that channel sooner or later?

Briggs: They probably will. But I can't imagine that the best alternative for NIKE in that case wouldn't be to *buy* Descente. It's known to be a superior brand.

Peter wonders why Adidas doesn't buy Descente given that it could sell its goods through its global distribution network and boost sales by who knows how much. And, frankly, I'd be surprised if Adidas or someone like Adidas wasn't already considering acquiring a stake in Descente or even acquiring 'em outright.

OID: May I ask what you've paid for this one?

Briggs: Our average cost on Descente is just under ¥300. But we've paid as little as ¥250 and as much as ¥330. And we own about 4% of the company.

YOU CAN PAY FOR JAPAN'S IBM-EQUIVALENT AND GET ITS GE UNDERSTUDY FOR FREE.

OID: We ran out of pages four ideas ago. But I gather that the ones you told us about aren't uniquely cheap — that you're finding lots of similar ideas...

Briggs: Absolutely. For example, Fuji Electric is a *great* one. It's *definitely* compelling.

OID: Could you give us the thumbnail version?

Briggs: Fuji Electric is trading at around ¥430. So given its 715 million shares outstanding, its market cap is about ¥310 billion. But Fuji owns stakes in several other companies — the largest of which is a 243 million share stake in Fujitsu which trades at just under ¥1,350 per share. Therefore, Fuji Electric's stake in Fujitsu alone has a current market value of approximately ¥325 billion — which is greater than Fuji's current market cap.

OID: So far, so good.

Briggs: Fujitsu has a bit of a growth premium in its price because it's something of a growth story. It models itself after IBM incidentally. It's in the same businesses — PCs, mainframes, software and data processing services. And like IBM, its strategy is to provide a full array of computer-related services. It's the largest computer maker in Japan. It even rivals IBM in sales. Given its sales of about ¥5 trillion, even with the yen trading north of 128 to the US$1.00, that's still nearly US$40 billion.

OID: So it ain't chopped ~~liver~~ sushi.

Briggs: That's right. It's even trying to accomplish the same thing IBM accomplished over the past five years — in terms of refocusing, restructuring, etc.

OID: So long as its nickname isn't Big Fu...

Briggs: Fujitsu is one of the *very* few big Japanese electronic equipment companies — the *only* one I know of actually — whose operating profits will be up 20% this year. And they'll be up 20% despite the slowdowns in sales of PCs, DRAMs, the recession, etc. So I'm very impressed by how well they're doing given the very adverse conditions. Fujitsu's reported net will decline. But that's only because of goodwill amortization associated with the purchase of the part of Amdahl they didn't own already. So Fujitsu is a very compelling story in its own right.

OID: Sounds like it.

Briggs: Yet Fujitsu is carried on Fuji Electric's books for virtually nothing — in effect, based on 1932 prices because that's when Fuji Electric spun off most of it.

And even though the value of its stake in Fujitsu today exceeds its own market cap, the only way you can even find out that Fuji Electric owns a stake in Fujitsu is by looking through its filings with the Ministry of Finance or reverse engineering — backtracking through ownership records of companies in which it owns stakes.

OID: It's not in Fuji Electric's annual report?!

Briggs: Nope. In fact, in their English annual report, you won't even find the *word* "Fujitsu".

OID: What kind of valuation is Fujitsu getting today?

Briggs: At Fujitsu's current stock price, it has a market cap of around ¥2.5 trillion. It has net debt of about ¥.95 trillion. So its enterprise value is slightly less than ¥3.5 trillion. Meanwhile, Fujitsu will have sales of about ¥5 trillion in its fiscal year ending March 1998. Therefore, its enterprise value is slightly less than 70% of sales.

OID: With its market cap totaling about 50% of sales and its net debt totaling just below 20% of sales.

Briggs: That's right. And some would argue that the biggest negative about Fujitsu is that it has so much debt. But it's very low rate debt. And Fujitsu's debt service is quite manageable.

OID: And if Fujitsu got a valuation similar to the one IBM's averaged historically — 1 to 1-1/4 times sales — other things being equal, its stock would be something between 60% and 110% above its current price.

Briggs: That sounds about right. And that kind of valuation may not be too far off the mark — assuming that management continues to build Fujitsu's business, make it more cost-effective, etc.

Plus, Fuji Electric has other smaller stakes — the largest of which is a 10.5 million share stake in Fanuc. But those are small potatoes relative to its stake in Fujitsu. Fanuc is currently trading at around ¥4,400. So that stake has a value today of nearly ¥50 billion. Therefore, the value of Fuji Electric's stakes in Fujitsu and Fanuc total something around ¥375 billion.

Meanwhile, Fuji has debt of about ¥100 billion. And when we add its ¥100 billion of debt to its ¥310 billion market cap, we arrive at an enterprise value of ¥410 billion — roughly the same as the combined value of its stakes in

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PETER CUNDILL & ASSOCIATES'
TIM MCELVAINE & DAVID BRIGGS
(cont'd from preceding page)

Fujitsu and Fanuc.

FUJI ELECTRIC: THE RIGHT ROLE MODELS,
THE RIGHT MARKET SHARE AND THE RIGHT PRICE.

Briggs: Therefore, one way of looking at it is that you're getting the rest of Fuji Electric for free. And what do you get for free? We believe that the answer is "a *lot*". What makes Fuji Electric compelling at today's stock price is its own business — which during the fiscal year ending in March 1998 will have revenues of about ¥1 trillion.

So even if you disregard its stakes in Fujitsu, Fanuc, and so forth, Fuji Electric's ¥310± billion market cap is only about 30% of its Fiscal 1998 sales.

OID: And that's good?

Briggs: I think it's *very* good. I'd think Fuji Electric's business could be worth at least *50%* of sales. Its revenues and profits are growing. And they've been growing, in fact, since Fiscal 1994. That's probably been the result of several factors. First, they've benefited from a weaker yen. Second, they've been aggressively restructuring operations — focusing on significantly lowering their costs. And third, they've sought out new opportunities for growth.

So when Peter met with its management in December, they told him, "We only want to be in businesses where we're #1 or #2."

OID: Sounds familiar.

Briggs: *Very* familiar. So Peter asked 'em, "Do you know who Jack Welch is?" And boy *do* they! They said, "Jack Welch says to concentrate assets only in profitable businesses with large market shares — where you can be #1 or #2 — in a global market. We follow a similar policy."

OID: Having the right role models goes a long way — outside of publishing anyway...

Briggs: It sounded mighty good to us. Traditionally, they produced electric machinery — including turbines which they produced with Siemens. Plus, they're the #1 manufacturer of vending machines — which are all over the place in Japan. But that's a very mature business. Thus, they began focusing on producing magnetic disks for hard disk drives. And today, they're #4 in that business — after Komag, IBM and Seagate.

OID: Whatever happened to the #1 or #2 criteria?

Briggs: Of the three magnetic disk producers that Fuji Electric trails, two — Quantum and Seagate — produce them primarily for their *own* hard drives. So among companies producing them primarily for resale, the only competitor with a larger share than Fuji is Komag with a market share of about 15%. So Fuji *is* #2 today — with a share of around 7%.

And Fuji Electric's goal (which they expect to achieve sometime this year) is to be the #1 producer in the world.

OID: So? Our goal is to come out bimonthly...

Briggs: Among the reasons why Fuji Electric expects to overtake Komag very shortly is that they spent the last year building a plant in Malaysia which is supposed to triple their market share — up to 20%. So once that new plant comes online, Fuji Electric should become #1 in the world in relatively short order.

OID: Assuming everyone sells everything they produce. But you don't worry about that new capacity — whether it belongs to Fuji Electric or someone else — going begging and/or driving prices down?

Briggs: That's a very good question. But traditionally, demand for hard drives has always outstripped supply. And that's one of the big reasons for their commitment to the sector.

OID: But isn't that contrary to the law of economics — ruinous profits breeding ruinous competition, etc.?

Briggs: Apparently, it is — because what's happened this year is that supply has overtaken demand and, therefore, prices are coming down. So Seagate, Quantum and other hard drive producers are being forced to deal with pricing pressures as a result.

OID: And yet Fuji Electric's management continues to believe that if they build 'em, buyers will come?

Briggs: Over the *long* term — that's right. Also, they believe they avoid the most intense cutthroat competition by focusing on magnetic disks for higher-end products — like higher-end servers, work stations and so forth.

OID: Is that hard fact or soft spin?

Briggs: I think it's true to a degree. But whether it's true or not, Fuji Electric's taking market share like crazy — based in part on having the best technology and in part on having the best product quality.

DESPITE IT'S EBITDA BEING LOW AND IMPROVEABLE,
FUJI SELLS AT LESS THAN 1 TIMES EBITDA TODAY.

OID: I'd ask about earnings. But since we're talking about a Japanese company...

Briggs: That's right. Like most Japanese companies, Fuji Electric over-depreciates its fixed assets. But that doesn't keep us from looking at results *before* depreciation. We don't like to use EBITDA. But Fuji over-depreciates everything and it has an effective tax rate of 60%±. So it's one of the few ways that you can get your hands around it.

OID: That's what SoGen's Jean-Marie Eveillard tells us.

Briggs: And Fuji's expected to report operating profit of ¥36 per share for Fiscal 1998. It should have depreciation of about ¥40 per share. So its EBITDA should be up around ¥76 per share.

And if you deduct the value of its stakes in Fujitsu and Fanuc when you calculate its enterprise value, you conclude that you're paying a very low multiple of EBITDA — less than 1 times EBITDA — because the numerator (Fuji Electric's enterprise value) becomes so small.

OID: And even if you ignore those stakes, Fuji's current market cap is only about 5.6 times EBITDA.

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PETER CUNDILL & ASSOCIATES'
TIM MCELVAINE & DAVID BRIGGS
(cont'd from preceding page)

Briggs: That's right. And I suspect its global peers might trade at closer to 8 times EBITDA. And, incidentally, that's assuming operating earnings in Fiscal 1998 of around ¥25 billion — or only about 2-1/2% of sales.

OID: Wow. That hardly sounds like peak earnings.

Briggs: Exactly. And management's firmly committed to improving those earnings. Needless to say, many Japanese companies — if not most — are reporting very weak earnings. So it wouldn't surprise us — or worry us — if Fuji's earnings were weak this year, too, although management so far says they aren't expecting it.

Long term, we foresee growth ahead for Fuji Electric as a result of the technology it's developed. We expect it to continue improving its earnings. And if being #1 in the magnetic disk business turns out to be very profitable, then Fuji Electric will probably get a valuation to match.

OID: Incidentally, if we're reading these financials correctly, it looks like Komag's net profit margins averaged more than 18% the last three years — although it looks like they'll report a loss in 1997...

Briggs: That's probably due to the market conditions I mentioned earlier. The industry's been under very severe pricing pressure. When PC sales slowed, so did demand for hard drives and hard drive components.

But when we've asked Fuji's management about the likely fallout, they've told us that they don't expect anything too severe. But we wouldn't be too surprised — or too discouraged for that matter — if it turned out to be more painful than they expect. Fuji Electric's management figures that this is a business they want to be in long term. So they're looking past the current turmoil and so are we.

OID: May we ask what you've paid?

Briggs: Our average cost in Fuji Electric is just over ¥400 — or slightly below its current price. But we started buying it around ¥500. And we kept buying it as it went down. So we've paid as much as ¥500 and as little as ¥300.

OID: I can relate.

Briggs: Peter says virtually all the good ones go down and give you a chance to buy more. So we always try to take advantage of that opportunity. That's important in our view — not to let anyone talk you out of it. If you've done the work, when that happens, just buy more.

DELGRO'S SELLING AT NET CASH OR LESS
AND AT LESS THAN 40% OF BOOK VALUE & NAV.

Briggs: And that's what we've done in Delgro, too. We talked about that one at the Cundill Conference. It was very cheap then — and it's gotten much cheaper since. So we've been taking advantage of that weakness to buy more.

OID: Could you give us an update in 25 words or less?

Briggs: I'll try. As we mentioned, Singapore Bus believed that investors weren't giving it credit for the value of its separate pieces. Therefore, it changed its name to Delgro (short for Delta Growth), created a separate listing for its bus division to which it assigned its former name (i.e., Singapore Bus), spun off 25% of that division to its shareholders and, finally, undertook a 2-for-1 split.

OID: So what was Singapore Bus is now Delgro. And Delgro now own 75% of a publicly traded company called Singapore Bus.

Briggs: That's right. So on a pre-split, pre-spinoff basis, when we talked about it at the conference, it was trading at about S$7.00. However, since that time, each pre-split share of Delgro received one share of the new Singapore Bus — which was trading at about S$1.00 when it was spun off. So subtracting that S$1.00 from the S$7.00 and adjusting for its 2-for-1 split would be equivalent to about S$3.00 per share of the current Delgro.

And today, it's trading at about S$2.00. So it's declined about a third since. In fact, it recently got as low as S$1.20. And we bought some at that price.

OID: Could you give us your rationale in a nutshell?

Briggs: Delgro's book value is up around S$5.00. Its total net asset value is probably about the same. And it probably has net cash alone roughly equivalent to its current stock price, possibly more — with the balance consisting of its residual 75% stake in Singapore Bus, a taxicab business, Citicab, that they intend to spin off and some real estate.

OID: What kind of valuation is the bus division getting now that it's a separate company?

Briggs: Management thought that the bus division was dragging down its valuation. But for some reason, Singapore Bus is trading at a big premium. Go figure.

OID: So maybe it was their other businesses bringing down the valuation of their bus business.

Briggs: By the way, it's possible that after completing the sale of their most recent real estate development, they could have anywhere between S$2.50 and S$3.25 per share of cash. Either way, their net asset value would still be up around S$5.00.

THERE ARE *SO* MANY WONDERFUL BARGAINS
THAT PETER'S NO LONGER COUNTING *SHEEP*.

OID: Did I mention that we ran out of pages...

Briggs: Then let me just mention two more in passing that I know you'll like. Times Publishing is also compelling. It's selling at about S$3.25. Its nominal book value is around S$4.00. And its net asset value is slightly higher. It's very cash rich. In fact, half of its market cap is cash. And if you back out its cash, it turns out that you're only paying 5-6 times after-tax earnings.

And two-thirds of its business is outside Singapore. It's a player in publishing educational books for China — which, to say the least, could be a growth business. And it

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PETER CUNDILL & ASSOCIATES'
TIM MCELVAINE & DAVID BRIGGS
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publishes a broad range of other books in Europe and the U.S. Also, it prints time-sensitive magazines like *Time* and *Business Week*, among others, in Singapore and Asia. And, finally, it operates conferences and exhibitions in Singapore and 43 bookstores mainly in Singapore, but also in Malaysia and Indonesia.

It's a sleepy, boring, overcapitalized company — which is typical of OCBC [Overseas Chinese Banking Corporation] Group — which represents the interests of one of the main Singapore families. By the way, we expect Singapore to follow in Japan's footsteps later this year and allow its companies to repurchase their shares. And when Peter met with Times Publishing's president in December, he mentioned that they plan to buy back shares as soon as they're allowed — which is a signal to us that they're intent on improving shareholder returns.

OID: But before doing any of those things, it's already a publishing firm with emerging markets exposure selling at 5-6 times earnings?

Briggs: You've got it. And Times Publishing's management seem to be relatively good.

Shionogi's a similar story. It's also very compelling. It's a cash rich Japanese pharmaceuticals company. And it's out of favor for several reasons: First, Japan is notorious for overprescribing pharmaceuticals. However, the Japanese government is finally beginning to clamp down a bit on that phenomenon. So there's been a pullback in the industry generally.

But Shionogi's been especially hard hit for a couple of reasons: First, it has very little in the way of exports. And second, it has very little in the way of in-house drugs. So it's historically been primarily a distributor of drugs owned by other companies — such as Eli Lilly and Merck.

OID: Those sound like negatives, all right.

Briggs: They are. Plus, Shionogi is poorly managed. But they know it. And they're taking steps to restructure their operations by offering workers voluntary retirement and rationalizing their distribution. Also, to address their shortage of products in the pipeline, they've set up a research subsidiary in the U.S. And they hope to use it to incentivize researchers to do new product development. However, again, there's lots of potential for improvement.

OID: Sounds charming.

Briggs: And that's why it's cheap. Shionogi's net-net working capital including unrecognized gains in its investment portfolio is up around ¥700 per share. And if you total up its net cash plus those unrecognized gains, you come up with net cash of about ¥500 per share.

When you deduct that ¥500 per share from its current stock price — which is about ¥665 — you're paying less than ¥175 per share for an antibiotics company that's generating an operating profit of about ¥50 per share. So you're really only paying about 3-1/2 times operating profit.

OID: Interesting.

Briggs: And then Shionogi's spending another ¥73 per share on research and development annually. So you're actually paying less than 1-1/2 times its pre-R&D operating profit. Therefore, you could buy the company, get back your ¥500 per share, stop the expenditures on R&D and spin off the antibiotics division and the distribution division. Or alternatively, you can view it as a cheap call option on Shionogi's future drug development.

OID: Either way, it sounds ridiculously cheap.

Briggs: It certainly looks that way to me. So in answer to your question — we're finding lots of bargains like the ones we've talked about. These are the companies we know best and, in some cases, the ones that we're furthest along with in our buy programs. But there are *oodles* of bargains out there.

Therefore, we're out there raising money aggressively. And I'm sure you know the story about Sir John Templeton calling his broker at the outbreak of World War II with an order to buy $100 worth of every stock on either U.S. exchange trading at $1 or less that wasn't entirely bankrupt. I understand it was quite a coup.

[Editor's note: As described in John Train's classic, *The Money Masters*, John Templeton's average holding period for the 104 positions which resulted was about four years during which time he roughly quadrupled his investment.]

Briggs: Similarly, if clients sent us US$200 million more to invest tomorrow, we could put US$1 million each in 200 net-nets in Japan alone that would probably prove to be shrewd investments indeed. And virtually every one of them would be debt free.

No doubt, the managers of some of those companies would waste their cash or defraud their companies. And certain assets would inevitably turn out to be overstated. Peter could tell you some great stories there. However, because the ones we'd buy would be debt-free, they'd have very little bankruptcy risk. So in that way, at least, they'd actually be *better* than the ones Sir John bought.

So that's why Peter's so excited.

OID: Yeah. I can't recall ever hearing him so excited about anything — aside from finishing our features...

Briggs: Yeah. He says he sometimes gets so excited thinking about these ideas that he can't sleep some nights. We truly believe that it's a rare opportunity.

OID: They sound like remarkable developments and remarkable ideas. Our thanks to Peter, Tim, Jim and you for sharing 'em with us.

Briggs: The pleasure was ours. Thanks for having us.

—OID

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WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED: LESSON #2, PART 2
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lecture and answers to student questions thereafter during a visit to a Stanford Law School course he endowed entitled, "Business: What Lawyers Should Know". The course is taught by Professor William Lazier without whose assistance this feature would not have been possible.

As always, we highly recommend that you give Munger's comments a thorough reading, re-reading, etc.

ONE OF THE MOST EXTREME DISTORTERS — BEWARE THE IDEOLOGICAL MISFUNCTIONS.

The most important missing models may be from psychology.

Munger: OK. We've been through some of the general ideas in the search for worldly wisdom. And now I want to turn to something even more extreme and peculiar than the talk I've already given you. Of all the models that people ought to have in useful form and don't, perhaps the most important lie in the area of *psychology*....

A junior professor disputes the greatest semanticist ever....

Munger: I recently had an instructive experience: I just returned from Hong Kong. I have a pal there who's a headmaster of one of the leading schools. He gave me this book called *The Language Instinct* written by Steven Pinker. Well, Pinker is a semanticist professor who rose in the shadow of Noam Chomsky — Linguistics Institute Professor at M.I.T. — who is probably the greatest semanticist who ever lived....

And Pinker says that human language ability is not just learned — it's deeply buried, to a considerable extent, in the *genome*. It's not in the genome of the other animals, including the chimpanzee, to any really useful extent. It's a gift that came to humans. And Pinker proves his point pretty well.

Of course, Chomsky's already proven it. You have to be pretty ignorant not to realize that a good deal of language ability is right there in the human genome. And even though you have to work like hell to improve it through education, you *start* with a big leg up in your genes.

And the junior professor is clearly *right*.

Munger: Pinker can't understand why Chomsky — who, again, is such a genius — takes the position that the jury's still out about why this ability is in the human genome. Pinker, in effect, says: "Like *hell* the jury is still out! The language instinct got into humans in exactly the same way that everything *else* got there — through Darwinian natural selection."

Well, the junior professor is clearly right — and Chomsky's hesitation is a little *daft*.

(continued in next column)

What's blinded Chomsky is quite clear — it's ideological *bias*.

Munger: But if the junior professor and I are right, how has a genius like Chomsky made an obvious misjudgment? The answer's quite clear to me — Chomsky is passionately *ideological*. He is an extreme egalitarian leftist who happens to be a genius. And he's so smart that he realizes that if he concedes this particular Darwinian point, the implications threaten his leftist ideology. So he naturally has his conclusion affected by his ideological *bias*.

I think that this is the way the human mind works — and the process doesn't exempt people merely because they're smart and work hard.

Heavy ideology is one of the most extreme distorters....

Munger: And that gets into another lesson in worldly wisdom: If ideology can screw up the head of a Chomsky, imagine what it does to people like you and me.

Heavy ideology is one of the most extreme distorters of human cognition. Look at these Islamic Fundamentalists who just gunned down a bunch of Greek tourists shouting, "God's work!"

Ideology does some strange things and distorts cognition *terribly*. If you get a lot of heavy ideology *young* — and, then, you start expressing it — you are really locking your brain into a very unfortunate pattern. And you are going to distort your general cognition.

Warren Buffett decided early on that ideology was dangerous.

Munger: There's a very interesting history if you take Warren Buffett as an example of worldly wisdom: Warren adored his father — who was a wonderful man. But he was a very heavy idealogue, (right wing, it happened to be), who hung around with other very heavy ideologues, (right wing, naturally).

Warren observed this as a kid. And he decided that ideology was dangerous — and that he was going to stay a long way away from it. And he *has* throughout his whole life. That has *enormously* helped the accuracy of his cognition.

And I was lucky ideology-wise to have a good role model.

Munger: I learned the same lesson in a different way. My father hated ideology. Therefore, all I had to do was imitate my father and, thereby, stay in what I regard as the right path. People like Dornan on the right or Nader on the left have obviously gone a little daft. They're extreme examples of what ideology will do to you — particularly violently *expressed* ideology. Since it pounds ideas *in* better than it convinces *out*, it's a very dangerous thing to do.

Therefore, in a system of multiple models across multiple disciplines, I should add as an extra rule that you should be very wary of heavy ideology.

Being 100% sure on hard issues makes you a lousy thinker.

Munger: You can have heavy ideology in favor of accuracy, diligence and objectivity. But a heavy ideology that makes you *absolutely sure* that the minimum wage should be raised or that it shouldn't — and it's kind of a holy construct where you know you're right — makes you a bit nuts.

This is a very complicated system. And life is one damn relatedness after another. It's all right to think that, on balance, you suspect that civilization is better if it lowers

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

the minimum wage or raises it. Either position is OK. But being totally *sure* on issues like that with a strong, violent ideology, in my opinion, turns you into a lousy thinker. So beware of ideology-based mental misfunctions.

THREE VERY POWERFUL FORCES FROM PSYCHOLOGY — BUT DON'T LOOK TO THE TEXTS OR THE PROFESSORS.

Don't ask the barber if you need a haircut....

Munger: Another source of misfunction that comes directly out of psychology is what I call *incentive*-caused bias: A doctor decides that some procedure that's good for him is also good for you. Or a lawyer decides that some case that's good for him to litigate is good for you — when it's really not.

People at a subconscious level are so influenced by this incentive-caused bias that it's one of the principal things that you'll have to deal with all your life. So, obviously, this is a *very* powerful psychological idea.

But don't look to the psychology texts. They're *daft*.

Munger: And, yet, it's not effectively dealt with in the psychology texts. You will not find an adequate account of incentive-caused bias — what it does to human cognition and how it screws up human institutions — in any psychology book that I've read. Admittedly, I have only read three. However, they just don't have it right.

Another reason that I mentioned Pinker, the semanticist who wrote the book that I told you about earlier, is that at the end of his book, he says (roughly), "I've read the psychology textbooks. And they're *daft*." He says, "This whole subject is misorganized and mistaught."

Well, I have far less in the way of qualifications than Pinker. In fact, I've never taken a single course in psychology. However, I've come to *exactly* the same conclusion — that the psychology texts, while they are wonderful in part, are also significantly *daft*.

You won't even find an adequate treatment of simple *denial*.

Munger: In fact, just take simple psychological *denial*. A couple of centuries before the birth of Christ, Demosthenes said, "What a man *wishes*, that also will he *believe*." Well, Demosthenes was right.

I had a family acquaintance whose much-loved son — who was brilliant and a star football player — flew off an aircraft carrier and never came back. Well, his mother thought he was still alive. The mind will sometimes flip so that the wish becomes the belief. It will do so at various levels. Individuals vary in how much psychological denial they get. But miscognition from denial *overwhelmingly* pervades the reality that you're going to have to deal with. And, yet, you won't find an adequate treatment of simple psychological denial in psychology texts.

A lot has been discovered, but no one has put it all *together*.

Munger: So you can't learn psychology the way your professors teach it. You've got to learn everything they teach. But you've got to learn a lot more that they *don't* teach — because they don't handle their own subject correctly.

Psychology to me, as currently organized, is like electromagnetism after Faraday, but before Maxwell — a lot has been discovered, but no one mind has put it all *together* in proper form. And it *should* be done because it wouldn't be that hard to do — and it's *enormously* important.

Psychology without *envy, denial* or incentive-caused *bias*?!

Munger: Just open a psychology text, turn to the index and look up *envy*. Well, envy made it into one or two or three of the *Ten Commandments*. Moses knew all about envy. The old Jews when they were herding sheep knew all about envy. It's just that *psychology* professors don't know about envy.

Books that thick are teaching a psychology course without *envy*?! And with no simple psychological *denial*?! And no incentive-caused *bias*?!

HOW CAN SMART PEOPLE BE SO DUMB? NO *CHECKLIST*. AND WITHOUT ONE, YOU'LL SCREW UP TIME AFTER TIME.

Even the most publicized experiment *ever* isn't understood.

Munger: And psychological texts don't deal adequately with *combinations* of factors. I told you earlier to be aware of the lollapalooza effect when two or three or more forces are operating in the same direction.

Well, the single most publicized psychology experiment ever done is the Milgram experiment — where they asked people to apply what they had every reason to believe was heavy electrical torture on innocent fellow human beings. And they manipulated most of these decent volunteers into *doing* the torture.

Milgram performed the experiment right after Hitler had gotten a bunch of believing Lutherans, Catholics and so forth to perform unholy acts they should have known were wrong. He was trying to find out how much authority could be used to manipulate high grade people into doing things that were clearly and grossly wrong.

And he got a very dramatic effect. He managed to get high grade people to *do* many awful things.

But it wasn't just *authority*. It was a lollapalooza effect....

Munger: But, for years it was in the psychology books as a demonstration of *authority* — how authority could be used to persuade people to do awful things.

Of course, that's mere first-conclusion bias. That's not the complete and correct explanation. Authority is part of it. However, there were also quite a few other psychological principles, all operating in the same direction, which achieved that lollapalooza effect precisely because they acted in combination toward the same end.

How can they be so *stupid*? They don't use a model *checklist*.

Munger: People have gradually figured that out. And if you read the recent psychology texts at a place like Stanford, you'll see that they've now managed to get it about two-thirds right. However, here's the main experiment in all of psychology. And even at Stanford, they still leave out some of the important causes of Milgram's results.

How can smart people be so wrong? Well, the answer is that they don't do what I'm telling you to do — which is to take all the main models from psychology and use them

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as a *checklist* in reviewing outcomes in complex systems.

No pilot takes off without going through his checklist: A, B, C, D.... And no bridge player who needs two extra tricks plays a hand without going down his checklist and figuring out how to do it.

But these psychology professors think they're so smart that they don't *need* a checklist. But they aren't that smart. Almost nobody is. Or, maybe, nobody is.

And without a checklist, *you'll* screw up time after time, too.

Munger: If they used a checklist, they'd realize the Milgram experiment harnesses *six* psychological principles, at least — not *three*. All they'd have to do is to go down the checklist to see the ones that they missed.

Similarly, without this system of getting the main models and using them together in a multi-modular way, you'll screw up time after time after time, too.

YOU BETTER NOT DISREGARD LOLLAPALOOZA EFFECTS BECAUSE THEY CAN MAKE YOU RICH OR *KILL* YOU.

Because you can't demonstrate it doesn't justify *ignoring* it.

Munger: One reason psychology professors so screw up denial is that it's hard to do demonstrative experiments without conduct forbidden by ethics. To demonstrate how misery creates mental disfunction in people, think of what you have to do to your fellow human beings. And you have to do it without *telling* them about the injury to come. So, clearly, there are ethical reasons why it's practically impossible to do the experiments necessary to best lay out the ways human misery creates human mental misfunction.

Most professors solve this problem, in effect, by assuming, "If I can't demonstrate it with my experiments, then it doesn't exist." However, obviously, that's *asinine*. If something is very important, but can't be perfectly and precisely demonstrated because of ethical constraints, you can't just treat it like it doesn't exist. You have to do the best you can with it — with such evidence as is available.

Animal research is unpopular, but consider Pavlov's data.

Munger: Pavlov himself spent the last 10 years of his life torturing dogs. And he published. Thus, we have a *vast* amount of data about misery-caused mental misfunction in dogs — and its *correction*. Yet, it's in no introductory psychology book that you'll ever see.

I don't know whether they don't like the fact that Pavlov tortured dogs or whether B.F. Skinner, by overclaiming when he lapsed into his literary mode, made the drawing of implications from animal behavior into human behavior unpopular. However, for some crazy reason or other, the psychology books are *grossly* inadequate in dealing with misery-caused mental misfunction.

You can't *afford* to miss lollapalooza effects — good *or* bad.

Munger: You may say, "What difference does all this psychological ignorance make?" Well, if I'm right, you *need* these models that are blanked out by this ignorance. And, furthermore, you need them in a form whereby, if there are 20 constructs, you have all 20. In other words, you shouldn't be operating with 10. And you need to use them as a checklist. So you have to go back and put in your own head what I'd call the psychology of *misjudgment* in a form whereby you have all of the important models and you can use them.

And you especially need them when four or five forces from these models come together to operate in the same *direction*. In such cases, you often get lollapalooza effects — which can make you *rich* or they can *kill* you. So it's essential that you beware of lollapalooza effects.

There's only one right way to do it: You have to get the main doctrines together and use them as a checklist. And, to repeat for emphasis, you have to pay special attention to combinatorial effects that create lollapalooza consequences.

BUSINESS SCHOOLS HAVE ADDRESSED IT SOME. LAW SCHOOLS SHOULD, TOO. MEANWHILE...

Business schools had the sense to *address* the problem....

Munger: Since the psychology professoriate *refuses* to put its own subject in proper order, my own idea has been that law schools simply ought to do it *for* them.

And, in fact, business schools have done some of that. Almost no business school reaches out for a psychologist from the undergraduate psychology department. Instead, they change all the psychological terms. They invent new terms such as "organizational behavior". And they have the sense to fix some of the deficiencies of undergraduate psychology and teach it to business school students who need it. But they don't have the sense to do the whole job.

Properly taught, it'd be the most interesting thing you study.

Munger: Law schools could do the whole thing. I think the subject is so *important* that it ought to be the first thing that happens when you come to law school. I don't think it would take a *week* for people as smart as you to romp through psychology properly, learn the main ideas and how they intertwine. And the problems would be so interesting that it might be the single most interesting thing that ever happens to you at law school. And the rest of law school would become more interesting, too.

You are deficient. But you can fix it — just as I did....

Munger: But, of course, as far as I know, it isn't done. To me, it is perfectly asinine. How many of you are satisfied with what you know about psychology and the practical utility of what you have in your heads in terms of dealing with what you have to deal with? How many of you think you really have a good repertoire? [No response.]

How many of you feel quite *deficient*? [Many respond.] Well, you're right. But you can fix it. Once I realized how ignorant I was, I just bought three undergraduate psychology texts and waded right through. I just stuck everything that was obviously right and important into my little list of principles. And the three or four important things that I could see that they were leaving out, I just stuck in as additions to my system of models.

Doing it that way, you develop a complete system. And using such a complete system is the way that you should go through life if worldly wisdom is what you're after. Remember the Little Red Hen and do it yourself.

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KNOWING HOW YOUR MIND CAN BE BROKEN, YOU CAN TRAIN YOURSELF TO BEWARE.

Moonies have learned how to create lollapalooza effects.

Munger: Let me give you an example I gave in a previous talk at Cal Tech about how these lollapalooza effects in psychology creep in. Let's take Moonie conversions. How do you take a normal kid who's just a little miserable, take him off for a weekend in the country and turn him into a brainwashed zombie who, for the rest of his life, sells flowers on the streetcorner? Is that a lollapalooza effect? Yeah, it's *obvious*. It's a *total* lollapalooza.

How does it happen? You'd think the introductory psychology books would tell you. But they don't.

What worked for Pavlov works for the Moonies.

Munger: But I'll tell you how. Pavlov's dogs broke down at a certain point. He could break down *any* dog. He never failed. And like Pavlov's dogs, the human mind has a break point which varies from person to person. Therefore, the Moonies just apply all of this pressure and get a high percentage of people's minds to *"snap"* — which is the exact name they use in their "conversion" game. The mind "snaps". And it does. It breaks. So Pavlov broke dogs' minds, whereas the Moonies break people's minds.

Again, breaking people's minds is a lollapalooza effect. The Moonies achieve it by combining psychological tendencies to act in the same direction. There are about 20 standard tricks that can be used to *trigger* lousy cognition of that type. And the Moonies have figured out how to play four, five, six, seven or eight of 'em at the same time. For example, they use social proof: everyone present except the "conversion" target is an ardent believer. They use *stress*. Stress makes people suggestible. That's another psychological principle. They do four, five or six things at once — and the "conversion" process *works* to create the "snap" in a sadly high fraction of cases.

But you're not totally doomed by it. You can *protect* yourself.

Munger: Everyone should know the principles involved in Moonie tactics and their special power in combination. Universities should know and disseminate this knowledge as a matter of high moral obligation. They should hate losing students to "religious" totalism in cults. Just imagine having to call some loving parents to tell them, "You've lost your child to the Moonies." That's a disgrace at any institution.

But one beauty of psychology that we should consider as we emphasize these horrors is that you're not totally *doomed* by your natural psychological tendencies. You can *correct* those psychological deficiencies to some extent. Ben Franklin did it. And Darwin did it. He trained himself out of first-conclusion bias — which is an automatic tendency of the human mind. Once you understand elementary psychology well, you can train yourself to beware confluences of psychological tendencies. So tendency is not destiny.

CAPTAIN COOK KNEW ELEMENTARY PSYCHOLOGY YOU SHOULD, TOO — FOR PROTECTION & PERSUASION.

And you can use these psychological tendencies to persuade.

Munger: You can also learn when you're playing the game of persuasion — for a reputable reason [I hope] — to combine these forces in a way that makes you more effective.

Let me give you an example of that — of wise psychology of yore. In Captain Cook's day, he took these long voyages. At the time, scurvy was the dread of the long voyage. And in scurvy, your living gums putrefy in your mouth — after which the disease gets unpleasant and kills you.

And being on a primitive sailing ship with a bunch of dying sailors is a *very* awkward business. So everybody was terribly interested in scurvy, but they didn't *know* about Vitamin C. Well, Captain Cook, being a smart man with a multiple-model kind of approach, noticed that Dutch ships had less scurvy than English ships on long voyages. So he said, "What are the Dutch doing that's different?"

And he noticed they had all these barrels of sauerkraut. So he thought: "I'm going on these long voyages. And it's very dangerous. Sauerkraut may help." So he laid in all this sauerkraut which, incidentally, happens to contain a trace of vitamin C.

You can lead a sailor to sauerkraut, but you can't make him...

Munger: But English sailors were a tough, cranky and dangerous bunch in that day. They hated "krauts". And they were used to their standard food and booze. So how do you get such English sailors to eat sauerkraut?

Well, Cook didn't want to tell 'em that he was doing it in the hope it would prevent scurvy — because they might mutiny and take over the ship if they thought that he was taking them on a voyage so long that scurvy was likely.

But Cook knew elementary psychology. And you should, too.

Munger: So here's what he did: Officers ate one place where the men could observe them. And for a long time, he served sauerkraut to the officers, but not to the men. And, then, finally, Captain Cook said, "Well, the men can have it *one* day a week."

In due course, he had the whole crew eating sauerkraut. I regard that as a very constructive use of elementary psychology. It may have saved God knows how many lives and caused God knows how much achievement. However, if you don't *know* the right techniques, you can't use them.

If you don't, your education's been *gravely* deficient.

Munger: So the psychology is very important. And it has constructive, honorable uses, like that of Captain Cook, and destructive, dishonorable uses like the Moonies or the charlatan who uses it to sell swampland to retired teachers. So people should know how these things work.

But I'll bet that not one person in this room could describe the eight standard psychological techniques used by the Moonies to induce conversion. Who thinks he can? [No response.] See? I say that your education has been *gravely* deficient.

And it's not so hard to correct. You can learn what you need.

Munger: And it's not difficult. There are only about 20 or so psychological principles on a satisfactory checklist.

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And as you deal with a patch of reality, you run through your checklist and see if any principle explains anything. You're not going to find it very hard.

So I recommend that you treat your educational deficiencies as a serious problem and fix them. And, in the course of doing that, you'll learn the psychology you need.

WORLDLY WISDOM IS ACTUALLY VERY ELEMENTARY, BUT THE REWARDS ARE ABSOLUTELY *AWESOME*.

Psychology's worked wonders for Coke and Tupperware.

Munger: As I demonstrated, I think that psychology has worked *wonders* for Coca-Cola. And just think of all the harmless pleasure that their products have provided — to say nothing of the $3+ billion per year after taxes.

And Tupperware's made a huge and profitable business. Tupperware?! Little plastic containers — sold with no fancy selling quarters, but, instead, in people's homes at Tupperware parties?! What in hell is going on here?

The Procter & Gamble Rule is elementary worldly wisdom.

Munger: There are two very good lessons in the case of Tupperware: Lesson #1 is what I call the "Procter & Gamble Rule". Procter & Gamble has an internal rule that they don't allow their product development people to come in and say, "Procter & Gamble, you have all of this marketing muscle. Therefore, you should use it to sell this so-so product."

What Procter & Gamble says to its product development people is, "First, you make the product truly superior. Then, and *only* then, will we put our marketing muscle behind it."

That's a *very* good rule. You want lollapalooza effects which often come best from a combination of factors operating in the same direction. It's foolish to use just good, clever marketing when good clever marketing *plus* a superior product works so much better. It's obvious. So Procter & Gamble does that.

When I took you through the Coca-Cola example, I was following the Procter & Gamble Rule: First, make the product better. Get out the aftertaste. Add all the bells and whistles. Then, and *only* then, apply the muscle distributing it.

The Moonies have nothing on Tupperware....

Munger: Tupperware is a very good product. Even so, it wouldn't have sold worth a *damn* except for the fact that they invented a selling system with considerable similarity to that of the Moonies — except, of course, that Tupperware does little damage in the world. The Tupperware system uses about six psychological tricks, right out of the standard repertoire of 20, that they play at the same time at their "Tupperware parties".

And, lo and behold, Tupperware has earned pretax billions — from a combination of elementary psychology and the Procter & Gamble Rule.

It's actually very simple — and the rewards are *awesome*.

Munger: Again, the Procter & Gamble Rule's *automatic*. You want lollapalooza effects? Incorporate clever marketing *plus* a good product. Don't try to do either one alone.

Worldly wisdom is mostly very, very simple. And what I'm urging on you is not that hard to do if you have the will to plow through and do it. And the rewards are awesome — absolutely *awesome*.

But maybe you aren't *interested* in awesome rewards or avoiding a lot of misery or being more able to serve everything you love in life. And, if that's your attitude, then don't pay attention to what I've been trying to tell you — because you're already on the right track....

THE SINGLE BEST WAY TO DESTROY YOUR CIVILIZATION: JUST CREATE SYSTEMS THAT ARE EASY TO CHEAT....

If you make it easy to steal, you're working a great injury.

Munger: It can't be emphasized too much that issues of morality are *deeply* entwined with worldly wisdom considerations involving psychology. For example, take the issue of stealing. A very significant fraction of the people in the world will steal if (A) it's very easy to do and, (B) there's practically no chance of being caught.

And once they *start* stealing, the *consistency* principle — which is a big part of human psychology — will soon combine with operant conditioning to make stealing *habitual*. So if you run a business where it's easy to steal because of your methods, you're working a great moral injury on the people who work for you.

Again, that's obvious. It's *very, very* important to create human systems that are hard to cheat. Otherwise you're ruining your civilization because these big incentives will create incentive-caused bias and people will rationalize that bad behavior is OK.

It's dangerous to ignore these principles & let slop creep in.

Munger: Then, if somebody else does it, now you've got at least *two* psychological principles: incentive-caused bias plus social proof. Not only that, but you get *Serpico* effects: If *enough* people are profiting in a general social climate of doing wrong, then they'll turn on you and become dangerous *enemies* if you try and blow the whistle.

It's *very* dangerous to ignore these principles and let slop creep in. *Powerful* psychological forces are at work for evil.

To ruin the civilization, create systems people can easily cheat.

Munger: How does this relate to the law business? Well, people graduate from places like Stanford Law School and go into the legislatures of our nation and with the best of motives pass laws which are easily used by people to cheat. Well, there could hardly be a *worse* thing you could *do*.

Let's say you have a desire to do public service. As a natural part of your planning, you think in reverse and ask, "What can I do to *ruin* our civilization?" That's easy. If what you want to do is to ruin your civilization, just go to the legislature and pass laws that create systems wherein people can easily cheat. It will work perfectly.

Take the workers' compensation system in California. Stress is *real*. And its misery can be real. So you want to compensate people for their stress in the workplace. It seems like a noble thing to do.

But the trouble with such a compensation practice is that it's practically impossible to delete huge cheating. And once you reward cheating, you get crooked *lawyers*, crooked *doctors*, crooked *unions*, etc. participating in referral

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schemes. You get a total *miasma* of disastrous behavior. And the behavior makes all the people doing it *worse* as they do it. So you were trying to help your civilization. But what you did was create enormous *damage*, net.

So it's much better to let some things go uncompensated — to let life be hard — than to create systems that are easy to cheat.

<u>You must stop the slop *early*. Letting it run leads to tragedy.</u>

Munger: Let me give you an example: I have a friend who made an industrial product at a plant in Texas not far from the border. He was in a low-margin, *tough* business. He got massive fraud in the workers' compensation system — to the point that his premiums reached *32%* of payroll. And it was not *that* dangerous to produce his product. It's not like he was a demolition contractor or something....

So he pleaded with the union, "You've got to stop this. There's not enough money in making this product to cover all of this fraud."

But, by then, everyone's used to it. "It's extra income. It's extra money. Everybody does it. It can't be that wrong. Eminent lawyers, eminent doctors, eminent chiropractors — if there *are* any such things — are cheating."

And no one could tell them, "You can't do it anymore." Incidentally, that's Pavlovian mere association, too. When people get bad news, they hate the messenger. Therefore, it was very hard for the union representative to tell all of these people that the easy money was about to stop. That is not the way to advance as a union representative. Anyway, the human tragedy was that they *couldn't* stop.

So my friend closed his plant and moved the work to Utah among a community of believing Mormons. Well, the Mormons aren't *into* workers' compensation fraud — at least they aren't in my friend's plant. And guess what his workers' compensation expense is today? It's 2% of payroll [— down from 32%].

This sort of tragedy is caused by letting the slop run. You must stop slop *early*. It's very hard to stop slop and moral failure if you let it run for awhile.

YOU COULD HARDLY IMAGINE A MORE POWERFUL FORCE. AND, YET, IT ISN'T EVEN IN THE PSYCHOLOGY BOOKS.

<u>A very interesting psychology experiment — in Las Vegas....</u>

Munger: Let me explain one of the reasons why it's hard to stop previously rewarded slop. And here's another example of something that's not handled very well in the psychology books. It's demonstrated by one of the most interesting recent experiments in psychology. It was done not by professors, but by commercial types in Las Vegas. The old mechanical slot machine had a certain natural number of near misses. And it could only have so many — because that was how it was constructed. But once they made it electronic, they could program it to include as few or as many near misses as they wanted — in other words, bar, bar, *almost* bar, but something else.

One company had the dominant share of slot machines. But another company built electronic slot machines with an artificially enhanced number of near misses. And whenever they'd put one of their machines beside another machine that was exactly the same in every way except that it wasn't programmed for so many near misses, the one that provided more near misses would get about 20% more *play* over the course of a day — and people were pulling extra *fast*....

<u>Too many near misses would sully Nevada's reputation....</u>

Munger: Well, this was an *extremely* manipulative thing to do. But that's human nature in capitalism. People will manipulate their fellow man to make money if they can get by with it.

But what happened was quite interesting. The company with the dominant share sued under Nevada laws that say you have to be honest in gambling. You see, Nevada tolerates prostitution, but they don't like pimps and whores rolling the johns because it's bad for the state's reputation. Likewise, they don't mind manipulating people to their disadvantage using standard practices of *legal* gambling, but they hate *"cheating"* gambling. So the company with the leading market share in slot machines won its case by persuading the court to classify as "cheating" gambling the incorporation of all these artificial near misses....

What's happened? Guess what kind of slot machines now go to the Third World? It's what you would *expect*....

<u>A very powerful phenomenon, but it's not even in the books.</u>

Munger: What psychological principle is demonstrated by the fact that play is so much higher on the machine with the artificial number of near misses?

If you turn to the psychology textbooks, you won't find the answer very well laid out. You can hardly *imagine* a more powerful phenomenon than contemporary gambling. Moreover, gambling history is very instructive. One reason why horse races, bingo and these things have always been so popular is because of all these near *misses*. Obviously, a *very* powerful psychological force is at work here. But it's not properly dealt with in the psychology books.

<u>There's a *way* higher reaction to loss than gain.</u>

Munger: What *is* the force? I've invented my own name for it. I call it "deprival super-reaction syndrome". And it happens (A) when anything you like is taken away from you and (B) when you *almost* have something you like and *"lose"* it. Either way, the result is a powerful, subconscious, automatic deprival super-reaction syndrome that distorts your cognition.

And it's very *interesting*. In static electricity, it's so many units — coulombs in that case — plus or minus, from a same-size event. The forces are the same in amount, only reverse in direction.

In psychology, it doesn't work that way. In many ways, people react to a minus five unit force *way* more negatively than they react positively to a force of five unit *plus*, enhancing irrational attempts to "get even." And that's *very* important to know. The deprival super-reaction syndrome of man helps cause much ruin as people's cognition is distorted as a result of their suffering losses and seeing near misses.

<u>Deprival super-reaction syndrome in business and history.</u>

Munger: Does all this miscognition caused by operation of elementary psychological principles have

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practical consequences? You bet it does. Try to get takeaways in labor negotiations. (A) You're facing deprival super-reaction syndrome — people just go *bananas*. And (B) the union representative has to bring his members the deprival message and endure the Pavlovian mere-association hatred that results. Therefore, *he* won't do it — largely for *that* reason. So you have *two* powerful psychological effects making it hell.

All of those strikes in the late 1800s and the early 1900s where Pinkerton guards were shooting people were about takeaways. Arriving immigrants were willing to work cheap. And capitalist proprietors tried to reduce wages — sometimes because they felt that they *had* to because their competitors were doing it and sometimes because they simply wanted to make more money.

At any rate, all of that murder and mayhem was the result of deprival super-reaction syndrome plus the reality that nobody wanted to be the carrier of bad news. So deprival super-reaction syndrome is a *very* powerful force with *enormous* practical consequences.

Moreover, deprival super-reaction syndrome helps cause what I call the Serpico Syndrome. In life, messy as it is, these psychological tendencies interact in ways which are often quite predictable.

Gambling's a *huge* force in society, but not in psychology texts.

Munger: Therefore, it's hard to understand why the psychology texts so underemphasize gambling.... Look at the present civilization — with Indian tribal casinos and all of the illegal betting on sports.... Clearly, we have a *huge* mass of gambling driven by powerful psychological forces.

However, if you look under gambling in a 1,000-page psychology text, you'll occasionally find a sentence or two pointing out that B.F. Skinner's conditioned-reflex extinction curves partly explain how gambling *hooks* you. And, by the way, they do. But that's only a small part of it.

So to understand gambling, you have to do it yourself....

Munger: Part of how gambling hooks you is that you get behind and want to catch up. Deprival super-reaction syndrome sends a surge of irrationality through your mind. And *that's* a big part of what hooks and destroys people....

So gambling can be explained by two or three psychological doctrines in combination. But it's easy to reduce this type of miscognition if you work at it. Unfortunately, the people who teach psychology in America seem to feel no obligation to put 'em together and teach it right. Therefore, you've got to go do it yourself....

IF BRILLIANT FOLKS AT COKE CAN MAKE A *HUGE* BONER, SO CAN YOU. BUT YOU DON'T HAVE TO.

The "New Coke" snafu....

Student: Could you describe what psychological forces went into the decision to change the Coke formula and where the big psychological breakdown was there?

Munger: Oh, that's a *wonderful* question.... Coke had consultants and lawyers and experts — including advertising experts who were much trained in psychology. Plus, the gentlemen running Coke — Keogh and Goizueta — were both brilliant. And so were their junior executives. They'd spent their entire lives thinking about the soft drink business and building up Pavlovian mere-association effects — which were powerfully aiding their business.

But they learned that, by a slight but mildly significant margin, people preferred the taste of Pepsi in blind taste tests — i.e., in ingesting unidentified beverages. Because of those blind taste test results, they decided to change Coke's flavor. And it was such a *big* change that they couldn't just sneak it in. Therefore, they decided that they'd have to announce the change — which, of course, they announced as an improvement.

It was a *ghastly* error — caused by ignorance.

Munger: But, by that time, of course, Coke had already spent umteen-billion dollars to make people associate its long-established flavor with everything good in life. All it *had* was a trademarked flavor with stimulation and food value — the power of which had been dramatically enhanced by Coke's past use of psychology. Now Coke was going to tell the public that the flavor was going to change and that the change was an *improvement*?!

Of course, the "New Coke" decision was totally asinine. I just taught you about deprival super-reaction syndrome and how it's such a powerful basic force — not so much in the psychology textbooks, but in psychology as it really *is*. Coke was sure to get a huge, hostile reaction.

So it was a *ghastly* error. But I will say this — they reversed course and scrambled back quickly. If they hadn't, Coke's competitors would have brought out the "Old Coke" flavor under their own trademarks. So that error almost led to the biggest single mishap in the history of *business* — all as a result of ignorance about elementary psychology.

Brilliant people made that blunder, but *you* don't have to.

Munger: It demonstrates that universities provide gravely deficient psychological education. If it were not so, the brilliant, well-trained people at Coke could not have made such an error. And one of the reasons I'm here giving this talk is I figure that if people as brilliant as the folks at Coke were so miseducated that they couldn't apply an ordinary lesson from psychology to something as important as what they were doing with the most valuable trademark in the world, then I suspect that some of *you* might benefit from a little of this instruction.

If all *those* smart people — ad experts, lawyers, Goizueta and Keogh (who, again, are both brilliant) — can make very important mistakes like that, then so can you. But you don't *have* to. All you have to do is open up the psychology texts, assimilate about 16 little doctrines into your repertoire, add the four or five that the books don't contain or explain well and add better recognition of how these things combine. And *boomo* — you've got an edge on the rest of humanity. It'll help you in business. It'll help you in law. It'll help you in life. And it'll help you in love. It'll help you in *everything*.

But that was a marvelous question about Coke. The "New Coke" story, properly explained, ought hereafter to be in every introductory psychology text, forever.

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But there are limits to the use of these techniques....

Munger: Of course, as I said before, there is one big consideration that needs huge and special attention as part of any use of techniques deliberately harnessing elementary psychological forces: And that is that once you know *how* to do it, there are real moral limits regarding how much you *should* do it. Not all of what you know how to do should you use to manipulate people.

Also, if you're willing to transcend the moral limits and the person you're trying to manipulate realizes what you're doing because he also understands the psychology, he'll hate you. There is wonderfully persuasive evidence of this effect taken from labor relations — some in Israel. So not only are there *moral* objections, but there are also *practical* objections — *big* ones in some cases....

WE'VE SUCCEEDED BY MAKING THE WORLD *EASY* — NOT BY SOLVING HARD PROBLEMS.

About 98% of the time, we agree with Jack Welch....

Student: How do you incorporate psychology in your investment decisions? I think it would be more than just picking products that will appeal to everybody like Coke. After all, there are a lot of smart people out there who obviously think just the way that you showed us today. So are you looking for failure in the thinking of other investors as you go about picking successful companies?

Munger: What makes investment hard, as I said at U.S.C., is that it's easy to see that some companies have better businesses than others. But the price of the stock goes up so high that, all of a sudden, the question of which *stock* is the best to buy gets quite *difficult*.

We've never eliminated the difficulty of that problem. And 98% of the time, our attitude toward the market is ... [that] we're *agnostics*. We don't *know*. Is GM valued properly vis-a-vis Ford? We don't know.

We've succeeded by making the world *easy*.

Munger: We're always looking for something where we think we have an insight which gives us a big statistical

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advantage. And sometimes it comes from psychology, but often it comes from something else. And we only find a *few* — maybe one or two a year. We have no system for having automatic good judgement on all investment decisions that can be made. Ours is a totally different system.

We just look for no-brainer decisions. As Buffett and I say over and over again, we don't leap seven-foot fences. Instead, we look for *one*-foot fences with big rewards on the other side. So we've succeeded by making the world easy for ourselves, not by solving hard problems.

We only find a few that meet our criteria. But that's *enough*.

Student: Based on statistical analysis and insight?

Munger: Well, certainly when we do make a decision, we think that we have an insight advantage. And it's true that some of the insight is statistical in nature. However, again, we find only a few of those.

It doesn't help us merely for favorable odds to exist. They have to be in a place where we can *recognize* them. So it takes a mispriced opportunity that we're smart enough to recognize. And that combination doesn't occur often.

But it doesn't *have* to. If you wait for the big opportunity and have the courage and vigor to grasp it firmly when it arrives, how many do you *need*? For example, take the top 10 business investments Berkshire Hathaway's ever made. We would be very rich if we'd never done anything else — in two *lifetimes*.

So, once again, we don't have any system for giving you perfect investment judgement on all subjects at all times. That would be ridiculous. I'm just trying to give you a method you can use to sift reality to obtain an occasional opportunity for rational reaction.

If you take that method into something as competitive as common stock picking, you're competing with many brilliant people. So, even with our method, we only get a few opportunities. Fortunately, that happens to be enough.

WE HAVE A *SPECIAL* LACK OF APTITUDE IN HIGH TECH. WHY SHOULD WE PLAY WHERE WE'RE *DIS*ADVANTAGED.

Open-mindedness is not just a virtue. It's a *necessity*.

Student: Have you been successful in creating an atmosphere where people below you can do the same things you're talking about doing yourself? For example, you talked about the tendency towards commitment and consistency....

Munger: ...Mostly about the terrible *mistakes* it causes you to make.

Student: ...How have you created an atmosphere comfortable [enough] for people to abandon that tendency and admit that they've made a mistake?

For example, someone here earlier this year from Intel talked about problems that occurred with their Pentium chip. One of the most difficult things for them to do was to realize they'd been going about it the wrong way and turn course. And it's very difficult to do that in a complex structure.

How do you foster that?

Munger: Intel and its ilk create a coherent culture where teams solve difficult problems on the cutting edge of science. That's radically different from Berkshire Hathaway. Berkshire is a *holding* company. We've *decentralized* all the power except for natural headquarters-type capital allocation.

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By and large, we've chosen people we admire enormously to have the power beneath us. It's easy for us to get along with them on average because we love and admire them. And *they* create the culture for whatever invention and reality recognition is going on in their businesses. And included in that reality recognition is the recognition that previous conclusions were incorrect.

But we're a totally different kind of company. It's not at all clear to me that Warren or I would be that good at doing what Andy Grove does. We don't have special competence in that field. We are fairly good at relating to brilliant people we love. But we have defects. For example, some regard me as absentminded and opinionated. I might be a *mess* at Intel.

However, both Warren and I are very good at changing our prior conclusions. We work at developing that facility because without it, disaster often comes.

Why not high tech? We have a *special* lack of aptitude there.

Student: Would you talk a little bit about your seeming predilection away from investing in high technology stocks — on your own part and the part of Berkshire Hathaway. One of the things I've found eye-opening and a little surprising is how the difficulties of running a low-tech business and those of running a high-tech business aren't all that different.

Munger: They're *all* hard. But why should it be *easy* to get rich? In a competitive world, shouldn't it be impossible for there to be an easy way for everybody to get rich? Of *course*, they're all hard.

The reason we're not in high-tech businesses is that we have a *special* lack of aptitude in that area. And, yes — a *low*-tech business can be *plenty* hard. Just try to open a restaurant and make it succeed.

Why play to our weaknesses instead of our strengths?

Student: You seem to be suggesting that there's special aptitude required in high-tech businesses — that they're harder. But aren't they *equally* difficult?

Munger: The advantage of low-tech stuff for us is that we think we understand it fairly well. The other stuff we don't. And we'd rather deal with what we understand.

Why should we want to play a competitive game in a field where we have *no* advantage — maybe a *disadvantage* — instead of playing in a field where we have a clear *advantage*?

Each of you will have to figure out where *your* talents lie. And you'll have to use your advantages. But if you try to succeed in what you're worst at, you're going to have a very lousy career. I can almost guarantee it. To do otherwise, you'd have to buy a winning lottery ticket or get very lucky somewhere else.

THERE'S NO WAY TO AVOID LOTS OF MISTAKES.
BUT YOU HAVE TO LEARN HOW TO HANDLE 'EM.

USAir wasn't a bet on the common, but it *was* a mistake.

Student: Warren Buffett has said that the investment Berkshire made in an airline was a good example of what *not* to do. What chain of thinking led to that wrong decision?

Munger: We were not buying stock in USAir on the theory that the common shareholders were certain to prosper — because the history of the airline business in terms of taking care of shareholders has been *terrible*. It was a preferred stock with a mandatory redemption. In effect, we were *loaning* money to USAir and we had this equity kicker.

We weren't guessing whether it would be a great place for the shareholders. We were guessing whether it would remain prosperous enough to pay off a credit instrument — carrying a fixed dividend and a mandatory redemption. And we guessed that the business would not get so bad that we'd have a credit threat for which we were not being adequately compensated by the high rate we were getting. As it happened, USAir went right to the *brink* of going broke. It was hanging by a *thread* for several months.

It's since come back. And we'll probably get all our money back plus the whole coupon. But it was a mistake.

There's no *way* you can avoid making many mistakes.

Munger: I don't want you to think we have any way of learning or behaving so you won't make a lot of mistakes. I'm just saying that you can learn to make *fewer* mistakes than other people — and how to fix your mistakes *faster* when you *do* make them. But there's no *way* that you can live an adequate life without [making] many mistakes.

One of the tricks in life is to get so you can *handle* mistakes.

Munger: In fact, one trick in life is to get so you can *handle* mistakes. Failure to handle psychological denial is a common way for people to go broke: You've made an enormous commitment to something. You've poured effort and money in. And the more you put in, the more that the whole consistency principle makes you think, "Now it *has* to work. If I put in just a *little* more, *then* it'll work."

And deprival super-reaction syndrome also comes in: You're going to lose the whole thing if you don't put in a little more. People go *broke* that way — because they can't stop, rethink and say, "I can afford to write this one off and live to fight again. I don't have to pursue this thing as an obsession — in a way that will break me."

Part of what you must learn is how to handle mistakes and new facts that change the odds. Life, in part, is like a poker game, wherein you have to learn to quit sometimes when holding a much-loved hand.

A *MARVELOUS* MODEL: YOU JUST SIT THERE WHILE
THE WORLD CARRIES YOU FORWARD BY THE *BILLION*.

Like Coke, Disney just got this *enormous* tailwind.

Student: Could you talk about the thoughts that went into your decision to swap your Capital Cities stock for Disney rather than taking cash. In the media, it was reported that you mentioned thinking about taking the cash.

Munger: Disney's a perfectly marvelous company, but it's also very high-priced. Part of what it does is to make ordinary movies — which is not a business that attracts me at all. However, part of what Disney has is better than a great *gold* mine. My grandchildren — I mean, those videocassettes....

Disney is an amazing example of autocatalysis.... They *had* all those movies in the can. They owned the copyright. And just as Coke could prosper when

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refrigeration came, when the videocassette was invented, Disney didn't have to invent anything or do anything except take the thing out of the can and stick it on the cassette. And every parent and grandparent wanted his descendents to sit around and watch that stuff at home on videocassette. So Disney got this *enormous* tailwind from life. And it was *billions* of dollars worth of tailwind.

Obviously, that's a *marvelous* model if you can find it. You don't have to invent anything. All you have to do is to sit there while the world carries you forward....

Disney's been brilliant about creating the new stuff, too.

Munger: Disney's done a lot of new things right. Don't misunderstand me. But a *lot* of what happened to Disney was like what a friend of mine said about an ignorant fraternity brother of his who succeeded in life, "He was a duck sitting on a pond. And they raised the level of the pond."

Eisner and Wells were brilliant in how they ran Disney. But the huge tailwind from videocassette sales on all of the old stuff that was there when they came in, that was just an automatic break for the new management.

To be fair, they have been brilliant about creating new stuff — like *Pocahantas* and *The Lion King* — to catch the same tailwind. But by the time it's done, *The Lion King* alone is going to do plural billions. And, by the way, when I say "when it's done", I mean 50 years from now or something. But *plural* billions — from *one* movie!?

THE MANLY ART OF WAGERING IS ONE THING.
PROFESSIONAL GAMBLING IS QUITE ANOTHER.

Why investment over law? I just did what came naturally.

Student: Could you talk about why you left the law?

Munger: I had a *huge* family. Nancy and I supported eight children.... And I didn't *realize* that the law was going to get as prosperous as it suddenly got. The big money came into law shortly after I left it. By 1962, I was mostly out. And I was totally out by 1965. So that was a *long* time ago.

Also, I preferred making the decisions and gambling my own money. I usually thought I knew better than the client anyway. So why should I have to do it his way? So, partly, it was having an opinionated personality. And partly, it was a desire to get resources permitting independence.

Also, the bulk of my clients were terrific. But there were one or two I didn't enjoy. Plus, I liked the independence of a capitalist. And I'd always had sort of a gambling personality. I *like* figuring things out and making bets. So I simply did what came naturally.

Why would I ever want to wager against house odds?.

Student: Do you ever gamble Las Vegas-style?

Munger: I won't bet $100 against house odds between now and the grave. I don't *do* that. Why *should* I? I will gamble recreationaly with my pals. And I'll occasionally play a much better bridge player, like Bob Hamman, who might be the best card player in the *world*. But I *know* I'm paying for the fun of playing with him. That's recreational.

As for gambling with simple mechanical house odds against me, why in the world would I ever want to do *that* — particularly given how I detest the manipulative *culture* of legalized gambling. And I'm not comfortable in Las Vegas, even though it does now include a higher percentage of wholesome family recreation. I don't like to be with many of the types who hang around card parlors and so forth. So I don't like legalized gambling.

On the other hand, I do like the manly art of wagering, so to speak. And I like light social gambling among friends. But I do *not* like the professional gambling milieu.

Money management's been a *gold* mine, only not for us....

Student: Could you say something about how the mutual fund and money management business has changed since you got into it — and the growth of capital markets?

Munger: Actually, I didn't really get *into* it. I had a little private partnership for 14 years — up until a little over 20 years ago. However, I never had enough money from other people to amount to a hill of beans — at least by current investment-management standards. So I've never really been *part* of the mutual fund business.

But the money management business has been one of the great growth businesses in the recent history of the United States. It's created many affluent professionals and multi-millionaires. It's been a perfect *gold* mine for people who got in it early. The growth of pension funds, the value of American corporations, and the world's wealth have created a *fabulous* profession for many and carried lots of them up to affluence.

And we deal with them in a variety of ways. However, we haven't been *part* of it for many years. We've basically invested our own money for a long, long time.

Student: Do you expect this [bull] run to continue?

Munger: Well, I'd be amazed if the capitalized value of all American business weren't considerably higher 25 years from now. And if people continue to trade with one another and shuffle these pieces of paper around, then money management may *continue* to be a marvelous business for the managers.

But except for what might be called our *own* money, we're really not *in* it.

WARREN AND I ARE IN UNCHARTED TERRITORY.
AND I'M NOT SURE THAT WE'LL DO IT *RIGHT*.

Adapt your strategy to your nature and talents. *I* did.

Student: I was interested in the evolution of your investment strategy from when you first began — using the Ben Graham model — to the Berkshire Hathaway model. Would you recommend that model to a beginning investor — i.e., dumping most of it or all of it into one opportunity we think is a great one and leaving it there for decades? Or is that strategy really for a more mature investor?

Munger: Each person has to play the game given his own marginal utility considerations and in a way that takes into account his own psychology. If losses are going to make you *miserable* — and some losses are *inevitable* — you might be wise to utilize a very conservative pattern of investment and saving all your life. So you have to adapt your strategy to your own nature and your own talents. I don't think there's a one-size-fits-all investment strategy

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that I can give you.

Mine works fine for *me*. But, in part, that's because I'm *good* at *taking* losses. I can take 'em psychologically. And, besides, I *have* very few. The combination works *fine*.

Warren and I have never *done* this before. We're learning.

Student: You and Buffett have said that Berkshire's stock is overvalued and you wouldn't recommend buying it.

Munger: We didn't say [we thought it was overvalued]. We just said that we wouldn't buy it or recommend that our friends buy it at the prices then prevailing. But that just related to Berkshire's intrinsic value as it was at that time.

Student: If I had the money, I *would* buy it — because you've been saying that your returns will go down for 20 *years*....

Munger: Well, I hope that your optimism is justified. But I do not change my opinion. After all, today, we're in uncharted *territory*. I sometimes tell my friends, "I'm doing the best I can. But, I've never grown *old* before. I'm doing it for the first time. And I'm not sure that I'll do it *right*."

Warren and I have never *been* in this kind of territory — with high valuations and a huge amount of capital. We've never *done* it before. So we're *learning*.

A continuation of *hog heaven*-level returns is impossible.

Student: Everything you and Buffett say seems logical. But it sounds like exactly the same language that Ben Graham was using 30 years ago when he was saying the stock market was overvalued — when it was at 900.

Munger: Oh, I don't think that we share that with him. Graham, great, great though he was as a man, had a screw loose as he tried to predict outcomes for the stock market as a whole. In contrast, Warren and I are almost always agnostic about the market.

On the other hand, we *have* said that common stocks generally have generated returns of 10-11% after inflation for many years and that those returns can't continue for a very long period. And they *can't*. It's simply impossible. The wealth of the world will compound at no such rate. Whatever experience Stanford has had in its portfolio for the last 15 years, its future experience is virtually *certain* to be worse. It may still be *OK*. But it's been a *hog heaven* period for investors over the last 15 years. Bonanza effects of such scale can't last forever.

That our returns will slow isn't an *opinion*. It's a *promise*.

Student: Berkshire's annual report got a lot of press for being pessimistic and for expressing concern about the shrinking pool of opportunities as the company gets bigger and bigger? Where does that leave you 10 years from now?

Munger: We've said over and over that our future rate of compounding our shareholders' wealth is going to go *down* compared to our past — and that our size will be an *anchor* dragging on performance. And we've said over and over again that this is not an *opinion*, but a *promise*.

However, let's suppose that we were able to compound our present book value at *15%* per annum from this point. That would not be so bad and would work out OK for our long-term shareholder. I'm just saying that we could afford to slow down some, as we surely will, and still do OK for the long-term shareholder....

By the way, I'm not promising that we *will* compound our present book value at *15%* per annum.

WHAT COULD POSSIBLY BE *MORE* VALUABLE IN LIFE THAN KNOWING WHAT YOU *KNOW* & WHAT YOU *DON'T*.

You can't make sure you're right. That's the *point*....

Student: You talked about how important it was not to have an extreme ideology. What responsibility, if any, do you think the business and legal communities have for helping inner city areas, spreading the wealth and so on?

Munger: I'm all for fixing social problems. I'm all for being generous to the less fortunate. And I'm all for doing things where, based on a slight preponderance of the evidence, you *guess* that it's likely to do more good than harm....

What I'm *against* is being very confident and feeling that you know, for sure, that your particular intervention will do more good than harm given that you're dealing with highly complex systems wherein everything is interacting with everything *else*.

Student: So [what you're saying is to] just make sure that what you're doing [is doing more good]...

Munger: You *can't* make sure. That's my *point*....

What could be more important than knowing what you know?

Munger: On the other hand, I did recently reverse [the conclusions of] two sets of engineers. How did I have enough confidence in such a complicated field to do that? Well, you might think, "Oh, this guy is just an egomaniac who's made some money and thinks he knows everything."

Well, I may be an egomaniac, but I *don't* think I know everything. But I saw huge reasons in the circumstances for *bias* in each set of engineers as each recommended a course of action very advantageous to itself. And what each was saying was so consonant with a natural bias that it made me distrust it. Also, perhaps I knew enough engineering to know that [what they were saying] didn't make sense.

Finally, I found a third engineer who recommended a solution I approved. And, thereafter, the second engineer came to me and said, "Charlie, why didn't *I* think of that?" — which is to his credit. It was a much better *solution*, both safer and cheaper.

You must have the confidence to override people with more credentials than you whose cognition is impaired by incentive-caused bias or some similar psychological force that is obviously present. But there are also cases where you have to recognize that you have no wisdom to *add* — and that your best course is to trust some expert....

In effect, you've got to know what you *know* and what you *don't* know. What could possibly be more useful in life than that?

When you don't know, don't be afraid to *say* so....

Student: You discussed Coke's mistake. Do you have any thoughts about where Apple went wrong?

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Munger: Let me give you a very good answer — one I'm copying from Jack Welch, the CEO of General Electric. He has a Ph.D. in engineering. He's a star businessman. He's a marvelous guy. And recently, in Warren's presence, someone asked him, "Jack, what did Apple do *wrong*?"

His answer? "I don't have any special competence that would enable me to answer that question." And I'll give you the very same answer. That's not a field in which I'm capable of giving you any special insight.

On the other hand, in copying Jack Welch, I am trying to teach you something. When you don't know and you don't have any special competence, don't be afraid to *say* so.

Nobody *expects* you to know everything....

Munger: There's another type of person I compare to an example from biology: When a bee finds nectar, it comes back and does a little dance that tells the rest of the hive, as a matter of genetic programming, which direction to go and how far. So about 40 or 50 years ago, some clever scientist stuck the nectar straight *up*. Well, the nectar's *never* straight up in the ordinary life of a bee. The nectar's *out*. So the bee finds the nectar and returns to the hive. But it doesn't have the genetic programming to do a dance that says straight up. So what does it do?

Well, if it were like Jack Welch, it would just *sit* there. But what it actually does is to dance this incoherent dance that gums things up. And a lot of people are like that bee. They attempt to *answer* a question like that. And that is a *huge* mistake. Nobody *expects* you to know everything about everything.

I try to get *rid* of people who always confidently answer questions about which they don't have any real knowledge. To me, they're like the bee dancing its incoherent dance. They're just screwing up the *hive*.

A GREAT LESSON MY FATHER TAUGHT ME EARLY
THAT I'VE HELD THROUGH ALL THESE DECADES.

There are perverse incentives at work in law firms....

Student: As someone who's been in legal practice and business, how did you incorporate, or *did* you incorporate, these models into your legal practice? And how did it work? I suspect many of us have seen law firms that don't appear to adhere to these kinds of models.

Munger: Well, the models are there. But just as there are perverse incentives in academia, there are perverse incentives in law firms. In fact, in some respects, at the law firms, it's much *worse*.

The Grant McFayden model....

Munger: Here's another model from law practice: When I was very young, my father practiced law. One of his best friends, Grant McFayden — Omaha's Pioneer Ford dealer — was a client. He was a perfectly *marvelous* man — a self-made Irishman who'd run away uneducated from a farm as a youth because his father beat him. So he made his own way in the world. And he was a brilliant man of enormous charm and integrity — just a wonderful, wonderful man.

In contrast, my father had another client who was a blowhard, overreaching, unfair, pompous, difficult man. And I must have been 14 years old or thereabouts when I asked, "Dad, why do you do so much work for Mr. X — this overreaching blowhard instead of working more for wonderful men like Grant McFayden?"

My father said, "Grant McFayden treats his employees right, his customers right and his problems right. And if he gets involved with a psychotic, he quickly walks over to where the psychotic is and works out an exit as fast as he can. Therefore, Grant McFayden doesn't have enough remunerative law business to keep you in Coca-Cola. But Mr. *X* is a walking *minefield* of wonderful legal business."

What drove me from practicing law....

Munger: This case demonstrates one of the troubles with practicing law. To a considerable extent, you're going to be dealing with grossly defective people. They create an enormous amount of the remunerative law business. And even when your own client is a paragon of virtue, you'll often be dealing with gross defectives on the other side or even on the bench. That's partly what drove me out of the profession.

The rest was my own greed, but my success in serving greed partly allowed me to make easier the process of being honorable and sensible. Like Ben Franklin observed, "It's hard for an empty sack to stand upright".

You can *work* for defectives, but *live* like Grant McFayden.

Munger: I'd argue that my father's model when I asked him about the two clients was totally correct didaction. He taught me the right lesson. The lesson? As you go through life, sell your services once in awhile to an unreasonable blowhard if that's what you must do to feed your family. But run your *own* life like Grant McFayden. That was a great lesson.

And by making me reach, he taught me the lesson for good.

Munger: And he taught it in a very clever way — because instead of just pounding it in, he told it to me in a way that required a slight mental reach. And I had to make the reach *myself* in order to get the idea that I should behave like Grant McFayden. And because I had to *reach* for it, he figured, I'd hold it better. And, indeed, I've held it all the way through until today — through all of these decades. That's a very clever teaching method.

There, again, we're talking about elementary psychology. It's elementary literature. Good literature makes the reader reach a little for understanding. Then, it *works* better. You *hold* it better. It's the commitment and consistency tendency. If you've *reached* for it, the idea's pounded in *better*.

As a lawyer or executive, you'll want to teach somebody what my father taught me or maybe you'll want to teach them something else. And you can use lessons like this. Isn't that a great way to teach a child? My father used indirection on purpose. And look at how powerfully it worked — like Captain Cook's wise use of psychology. I've been trying to imitate Grant McFayden ever since — for all my life. I may have had a few lapses. But, at least, I've been trying.

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WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED: LESSON #2, PART 2
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BY THINKING CORRECTLY & KNOWING A FEW TRICKS, YOU CAN ADD GREAT VALUE TO THOSE AROUND YOU.

If you think correctly, you can add great value....

Student: At the end of your article in *OID*, you mentioned that only a select few investment managers actually add value. Since you're speaking to an audience of future lawyers, what would you encourage us to do in order to be able to add value in our profession.

Munger: To the extent you become a person who thinks correctly, you can add great value. To the extent you've learned it so well that you have enough confidence to intervene where it takes a little courage, you can add great value. And to the extent that you can prevent or stop some asininity which would otherwise destroy your firm, your client or something or someone that you care about, you can add great value.

Humorous examples can *enormously* aid persuasion.

Munger: And there are constructive tricks you can use. For example, one reason why my old classmate, Joe Flom of Skadden Arps, has been such a successful lawyer is that he's very good at dreaming up little, vivid examples that serve to pound the point home in a way that really works. It's *enormously* helpful when you're serving clients or otherwise trying to persuade someone in a good cause to come up with a little humorous example.

The ability to do that is a knack. So you could argue that the Joe Floms of the world are almost born with a gift. But he's *honed* the gift. And to one degree or another, all of *you* were born with the gift. And you can hone it, too.

Another psychological principle — appealing to *interest*.

Munger: Occasionally, you get into borderline stuff. For instance, suppose you've got a client who really wants to commit tax fraud. If he doesn't push the tax law way beyond the line, he can't *stand* it. He can't shave in the morning if he thinks there's been any cheating he could get by with that he hasn't done. And there are people like that. They just feel they aren't living aggressively enough.

You can approach that situation in either of two ways: (A) You can say, "I just won't work for him," and duck it. Or, (B) you can say, "Well, the circumstances of my life require that I work for him. And what *I'm* doing for him doesn't involve my cheating. Therefore, I'll do it."

And if you see he wants to do something really stupid, it probably won't work to tell him, "What you're doing is bad. I have better morals than you."

That *offends* him. You're young. He's old. Therefore, instead of being persuaded, he's more likely to react with, "Who in the hell are you to establish the moral code of the whole world?"

But, instead, you can say to him, "You can't do that without three other people beneath you knowing about it. Therefore, you're making yourself subject to *blackmail*. You're risking your *reputation*. You're risking your *family*, your *money*, etc."

That is likely to *work*. And you're telling him something that's *true*. Do you want to spend a lot of time working for people where you have to use methods like that to get them to behave well? I think the answer is *no*. But if you're hooked with it, appealing to *interest* is likely to work better as a matter of human persuasion than appeal to anything else. That, again, is a powerful psychological principle with deep biological roots.

CEOs don't like the idea of being ruined, disgraced and fired.

Munger: I saw that psychological principle totally blown at Salomon. Salomon's general counsel *knew* that the CEO, Gutfreund, should have promptly told the Federal authorities all about Salomon's trading improprieties in which Gutfreund didn't participate and which he hadn't caused. And the general counsel urged Gutfreund to do it. He told Gutfreund, in effect, "You're probably not legally required to do that, but it's the right thing to do. You really should."

But it didn't work. The task was easy to put off — because it was unpleasant. So that's what Gutfreund did — he put it off.

And the general counsel had very little constituency within Salomon *except* for the CEO. If the CEO went down, the general counsel was going down with him. Therefore, his whole career was on the line. So to save his career, he needed to talk the dilatory CEO into doing the right thing.

It would've been child's play to get that job done right. All the general counsel had to do was to tell his boss, "John, this situation could ruin your *life*. You could lose your *wealth*. You could lose your *reputation*...." And it would have *worked*. CEOs don't *like* the idea of being ruined, disgraced and fired.

Salomon executives made that mistake. You don't have to.

Munger: And the ex-general counsel of Salomon is brilliant and generous — and he had the right idea. However, he lost his job because he didn't apply a little elementary psychology. He failed to recognize that what works best in most cases is to appeal to a man's interest.

But you don't have to get similarly lousy results when you face similar situations. Just remember what happened to Gutfreund and his general counsel. The right lessons are easily learned if you'll work at it. And if you do learn them, you can be especially useful at crucial moments when others fail. And to the extent that you do become wise, diligent, objective and, especially able to persuade in a good cause, then you're adding value....

HIGHER LEGAL & REGULATORY COSTS ARE A REALITY. AND IT WILL EVER BE THUS. BUT SOCIETY ADAPTS....

Not everyone favors less fraud....

Student: Would you discuss how the threat of litigation — shareholder lawsuits and so forth — and legal complexity in general has effected decision making in big business?

Munger: Well, every big business *screams* about its legal costs, *screams* about the amount of regulation, *screams* about the complexity of its life, *screams* about the plaintiff's bar — particularly the class action plaintiff's bar. So there's an absolute catechism on that where you could just copy the screams from one corporation to another and you'd hardly have to change a *word*.

But what causes the screams has, so far, been a

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WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED: LESSON #2, PART 2
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godsend for the law firms.... The big law firms have had a long updraft. And they now tend to kind of cluck like an undertaker in a plague. An undertaker, of course, would look very unseemly if he were jumping up and down and playing his fiddle during the plague. So law firm partners say, "Oh, isn't it *sad* — all this *complexity*, all this *litigation*, all this *unfairness*."

But, really, they're somewhat schizophrenic on the subject because it's been very good for [them]. Some recent California initiatives created some interesting conduct. Part of the defense bar lobbied quietly against certain propositions and, effectively, against their clients because they didn't want their clients to catch 'em in the process. And the reason that they did so was because they saw that the defense bar would suffer if it became harder for plaintiffs to bring cases.

If you make a living fighting overreaching and it keeps your children in school and somebody proposes a system that *eliminates* it — well, that's an adult experience and an adult choice that you have to make.

<u>And it will ever be thus</u>....

Munger: So big corporations adapt. They have more litigation. They have to have a bigger legal department. They scream about what they don't like. But they adapt.

Student: But hasn't that legal complexity consumed a lot more of companies' resources over the last few decades?

Munger: The answer is yes. Hardly a corporation in America isn't spending more on lawsuits and on compliance with various regulations than it was 20 years ago. And, yes, some of the new regulation is stupid and foolish. And some was damn well necessary. And it will ever be *thus*, albeit with some ebb and flow.

<u>I don't think big rich corporations should make helmets...</u>.

Student: But have you seen or experienced any change in decision-making at corporations in their being less likely to take on riskier investments for fear of failure or liability?

Munger: The only place I saw — with another friend, not <u>Warren [Buffett]</u> — [was where] I was part owner of the biggest shareholder in a company that invented a better policeman's helmet. It was made of Kevlar or something of that sort. And they brought it to us and wanted us to [manufacture] it.

As a matter of ideology, we're very pro-police.... I believe civilization needs a police force — although I don't believe in policemen creating too many widows and orphans unnecessarily either. But we like the idea of a better policeman's helmet.

However, we took one look at it and said to the people who invented it, "We're a rich corporation. We can't *afford* to make a better policeman's helmet. That's just how the civilization works. All risks considered, it can't work for us. But we want the civilization to *have* 'em."

"So don't maximize what we get for it. Get somebody else to make it.... Transfer the technology or whatever to somebody who can do it. But we're not going to."

Thus, we didn't try to disadvantage policemen [by keeping them from] getting new helmets, but we decided not to manufacture helmets ourselves.

There *are* businesses — given the way the civilization has developed — where being the only deep pocket around is bad business. In high school football, for example, a paraplegic or quadriplegic will inevitably be created occasionally. And who with deep pockets can the injured person best sue other than the helmet manufacturer? Then everyone feels sorry, the injuries are horrible, and the case is dangerous for the manufacturer....

I think big, rich corporations are seldom wise to make football helmets in the kind of a civilization we're in. And maybe it should be harder to successfully sue helmet makers.

<u>There are various ways of adapting to the litigation climate</u>.

Munger: I know two different doctors — each of whom had a sound marriage. And when the malpractice premiums got high enough, they divorced their wives and transferred most of their property to their wives. And they continued to practice — only *without* malpractice insurance.

They were angry at the civilization. They needed to adapt. And they trusted their wives. So that was that. And they've not carried any malpractice insurance *since*.

People adapt to a changing litigation climate. They have various ways of doing it. That's how it's always been and how it's always going to *be*.

NAVY MODEL IS BETTER THAN LAW SCHOOL MODEL
— BECAUSE THE CIVILIZATION WORKS *BETTER*.

<u>Better a few get treated harshly than society be corrupted</u>.

Munger: What I personally hate most are systems that make fraud *easy*. Probably way more than half of all the chiropractic income in California comes from pure fraud. For example, I have a friend who had a little fender bender — an auto accident — in a tough neighborhood. And he got two chiropractors' cards and one lawyer's card before he'd even left the *intersection*. They're in the *business* of manufacturing claims that necks hurt.

In California, I believe the Rand statistics showed that we have *twice* as many personal injuries per accident as in many other states. And we aren't getting twice as much real *injury* per accident. So the other half of that is *fraud*. People just get so that they think everybody does it and it's all right to do. I think it's *terrible* to let that stuff creep in.

If I were running the civilization, compensation for stress in workers' comp would be *zero* — not because there's no work-caused stress, but because I think the net social damage of allowing stress to be compensated at *all* is worse than what would happen if a few people that had real work-caused stress injuries went uncompensated.

<u>The Navy model causes people to pay attention</u>.

Munger: I like the Navy system. If you're a captain in the Navy and you've been up for 24 hours straight and have to go to sleep and you turn the ship over to a competent first mate in tough conditions and he takes the ship aground — clearly through no fault of *yours* — they don't court martial you, but your naval career is *over*.

Napoleon said he liked luckier generals — he wasn't into supporting losers. Well, the Navy likes luckier captains.

You can say, "That's too *tough*. That's not law school.

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WORLDLY WISDOM REVISITED: LESSON #2, PART 2
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That's not due process. Well, the Navy model is *better* in its context than would be the law school model. The Navy model *really* forces people to pay attention when conditions are tough — because they know that there's no *excuse*. Very simply, if your ship goes aground, your career is over.

"It doesn't *matter* whether it was your fault or not. Nobody's *interested* in your fault. It's just a *rule* that we happen to have — for the good of all, all effects considered."

The civilization works *better* with some of these rules.

Munger: I *like* some rules like that. I think that the civilization works *better* with some of these no-fault rules. But that stuff tends to be anathema around law schools. "It's not due process. You're not really searching for justice."

Well, I *am* searching for justice when I argue for the Navy rule — for the justice of fewer ships going aground. Considering the net benefit, I don't *care* if one captain has some unfairness in his life. After all, it's not like he's being court marshalled. He just has to look for a new line of work. And he keeps vested pension rights and so on. So it's not like it's the end of the world.

So I *like* things like that. However, I'm in a minority.

ACHIEVING WORLDLY WISDOM ISN'T THAT HARD. AND THE BENEFITS AND THE FUN LAST A LIFETIME.

It's not that hard....

Student: I'd like to hear you talk a little bit more about judgement. In your talk, you said we should read the psychology textbooks and take the 15 or 16 principles that are best or the ones that make sense...

Munger: The ones that are obviously important and obviously right. That's correct.... And then you stick in the ones that are obviously important and not in the books — and you've got a system.

Student: Right. My problem seems to be the prior step — which is determining which ones are obviously right. And that seems to me to be the more essential question to ask.

Munger: No, no. You overestimate the difficulty. Do you have difficulty understanding that people are heavily influenced by what other people think and what other people do — and that some of that happens on a subconscious level?

Student: No, I don't. I understand that.

Munger: Well, you can go right through the principles. And, one after another, they're like that. It's not that *hard*....

Do you have any difficulty with the idea that operant conditioning works — that people will repeat what worked for them the *last* time?

If you want it all laid out, maybe you should be a Moonie.

Student: It just seems to me like there's a lot of other things out there, as well, that also make a lot of sense. The system would quickly get too complicated, I imagine — as a result of too much cross-talk.

Munger: Well, if you're like me, it's kind of *fun* for it to be a little complicated. If you want it totally easy and totally laid out, maybe you should be a Moonie. I don't think that's a good way to go. I think you'll just have to endure the world — as complicated as it is. Einstein has a marvelous statement on that: "Everything should be made as simple as possible, but no *more* simple."

I'm afraid that's the way it is. If there are 20 factors and they interact some, you'll just have to learn to handle it — because that's the way the world is. But you won't find it that hard if you go at it Darwin-like, step by step with curious persistence. You'll be *amazed* at how good you can get.

It's awesome — in more ways than one....

Student: You've given us about three of the models that you use. I wondered where you found the other ones. And, second, do you have an easier way for us to find them than going through a psychology textbook? I'm not averse to doing that, but it takes longer....

Munger: There are a relatively small number of disciplines and a relatively small number of truly big ideas. And it's a lot of fun to figure it out. Plus, if you figure it out and do the outlining yourself, the ideas will *stick* better than if you memorize 'em using somebody else's cram list.

Even better, the fun never *stops*. I was miseducated horribly. And I hadn't bothered to pick up what's called modern Darwinism. I do a lot of miscellaneous reading, too. But I just *missed* it. And in the last year, I suddenly realized I was a total damned fool and hadn't picked it up properly. So I went back. And with the aid of Dawkins — Oxford's great biologist — and others, I picked it up....

Well, it was an absolute *circus* for me in my 70s to get the modern Darwinian synthesis in my head. It's so awesomely beautiful and so awesomely right. And it's so *simple* once you get it. So one beauty of my approach is that the fun never *stops*.... I suppose that it does stop eventually when you're drooling in the convalescent home at the end. But, at least, it lasts a long time.

A COURSE ON "REMEDIAL WORLDLY WISDOM" WOULD BE FABULOUS VALUE-WISE *AND* FUN-WISE.

Remedial Worldly Wisdom should be taught in law school.

Munger: If I were czar of a law school — although, of course, no law school will permit a czar, (they don't even want the dean to have much power) — I'd create a course which I'd call "Remedial Worldly Wisdom" that would, among other useful things, include a fair amount of properly taught psychology. And it might last three weeks or a month....

I think you could create a course that was so interesting — with pithy examples and powerful principles — that it would be a total *circus*. And I think that it would make the whole law school experience work better.

And I'd call it "Remedial" for a reason....

Munger: People raise their eyebrows at that idea. "People don't do that kind of thing." They may not like the *derision* that's implicit in the title: "Remedial Worldly Wisdom". But the title would be my way of announcing, "Everybody ought to *know* this." And, if you call it remedial, isn't that what you're saying? "This is really basic and everybody has to know it."

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Such a course would be a perfect *circus*. The examples are so legion. I don't see why people don't do it. They may not do it mostly because they don't want to. But, also, maybe they don't know *how*. And maybe they don't want to offend their undergraduate departments. I don't know *what* it is.

But the whole law school experience would be much more fun if the really basic ideas were integrated and pounded in with good examples for a month or so before you got into conventional law school material.... I think the whole system of education would work better. But nobody has any interest in doing it.

Inanity has a way of creeping into most areas of academia.

Munger: And when law schools do reach out beyond traditional material, they often do it in what looks to me like a pretty dumb way. If you think psychology is badly taught in America, you should look at corporate finance. Modern portfolio theory?! It's *demented*! It's truly amazing.

I don't know *how* these things happen. Hard science and engineering tend to be pretty reliably done. But the minute you get outside of those areas, a certain amount of inanity seems to creep into academia — even [in] academia involving people with very high I.Q.s.

This is not the way to do it.

Munger: But, boy, what a school would be like that pounded a lot of the silliness *out*. But the right way to pound it out is not to have some 70+ year old capitalist come in and tell seniors, "Here's a little remedial worldly wisdom." This is *not* the way to do it.

On the other hand, a month at the start of law school that really pounded in the basic doctrines.... *Many* of the legal doctrines are tied to other doctrines. They're joined at the *hip*. And, yet, they teach you those legal doctrines without pointing out how they're tied to the other important doctrines?! That's insanity — absolute insanity.

The human mind *needs* reasons. So does education & society.

Munger: Why do we have a rule that judges shouldn't talk about legal issues that aren't before them? In my day, they taught us the rule, but not in a way giving reasons tied to the guts of undergraduate courses. It's *crazy* that people don't have those reasons. The human mind is not constructed so that it works well without having reasons. You've got to hang reality on a theoretical structure with reasons. That's the way it hangs together in usable form so that you're an effective thinker.

And to teach doctrines — either with no reasons or with poorly explained reasons?! That's *wrong*!

Even the *name* would force sense....

Munger: Another reason why I like the idea of having a course on remedial worldly wisdom is that it would force more sense on the *professors*. It would be *awkward* for them to teach something that was contravened by lessons that were obviously correct and emphasized in a course named "Remedial Worldly Wisdom". Professors doing so would really have to justify themselves.

IT'S A SCREAMING OPPORTUNITY FOR SOMEBODY.
BUT I'M NOT EXACTLY HOLDING MY BREATH.

I have plenty else to do, but it's a screaming opportunity.

Munger: Is that a totally crazy idea? It may be crazy to expect it to be *done*. However, if somebody had done it, would you have found it useful?

Student: I think it would be a wonderful thing to have. Unfortunately, when it's created, we won't *be* here anymore. You're proposing that this would be good to teach people in a course form so it would be accessible to them. Is there any way that it could be more accessible to us — other than having to...

Munger: I get requests for pointers to easy learning all the time. And I'm trying to provide a little easy learning today. But one talk like this is not the right way to do it. The right way to do it would be in a book....

I hope what I'm saying will help you be more effective and better human beings. And if you don't get rich, that won't bother me. But I'm *always* asked this question: "Spoon feed me what you know." And, of course, what they're often saying is, "Teach me how to get rich with soft white hands *faster*. And not only let me get *rich* faster, but *teach* me faster, *too*."

I don't have much interest in writing a book myself. Plus it would be a lot of work for somebody like me to try and do it in my 70s. And I have plenty else to do in life. So I'm not going to do it. But it's a *screaming* opportunity for somebody. And I'd provide funds to support the writing of an appropriate book if I found someone with the wisdom and the will to do the job right.

Psychology professors may not be rocket scientists generally.

Munger: Let me turn to some of the probable reasons for present bad education. Part of the trouble is caused by the balkanization of academia. For instance, psychology is most powerful when combined with doctrines from other academic departments. But if your psychology professor doesn't *know* the other doctrines, then he isn't capable of doing the necessary integration.

And how would anyone get to be a psychology professor in the first place if he were good with non-psychology doctrines and constantly worked non-psychology doctrines into his material? Such a would-be professor would usually offend his peers and superiors.

There have been some fabulous psychology professors in the history of the world. Cialdini of Arizona State was very useful to me, as was B.F. Skinner — for his experimental results, if divorced from his monomania and utopianism. But averaged out, I don't believe that psychology professors in America are people whose alternative career paths were in the toughest part of physics. And that may be one of the reasons why they don't get it quite right.

I admire a college president who tries to correct the disgrace.

Munger: The schools of education, even at eminent universities, are pervaded by psychology. And they're almost an intellectual disgrace. It's not unheard of for academic departments — even at great institutions — to be quite deficient in important ways. And including a lot of material labeled as psychological is no cure-all.

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And given academic inertia, all academic deficiencies are very hard to fix. Do you know how they tried to fix psychology at the University of Chicago? Having tenured professors who were terrible, the president there actually *abolished* the entire psychology department.

And Chicago, in due course, will probably bring back a new and different psychology department. Indeed, by now, it probably has. Perhaps conditions are now better. And I must admit that I admire a college president who will do something like that.

And psychology's unable to attract Nobel Laureate-types....

Munger: I do not wish to imply in my criticism that the imperfections of academic psychology teaching are all attributable to some kind of human fault common only to such departments. Instead, the causes of many of the imperfections lie deep in the nature of things — in irritating peculiarities that can't be removed from psychology.

Let me demonstrate by a "thought experiment" involving a couple of questions: Are there not many fields that need a synthesizing super-mind like that of James Clerk Maxwell, but are destined never to attract one? And is academic psychology, by its nature, one of the most unfortunate of all the would-be attractors of super-minds? I think the answers are yes and yes.

One can see this by considering the case of any of the few members of each generation who can, as fast as fingers can move, accurately work through the problem sets in thermodynamics, electromagnetism and physical chemistry. Such a person will be begged by some of the most eminent people alive to enter the upper reaches of hard science.

Will such a super-gifted person instead choose academic psychology wherein lie very awkward realities: (A) that the tendencies demonstrated by social psychology paradoxically grow weaker as more people learn them, and, (B) that clinical (patient-treating) psychology has to deal with the awkward reality that happiness, physiologically measured, is often improved by believing things that are not true? The answer, I think, is plainly no. The super-mind will be repelled by academic psychology much as Nobel Laureate physicist, Max Planck, was repelled by economics, wherein he saw problems that wouldn't yield to his methods.

MASTER THE BEST THAT OTHERS HAVE FIGURED OUT.
NOBODY'S SMART ENOUGH TO DO IT THEMSELVES.

Workaholic or workaphobic, don't neglect worldly wisdom.

Student: We talk a lot about trade-offs between the quality of our life and our professional commitments.... Is there time for a professional life, learning about these models and doing whatever else interests you? Do you find time to do fun things besides learning?

Munger: I've *always* taken a fair amount of time to do what I really wanted to do — some of which was merely to fish or play bridge or play golf....

Each of us must figure out his or her own life-style.... You may want to work 70 hours a week for 10 years to make partner at Cravath and thereby obtain the obligation to do more of the same. Or you may say, "I'm not willing to *pay* that price." Either way, it's a totally personal decision which you have to make by your own lights.

But, whatever you decide, I think it's a *huge* mistake not to absorb elementary worldly wisdom if you're capable of doing it because it makes you better able to serve others, it makes you better able to serve yourself and it makes life more fun. So if you have an aptitude for doing it, I think you'd be crazy not to. Your life will be enriched — not only financially, but in a host of other ways — if you do.

Many activities are dignified by the need for money.

Munger: Now this has been a *very* peculiar talk for some businessman to come in and give at a law school — some guy who's never taken a course in psychology telling you that all of the psychology textbooks are wrong. This is *very* eccentric. But all I can tell you is that I'm sincere.

There's a lot of simple stuff that many of you are quite capable of learning. And your lives will work way better, too, if you do. Plus, learning it is a lot of fun. So I urge you to learn it.

We just *pretend* to be businessmen, but it's a pretty good act.

Student: Are you in effect fulfilling your responsibility to share the wisdom that you've acquired over the years?

Munger: Sure. Look at Berkshire Hathaway. I call it the ultimate didactic enterprise. Warren's never going to spend any money. He's going to give it all back to society. He's just building a platform so people will listen to his notions. Needless to say, they're very good notions. And the platform's not so bad either. But you could argue that Warren and I are academics in our own way....

Better to learn from the best. It's too hard otherwise.

Student: Most of what you've said is very compelling. And your quest for knowledge and, therefore, command of the human condition and money are all laudable goals.

Munger: I'm not sure the quest for money is so laudable.

Student: Well, then — understandable.

Munger: *That* I'll take. I don't sneer, incidentally, at making sales calls or proofreading bond indentures. If you need the money, it's fun earning it. And if you have to try a bunch of cases in the course of your career, you'll learn something doing *that*. You ought to do *something* to earn money. Many activities are dignified by the fact that you earn money.

Student: I understand your skepticism about overly ideological people. But is there an ideological component to what you do? Is there something that *you're* irrationally passionate about?

Munger: Yeah. I'm passionate about *wisdom*. I'm passionate about *accuracy* and some kinds of curiosity. Perhaps I have some streak of generosity in my nature and a desire to serve values which transcend my brief life. But maybe I'm just here to show off. Who knows?

I believe in the discipline of mastering the best that other people have ever figured out. I don't believe in just sitting down and trying to dream it all up *yourself*. Nobody's that *smart*....

—OID

V. PREM WATSA, FAIRFAX FINANCIAL HOLDINGS LIMITED

"Last year we made the point that 'with many warning lights flashing, we were being more cautious than usual in making any new stock investments'. Since making this profound statement, the TSE 300 and S&P 500 have increased 13% and 31% respectively in 1997. However, we have (perhaps stubbornly!) not changed our mind. In fact, we feel compelled to change the 'warning flashing lights' to 'red alert'. Given current market levels, the possibility of deflation (or certainly no inflation) caused by massive Asian stock market and currency devaluations, mindless 'long-term' investing in mutual funds ... and a lack of 'values' in their markets, we have reduced our U.S. and Canadian common stock investments significantly.

Perhaps an example will illustrate the amount of speculation in the U.S. market. According to a recent Doom, Boom and Gloom report by Marc Faber, GE's current market cap of C$241 billion exceeds the combined value of the stock markets of Malaysia, Indonesia, Thailand, the Philippines and South Korea. Readers with a sense of history recall that the market cap of Nippon Telephone, the Bell Canada of Japan, exceeded the total value of the Canadian stock market in 1987/88. The Japanese market [subsequently] dropped 60% from 1989 to 1991 and Nippon Telephone, ten years later, is still 62% below its 1987 high. According to the November 21, 1997 issue of *Grant's Interest Rate Observer*, GE is currently selling at 2.5 times revenue (the previous peak being 1.4 times in 1972) and 27.5 times earnings (the previous peak being 28 times in 1972). And just in case you have forgotten, between 1972 and 1974, the S&P 500 dropped by approximately 50%!

There are two major risks that we see in the U.S. and Canadian financial markets. The first risk is mutual funds. Eleven years ago, Citibank, one of the largest U.S. banks, had US$196 billion in assets while Fidelity, the largest mutual fund organization in the U.S., had US$70 billion in assets. Today, Citibank has US$311 billion in assets, while Fidelity has US$550 billion. Since the Depression, the U.S. and other major countries have developed mechanisms, including central banks like the Federal Reserve and the Bank of Canada, to prevent runs on banks. Today, the money is no longer in banks but in mutual funds which are one phone call away from having a run on them with no preventative measures in place. A run on equity mutual funds could cause 'a virulent decline', as Mr. Greenspan would say, in stock prices which could have a negative impact on the economy causing further damage.

The second major risk we see is what *Friedberg's Commodity and Currency Comments* calls the 'repricing of risk'. Falling interest rates and a benign economy have resulted in yield spreads declining significantly and bond investors reaching for yield. We are particularly cautious about bonds collateralized with consumer debt (credit card receivables, second mortgages, auto dealer receivables, etc.). We think future default experience will be much worse than the past and that these bonds will suffer a 'repricing for risk'. We ... [therefore] own only very good quality bonds....

Where have we invested...? In common equities, while we are very concerned about North American markets, we see many excellent opportunities in Japan and the Far East. These markets have declined 50%+, and many [of their] currencies are down as much. We plan to add to our positions in Japan and elsewhere in Asia while maintaining our Latin American investments and reducing our North American investments further. At December 31, 1997, our common stock holdings totaled only 10% of our US$5.8 billion portfolio — the lowest level since we began at Fairfax. And in the bond area, we've built large holdings of 'put' bonds... — high quality bonds with dual maturity dates, the first from 3 to 10 years and the second from 15 to 40 years.... From a buyers' perspective, if rates rise, they trade like short-term bonds. If [they] ... decline, they'll trade like long-term bonds and have significant upside.... So the risk/return characteristics ... are excellent....

In the monthly stress testing of violent market fluctuations on regulatory capital (which we call our doomsday test), all our companies pass. [But as you may gather], we're concerned that our 'doomsday' scenario may be tested some time soon."

Letter to shareholders of Fairfax Financial — February 27, 1998

Dear Subscriber,

"Happy Days Are Here Again" may be the theme song today for U.S. investors. But most holders of international small cap stocks — particularly those located in Asia — may feel like their portfolios are more akin to the Titanic. However, for those who believe that with great pain often come great bargains (like your ambulance chasing editor), sifting through the rubble does have a certain appeal.

Speaking of bargains, we're pleased to tell you that we believe this edition — thanks in large part to Peter Cundill and several of his very able associates, Tim McElvaine, David Briggs and James Morton — has its share and more. And thanks are due them, too, for opening our eyes to some remarkable once-in-a-generation-type developments which seem to represent contrary opinion in their own right.

But because most of the ideas in this edition trade primarily or exclusively on exchanges outside the U.S., investing indirectly (by hiring a manager such as Cundill, Baupost or Oakmark or by buying the stock of a company like Leucadia or Fairfax Financial) may make particularly good sense. Thus, for the convenience of do-it-yourselfers, we'll be posting a page on our website (oid.com) shortly with some helpful hints for those without much experience buying foreign securities.

Until next edition,

Henry J. Emerson

Your Editor

P.S. Thank you for your patience and your support.

Outstanding Investor Digest is published bimonthly (more or less) by Outstanding Investor Digest, Inc.
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