Outstanding Investor Digest

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

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Volume XIII Numbers 3 & 4 — September 24, 1998

CARRET & COMPANY'S
PHILIP L. CARRET
A MONEY MIND (AND MORE) IN MEMORIAM
"NO KING OR EMPEROR EVER HAD IT SO GOOD."

It is with great sorrow that we note the passing of a living legend and celebrate the life of an extraordinary man — Philip L. Carret. Although he died at the age of 101, which many would consider to be a ripe old age, he was as young at heart, vital and active to the last as anyone we know.

(continued on page 2)

FIRST PACIFIC ADVISORS'
BOB RODRIGUEZ
"IT'S PRETTY SPECTACULAR OUT THERE RIGHT NOW, BUT WE'RE JUST *STARTING* TO GET SERIOUS...."

When we first featured Bob Rodriguez in March 1989, we noted that his track record was only four years long, but that he'd been handpicked by contributor George Michaelis and that his ideas and insights had captured our eye. Well, if Michaelis hadn't passed away, we'd thank him personally because two of Rodriguez's favorite ideas from that feature rose over 10 and 20 times since (and far more at their highs).

He's been no slouch at running FPA Capital either. Shareholders earned a compound annual return of 20.7%

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
"WE DON'T GET PAID FOR *ACTIVITY*, JUST FOR BEING *RIGHT*. AS TO HOW *LONG* WE'LL WAIT, WE'LL WAIT *INDEFINITELY*."

Anyone with the good sense and vision to invest $10,000 in Buffett Partnership, Ltd. at its inception in 1956 and reinvest the proceeds in Berkshire Hathaway at the partnership's termination in 1969 would today own shares worth about $250 million — *after all taxes, fees and expenses.* (The reason why one of our favorite contributors calls Berkshire "the gift that keeps hurting.")

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GARDNER INVESTMENTS' TOM RUSSO
"GREAT VALUES ARISE DURING GREAT PESSIMISM — AND THAT'S TRUE OF MANY FOREIGN MARKETS TODAY."

In past *OID* interviews, Gardner Investments' Tom Russo has knocked the proverbial cover off the ball. Along the way, he's shown a rare ability to discern and take advantage of global opportunities while sidestepping most of its pitfalls.

Therefore, with turmoil roiling markets around the world, when we received Russo's latest letter to limited partners of Semper Vic Partners, we were particularly interested in what he had to say. And we're pleased to share it with you.

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IN MEMORIAM
PHILIP L. CARRET
(cont'd from page 1)

CARRET HAD A MONEY MIND AT 90 AND ALWAYS. — NOT SO UNUSUAL AMONG THE CARRETS....

Born November 29, 1896, he was a remarkable man in lots of ways: That he had a fabulous mind for investing — what he called "a money mind" — was well known. Among his many admirers, of course, was Warren Buffett who as recently as Berkshire Hathaway's most recent annual meeting said, "Phil's a hero of mine."

Carret began managing money for family and friends in 1924 while a reporter and feature writer for *Barron's*. He went on to establish what evolved into the Pioneer Fund in 1928. David Tripple, the chief investment officer of the Pioneer Group, echoing the sentiments of so many others, recently described Carret as "a wonderful person ... with a real passion for investing." He added: "In 101 years, I don't think he ever once got sucked up into a fad or frenzy."

In his book, *A Money Mind at Ninety*, Carret attributed his knack for investing, at least in part, to his having inherited (as the title implies) a "money mind." He relates how the first of his ancestors to demonstrate that talent that he knows of was his great grandfather in his capacity as the paymaster general (believe it or not) to Napoleon.

As Carret notes, his son (and Phil's grandfather, Joseph) inherited the money mind, too. Born in 1797 and brought across the Atlantic Ocean by General Carret to the American wilderness around 1800, he sought (and found) his fortune in "the thriving little metropolis of New York City." In fact, so successful was Grandfather Joseph that within only 20 or so years, he achieved the wherewithal to buy a splendid sugar plantation in what is now Cuba "on which he spent the balance of his life." Carret describes, "In good years, the plantation yielded income on the order of $25,000 — a princely sum at the time."

Carret mentions that although Grandmother Eliza left Joseph and Cuba "apparently with his consent" in 1850 taking her nine children with her to New England, remittances from the plantation enabled the family to live comfortably "as the nine children pursued their education."

REALISM AND OVERACHIEVEMENT BEGAN EARLY — AS DID AN ABIDING SENSE OF FAIRNESS AND HUMANITY.

But as he recounts with characteristic candor, his father did *not* inherit the money mind. Thus, even though he graduated from Harvard Law School and built a successful law practice, with the death of his grandparents and the waning of Spanish influence in Cuba, "the annual payments of profit from the plantation ceased. Effectively, the estate was no longer a family asset."

"A maiden aunt would occasionally talk of ... regaining possession of the property. [But] even at 16, I recognized such talk as wishful thinking. If I were ever to gain wealth, it would have to be by my own efforts."

And Carret wasted little time in doing so. Apparently an overachiever early, as he describes, "I was dimly aware that there were other colleges such as Dartmouth and Yale, [but] it never occurred to me that I had any other choice — and Harvard it was." "[Fortunately,] the entrance exams," which he took at the tender age of 16, "were easy." So he entered Harvard College — still at the tender age of 16 — and graduated in only three years, "substituting one year at Harvard Business School for the normal senior year."

An area in which young Carret *wasn't* an overachiever, however, was that of his social life. As he wrote, "At best, my social life at Harvard would have been difficult because of my age. A 16-year old freshman might be able to cope with his instructors but was less able to make friends with classmates a year or two older. Though I did acquire a few very good friends, none was a member of the social and financial elite who comprised the roster of Harvard's social clubs...."

"When it came to social clubs, I ... [had] one near miss. In my junior year, I received an invitation to join ... perhaps the least distinguished of these organizations.... [It] carried one stipulation: that I ditch my Jewish roommate. To reach a decision took no time at all. Until we graduated, David and I roomed together in harmony and friendship."

Following the outbreak of World War I, "[my] close friend and roommate ... [joined] the Navy, as did his younger brother Bob.... We all parted company, no doubt with assurances of a postwar reunion after the forces of democracy had triumphed.... [But] it was not to be. In September 1918, the Tampa, on which Dave served as an ensign, was sunk by a German submarine.... [And he became] one of 27 classmates sacrificed in the war 'to make the world safe for democracy.' "

AND HIS GENES WERE REMARKABLE IN MORE WAYS THAN ONE....

Our relationship (and indebtedness) to Carret actually dates back prior to the first issue of *OID*. You might even say he was one of *OID*'s founding fathers — in fact as well as (we hope) in spirit — because he graciously agreed to be the inaugural speaker at a program series your editor founded at the Harvard Business School Club of New York. As a fellow alumnus, he graciously accepted our invitation to kick off the series — "The Breakfast of Champions Series" — featuring (as you might not be so surprised to hear) money managers with exceptional long-term track records.

For his introduction, incidentally, we thought it only natural to turn to fellow Carret admirer Warren Buffett. Thus, his introduction consisted primarily of praise from a letter written by Buffett specifically for that purpose.

Subsequently, with the arrival of *OID*, Carret, his late son Jerry and his granddaughter Renee joined the ranks of our earliest contributors. And in our interactions with the Carret family, we had an opportunity to observe and interact with three generations of talented money minds. We joked with the Carrets about the remarkable genes that seemingly allowed them to age at half the rate of most of us.

For example, Phil continued coming into the office to analyze securities and manage money (activities he relished) until shortly before his death, his only concession to Father Time being to cut back to three days per week.

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IN MEMORIAM
PHILIP L. CARRET
(cont'd from preceding page)

He continued traveling to view eclipses around the world wherever they would be visible — his most recent sojourn having been to Aruba (on a Holland Cruise ship) this past February 26th. Also, but for an accident shortly before it, he would have continued his long tradition of attending Berkshire Hathaway's annual meeting each year.

As its oldest alumnus, he also enjoyed the honor of leading Harvard's commencement procession (notwithstanding a request by at least one younger alum that he not walk quite so fast). Even after his accident, Carret looked forward to leading this year's procession — enthusiastically performing his rehab exercises (although exercise was allegedly not one of his favorite words) in order to be ready. And we understand that except for the fallibility of doctors, he would have led it again this year.

Finally, Carret's minister told us how he was "carded" (asked to prove he was 65 years old) — when he was actually closer to 100 — on a visit to a movie theatre on a trip to England. His life was full of such anecdotes (which no one chuckled about either more often or more heartily than Phil himself) and remarkable accomplishments both.

CARRET ENTERS THE TAX PREPARATION SERVICE
— WITH THE HELP OF A LITTLE WHITE LIE....

But most impressive to your editor, frankly, was his very deeply ingrained — almost selfless — integrity and candor. What you saw was what you got. And what we saw always was wisdom, intellectual honesty and a levelheaded, cheerful, positive attitude — grounded in genuine humility, generosity and a thoroughly uncommon common sense. Like he said in his forward to "A Money Mind at Ninety," "If I've contributed even an infinitesimal bit to the welfare of society, my life has not been in vain."

But since Carret was never one to toot his own horn, you might never learn of his generosity. His book, however, offers a rare glimpse. He tells of volunteering to prepare the income taxes for his housekeeper and her husband. And to keep them from feeling obligated to pay him for his efforts or feel bad for not doing so, he told her: "I love making out income tax returns." As Carret confesses, "This was a little white lie."

Incidentally, his generosity didn't stop with *preparing* her returns. Writes Carret, "Perhaps [her] disapproval of the welfare system colored her view of the income tax — whose exactions she bitterly resented. [But] this attitude gave me some amusement, since I not only prepared her tax returns but paid the taxes out of my own pocket...."

(continued in next column)

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THE SUPREME SUCCESS OF PHIL CARRET'S LIFE.
"NO KING OR EMPEROR EVER HAD IT SO GOOD."

Along those lines, fittingly, among his closest friends was the late, great Norman Vincent Peale and his wife, Ruth. In the introduction to *The Money Mind at Ninety*, Peale observes: "Those of us who have had the rare good fortune for a long continuing friendship with the author are well aware of the wisdom his mind produces. Much of it is dropped in casual conversation, but [only] upon later reflection [can one appreciate] the intellectual force and truth of his thinking.... Phil Carret is a person from whom we can learn much...."

However, no memorial of Carret could ever be complete without mentioning his late wife, Betty — to whom he dedicates *A Money Mind at Ninety*:

"To Betty.
Forever the brightest star in my universe."

Of his late wife, he observes: "For many years, I regularly told Betty that I considered her 99.99% perfect. Why not 100%? The answer is simple. Only God is perfect. [But] in truth, I never detected any flaw in her that could represent a 0.01% shortfall. A beautiful, lovely and lovable, warm, intelligent human being, I loved her devotedly — even more so as the years passed. Like the famous French saying: 'More than yesterday, less than tomorrow.' "

"Looking back over an unusually long and active life, I can only consider myself incredibly fortunate. Memories of my childhood are of a generally happy period. In the years of high school, college and Harvard Business School, I achieved a moderately satisfactory record, but one well short of what it should have been. Only later in life did I accept the fact that there were a lot of people smarter than I and become comfortable with that realization."

"During my long life, I have achieved moderate success in business. [Through] my career ... profits and income generously covered a very comfortable life-style and allowed the accumulation of modest wealth. After 1932, I was always essentially my own boss, a very satisfactory situation. And for the most part, work has been fun...."

"The supreme success of my life, however, was my marriage. And in the most important aspect of my life — marriage and family — I was exceptionally fortunate. Almost from the day I met Betty — in November 1920 — until the day of her death 65 years later, we enjoyed a supremely happy relationship.

In retrospect, I came as close to enjoying Paradise on earth as any mortal could hope to do. In a subdued way, my life has been reasonably happy in its most recent years, even after losing the brightest star of my universe. All in all, I can say of my life that no king or emperor, no Morgan or Rockefeller, ever had it so good!"

—OID

[Editor's note: To review the preceding and other related features — on Carret and other of our contributors, we invite you to visit us at www.oid.com.]

FIRST PACIFIC ADVISORS'
BOB RODRIGUEZ
(cont'd from page 1)

after all fees and expenses versus 13.6% per year for the Russell 2000 for the 13-1/2 years ended 12/31/97 — having trounced the index for any three-year period during that entire time.

Here are the year-by-year performance figures for FPA Capital alongside those for the Russell 2000 Index. (All performance figures provided by First Pacific Advisors.)

Year	FPA Capital Total Return[1]	Russell 2000 Total Return
1984[2]	+ 7.0%	+ 2.4%
1985	+28.9	+31.1
1986	+12.6	+ 5.7
1987	+11.0	- 8.8
1988	+18.1	+24.9
1989	+25.3	+16.3
1990	-13.8	-19.5
1991	+64.5	+46.1
1992	+21.6	+18.4
1993	+16.7	+18.9
1994	+10.4	- 1.8
1995	+38.4	+28.4
1996	+37.8	+16.5
1997	+17.7	+22.4
1984-97[3]	+20.7%	+13.6%
1988-97	+22.1%	+15.8%
1993-97	+23.7%	+16.4%
1995-97	+30.9%	+22.3%

[1] Returns are calculated at net asset value after all fees and expenses.
[2] For the period 6/30/84 through 12/31/84.
[3] For the period 6/30/84 through 12/31/97.

Given our experience with Rodriguez, you no doubt understand why we're always interested in hearing what he's thinking — be it in his George Michaelis-style letters, in conversation or anywhere else. However, when we saw that Rodriguez was having a very uncharacteristic stretch of below average returns and that some of his ideas were actually down a lot, we were especially interested in hearing what he had to say.

Besides running FPA Capital, Rodriguez also runs a very highly rated fixed income fund — FPA New Income. Plus, he serves as the Chief Investment Officer of parent First Pacific Advisors — a promotion he received following George's tragic accident. Therefore, we'd like to extend a special thanks to Rodriguez for taking the time to speak with us despite being in the middle of a particularly hectic time in an always busy schedule.

The following excerpts were selected from a series of conversations that we had with Rodriguez. We found them more than a little intriguing and hope you will, too.

WE'VE SEEN THIS GAME PLAYED BEFORE — AND THE WAY IT ENDS AIN'T PRETTY.

OID: You've been awfully negative and awfully wrong for awhile — at least until recently. But I assume that your posture hasn't changed with small cap stocks...

Bob Rodriguez: ...Getting decimated here recently? No. Not that it hasn't been *tough*. I feel like my I.Q. has now gone subterranean. FPA Capital's returns last year were my worst relative to the Russell 2000 and my second worst relative to the S&P 500 since I began managing the Fund.

And this year so far — through September 23rd — the Fund is down 9-1/2%. So, obviously, I've become a bonehead idiot...

OID: You're not necessarily a bonehead. And the fact that you've been an idiot is the reason why we wanted to speak with you — one idiot to another...

Rodriguez: Yeah. We're the blind leading the lost.

OID: Tell me later who's who. I believe I'm qualified for either part. But, meanwhile, what happened? Have you lost your touch?

Rodriguez: Have I lost my touch? Well, time will tell. Our performance last year was hurt by several things: First, investors wildly overreacted to what we believe were temporary problems in Green Tree and drove its stock price down by 44% during the fourth quarter.

Also, we became more and more defensive during the last year or two. So our conservative posture cost us, too.

OID: Until recently, anyway.

Rodriguez: Until recently. But there's also been a wide disparity between the performance of the large caps and the small caps. The small caps were already cheaper, of course. But that disparity continued to widen last year. And this year, it's gotten *huge*. Through September 23rd, for example, the NASDAQ 100 is up 40.8%. By contrast, the Russell 2000 and the rest of the NASDAQ — both of which are more representative of most stocks — are *down* about 14% and 16%, respectively.

OID: That sounds like a huge disparity, all right.

Rodriguez: Also, we cut our holdings in financial and technology stocks way back because they were pricy. And they turned out to be among the best performing sectors within the Russell 2000.

But with the vast majority of stocks down an average of about 15% so far this year, you may wonder, "How can most mutual funds be *up* so far this year?" Well, I think the answer is *obvious*....

OID: You don't think it's been brilliant management?

Rodriguez: They've become trend followers — chasing a narrower and narrower group of companies. For example, I find it fascinating that Fidelity Magellan Fund has been able to outperform the market this year — and even more fascinating when I look at their top 10 holdings. They're, in effect, the "Who's *Who* of Who's *Movin'*."

OID: I smell a newsletter concept....

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FIRST PACIFIC ADVISORS'
BOB RODRIGUEZ
(cont'd from preceding page)

Rodriguez: Almost every fund I've looked at that's done very well this year — the funds whose returns are up in the high double-digit range — are invested in the holier-than-thou stocks...

OID: The Microsofts, Dells and Ciscos of the world.

Rodriguez: You've got it. They're skewed towards the bigger caps — with *very* few exceptions.

OID: I know you're right — because I'm doing well. But conclusive proof aside, what makes you so sure that those managers weren't just smart stock pickers?

Rodriguez: Maybe they were. But those stocks look a whole lot more like the Nifty Fifty to me. The generals are the only ones left leading the charge — or holding up the rear, depending on your point of view. And that very simply can't continue. Those trends are unsustainable. Something has to give.

The only question is what happens first — whether smaller stocks get so cheap that they can't be ignored and get bid up or whether the generals follow 'em down.

OID: And the answer?

Rodriguez: I'm inclined to believe that it's the latter — because that's what the essence of a bear market is: When people can't see any reason why the prices of most stocks should go up, they avoid them and more and more go towards the ones they think *are* going up. In effect, more and more people pile into fewer and fewer stocks.

The result is a mountain of rising prices on a narrower and narrower slice of stocks. Eventually, there are so many people chasing such a small number of stocks that the valuations just get out of hand. They get crazy. And it becomes obvious that the emperor has no clothes — and they all come tumbling down. It's like a pyramid. When it gets too top heavy, it topples over.

OID: That somehow rings true.

Rodriguez: And the longer the excess lasts — the more the party gets out of hand and the more people there are piling into fewer and fewer stocks — the worse people get hurt when they eventually *do* give up the ghost.

The last time that I recall seeing anything like the things I'm seeing today was back in 1972 and 1973 — during the days of the Nifty Fifty. So I'm sure that we're going to see a lot more pain and suffering. And I know that I shouldn't say, "I'm sure."

OID: Unless I'm on the other side of the trade...

Rodriguez: So let me put it another way: I think that it's *highly* probable that we're going to see a lot more pain and suffering. And I hope that not too many people will wind up getting hurt financially as a result. However, unfortunately, I think the odds are that a lot of people will.

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WE HAVEN'T HAD A *REAL* BEAR MARKET IN YEARS. SO SOME EXTENDED GUT WRENCHING IS OVERDUE.

OID: Speaking of pain, seeing some of your stocks "getting decimated" won't impact your posture?

Rodriguez: Not at all. I'm disappointed with our recent results. But interim volatility is one of the prices you have to pay to get long-term investment returns. Volatility is *good*. It's what gives investors the opportunity to take advantage of other people's fear and greed.

OID: Templeton and Buffett would definitely agree.

Rodriguez: As we speak, FPA Capital is about 30% in short-term liquidity and bonds. The highest it's *ever* been since I started managing the fund in 1984 was about 31%.

But I'm very happy to have the cash I do today. Actually, I'd prefer to have *more*. As I told my clients, I wasn't happy with the valuation characteristics of our portfolio. But if I sold every stock we owned that was trading at 18 or more times earnings, I'd wind up with only 40-50% of my assets in common stocks. So, in effect, I'd be betting my *business*.

If you take your cash to 40% or more for a sustained period, you're basically betting the firm. If you're not right, you're out of business. And I wasn't willing to risk that.

OID: As you stated in your letter of April 21st, "Why are investment managers rushing to buy stocks despite these growing risks? The stock market has to some degree ... [gone] from ... 'valuation-driven' to ... 'fee-driven'.... Investment managers are unwilling to hold virtually any ... short-term liquidity ... afraid that the client ... will take this liquidity away and, thus, the manager will earn less fee income."

Rodriguez: I think that's exactly right. So I told 'em, "If I'm going to get killed anyway, I'd prefer to get killed in stocks I know something about rather than in new things — because I can *lie* to you better about the ones I know."

And when I say I'd prefer to have more cash, I mean it. I'm also positioned more defensively *personally* — with more liquidity than at any other time in my entire business or investment career. Believe it or not, I'm 65-70% liquid at a personal level.

OID: That sounds defensive. Do you have any hedges?

Rodriguez: I have a couple in front of my house.

OID: Well, at least you're still somewhat offensive...

Rodriguez: If you're asking whether I own any puts, the answer is no. The 65-70% liquidity consists of just 100% money market funds. And, then, the stocks I still own have such a low cost basis that I can live with 'em — although, frankly, I fully expect them to get crushed, too.

So I hope that I'm not being overly pessimistic here. But I just don't like the *odds*.

OID: Oh?

Rodriguez: So I feel very comfortable right now. Things are progressing pretty much as I would expect.

(continued on next page)

FIRST PACIFIC ADVISORS'
BOB RODRIGUEZ
(cont'd from preceding page)

Actually, I think they should be a lot *worse*. I tell clients what I expect. Hopefully, I'll be more right than wrong. And I hope they'll be ready if and when it comes to pass.

OID: They certainly can't say you didn't warn 'em.

Rodriguez: Yeah. I don't think I could have warned our shareholders any more than I did. I pointed out that corporate profit margins were at 25-year highs. And I told 'em that stocks have historically had below-average returns following periods of high valuation. I even warned them that there was no room for disappointment of any kind and admitted, as I mentioned earlier, that I was uncomfortable with our *own* portfolio's valuation.

But I still remember 1973-74 like it was yesterday. There was such utter capital destruction. The period was *such* a debilitating experience. I'm not saying we'll go through the same thing *this* time...

OID: You certainly had me fooled.

Rodriguez: But I can remember that at the beginning of 1974, we had liquidity of between 20% and 25%. And by the middle of 1974, we were up to about *60%* liquidity — and we were *still* down more than 20% for the year.

I remember buying one stock at $22 and $18 and $14 and $12 — and I ran out of money with it selling at $8. And it ultimately traded below $1 — around 87-1/2¢.

OID: Ouch — a 95%+ haircut.

Rodriguez: And when it was trading around 87-1/2¢, it had $2 per share of cash plus Orange County real estate with a depreciated basis of between $3 and 3.50 per share that the company had acquired back in the 1950s. So it had 20-year old real estate that had been written down, but whose value — thanks to inflation — was far greater than its historical cost, much less its depreciated basis.

And the management was so petrified about what they might face that they paid off all their current liabilities — all their trade creditors — and all their long-term debt. Their only long-term liability, in fact, was a small amount of deferred tax liabilities.

So with the stock selling at 87-1/2¢, you could buy cash at 50¢ on the $1 and get the real estate for *free*.

OID: Wow.

Rodriguez: It was an absolute mind blower. But people said, "There's no business here." But even if there *were* no business, you could still liquidate the company and come out with double your money in cash and have real estate to boot. And right after the 1974 trough (in October or November), the company tendered for 25% of its shares. The last sale was at $1-1/8 or $1-1/4. And they tendered at $5-1/2.

OID: Amazing.

Rodriguez: They were oversubscribed. They bought in all of the stock. And two years later the company did an underwriting at approximately $22 per share for the exact same number of shares that they bought in 1974.

OID: Wow, again.

Rodriguez: I'd never seen anything like it. So when people ask me, "How cheap can stocks get?", I tell 'em that I've seen cash sell at a discount net of all debt.

OID: But that was 25 years ago. Plus, there was an oil embargo and the resignation of a President and a Vice President for God's sake. What makes you think we could be in for anything remotely like that today?

Rodriguez: Well, first of all, we haven't had a period of real fear in the financial markets in *years*. The last time we had real fear and devastation and a real bear market was in 1981-82. October 1987 doesn't count because it was over and done with in a matter of 24 hours. And 1990 doesn't count because it was over and done with in the matter of a month and a half.

But *real* bear markets last about one or two years. And we haven't had one of those for nearly two decades. For example, small cap stocks peaked in 1968 and didn't hit their trough until the 1974 — by which time they'd lost nearly 80% of their value. We haven't had a gut-wrenching bear market like that in years. So one's *overdue*.

WITH LIQUIDITY EXPANDING, CASH WAS *TRASH*.
BUT WITH LIQUIDITY SHRINKING, IT'LL BE *KING*.

Rodriguez: The latest figures I've seen — and these are rough figures — suggest that approximately 35-40% of the mutual fund industry's total assets today are in defined contribution-type accounts. And 70% of the assets within those accounts are invested in *equities*.

OID: And maybe the high equity allocation is related to our not having had a nasty bear market for awhile.

Rodriguez: Exactly. So the equities within those defined contribution accounts and IRAs represent between 24% and 28% of the total equities in mutual funds today. Meanwhile, those funds are maintaining liquidity of only 3-1/2% to 4%.

So a relatively minor shift in the equity allocation of those accounts — say 10 points — would eliminate 60-80% of the liquidity in the entire mutual fund industry. And a shift of more than *14* points would force managers to begin *liquidating* assets to fund redemptions. And that would hardly be radical.

OID: I wouldn't think so. A 54% equity allocation in retirement accounts doesn't sound wild-eyed.

Rodriguez: It's not. Only a decade ago, those retirement accounts had virtually no equity exposure at *all*. The investments-du-jour were money market funds and guaranteed investment contracts (GICs).

OID: Aren't you forgetting that this time ~~it's different~~ the individual investor is different...

Rodriguez: More seasoned and intelligent with a longer time horizon who can withstand the vicissitudes of the stock market.

OID: With their eyes firmly fixed on the distant future — and a time horizon similar to Buffett...

Rodriguez: That's unmitigated poppycock. Fear is

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still far stronger than greed. When the market's going up, it's "We're all in it together." When it's going down, then it's "Every man for himself."

I don't think the behavior of individuals is likely to be all that different than that of people at major corporations. And following major bear markets, the asset allocation in pension plans has historically shifted away from equities.

OID: And, presumably, towards equities following an extended bull run...

Rodriguez: Exactly. And when I say a 14-point shift away from equities would force fund managers to start liquidating assets in order to meet redemptions, I'm not factoring in anything for a shift in equity exposure *outside* of retirement accounts. However, if there were a shift away from equities in retirement accounts, then *of course* the equity allocation of taxable accounts would change, too.

OID: And a rising tide that's lifted most stocks higher and higher could reverse course — at least for a while.

Rodriguez: Exactly. That may seem hard to imagine today. But if we get into a difficult market environment — one much more difficult than today — one of the signs will be increased trading volumes. Also, you'll start to see a massive differential between upside and downside volume — with downside volume being much greater. And that will tell me that some level of capitulation has begun — that, very likely, there are redemptions underway. In other words, it means that we're seeing the *force majeure* sale of stocks — stocks that *must* be sold — to fund redemptions, margin calls and the like.

And that may not sound like such a big deal to you. But in practice, it's the difference between night and day. For example, today, if you have cash and a stock's at $10 and somebody gives you a $9 bid for a million shares, you can just tell 'em, "Go *stuff* it."

But if all your cash is gone, you're getting redemptions and you have a million shares that you need to sell and they say, "I'll give you $9.", you'll *take* it — because you have no choice. You've got to have the cash.

OID: Sounds very similar to investment publishing.

Rodriguez: Some of that's already begun to happen. For example, the convertible market's in total disarray. I was recently talking with a convertible trader. And he told me, "It's God-awful. There's absolutely no liquidity. There are virtually no bids out there in many cases."

For example, we bid down 1-1/4 points on one bond today and we still wound up *buying* some. But prior to the last few weeks, if we'd done that, we'd have been outbid and wound up empty-handed.

OID: So there's been a flight to quality. And everything else has taken a beating.

Rodriguez: Exactly. High-yield bonds have *collapsed* in recent weeks. So the pressures have begun to build.

OID: The pressures for redemptions, etc.

Rodriguez: That's right. And if that's going on, the over-the-counter stocks *should* get killed because there's not going to be any support from the dealer community. And with very few people having liquidity, the bids are going to be thin.

People will try to off-load their tertiary merchandise first. But if they can't move it, they'll have to start moving the *good* stuff. So that phenomenon will probably roll through the marketplace.

OID: Similar to the turmoil in Russia...

Rodriguez: Exactly. Also, if we have a protracted decline in stocks, I find it hard to believe that it's not going to get translated into the goods area of the economy.

Right after the 1987 Crash, *The Wall Street Journal* contacted 50 economists who had been participants in an *Economist* poll and asked them, "Given the massive decline in the stock market, would you like to change your forecast for the next six to twelve months?" And that resampling was published in the Wednesday or Thursday edition of *The Wall Street Journal.*

And there *had* been a major shift — a massive change — in their outlook. As I recall, 49 of those 50 economists said they expected a *recession* in the first half of 1988.

OID: Well, that sounds like <u>one</u> event you <u>didn't</u> have to worry about...

Rodriguez: Exactly. And it wasn't just economists who were subject to that mania. Furniture retailers out here increased their discounts from 25% all the way to 50-60% on their front line merchandise — because they were afraid that there was going to be a recession and they didn't want to get stuck with lots of inventory. Therefore, during the first week of 1988, we also took advantage of the mania to furnish our entire house.

OID: I assume there's a point here? Or were you just putting in a plug for your furniture dealer?

Rodriguez: In my letter, I wrote, "That forecast will raise serious questions about the economics 'profession' — that they would actually base their entire forecast on a single event."

I wrote, "Yes, the stock market did collapse. However, the greatest rally in financial assets *also* just occurred in the bond market — between October 19th and 20th. And, by the way, the consumer has far more money invested in bonds and money market instruments — especially bonds — than they do in the stock market."

"Therefore, given a 120 basis point rally in bonds, the consumer balance sheet is actually *better* off today than it was before the Crash. Thus, we will *not* have a recession in the first half of 1988."

OID: Very interesting.

Rodriguez: So fixed income securities were the key at that time. Today, it's exactly the *reverse* — because now the consumer has close to twice as much invested in *equities* as they do in bonds and money markets combined.

So I have to wonder how much the economy would be negatively impacted were there to be a stock market decline that lasted for a couple of years and wiped out 30-40% of the market cap of the average stock. I've, therefore, made it a priority to be prepared for that type of event. And I think I'm very much the exception in that regard.

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AN "IPO" WE'VE BOUGHT AT TWICE THE PRICE WHOSE FUNDAMENTALS ARE BETTER TODAY.

OID: Speaking of 30-40% declines, I gather that some of your holdings have not exactly shined lately...

Rodriguez: I assume you're referring to the fact that my portfolio is full of IPOs...

OID: I beg your pardon?

Rodriguez: IPOs — not "initial public offerings", but "increasing profit opportunities". Of course, if you prefer, we can refer to them by the other name that we use when we're talking with our clients — "strategic retrenchments" — because the lower they go, the higher they can bounce.

OID: Whatever name your shareholders ~~fall for~~ prefer...

Rodriguez: For example, we bought our first shares of Oregon Steel [OS/NYSE] about 2-1/2 years ago at $12-3/4 on an equity underwriting when it was trading at around $15. And we liked it so much that we held onto our shares in the Fall of 1997 when it traded all the way up to $28.

OID: North of $29, it appears, but who's counting...

Rodriguez: I didn't sell my shares at $29 because the company had just begun to come out with good earnings — which is also why the share price was up. Plus, it was such a smidgen position that, frankly, I was kind of hoping that it *would* come down so I'd get to take a *real* position.

Well, I got my wish — because the stock collapsed. And between December and February, we more than quadrupled our position to the point that we now own more than 10% of Oregon Steel's common shares.

We bought most of those shares, incidentally, at between $17 and $18.50 per share. But I think we paid north of $20 for some of 'em. As a result, our average cost in FPA Capital as of March 31st was in excess of $18.

Then, lo and behold, the stock ran up once again — this time to a high of $24 this past April...

OID: More like $26.50, but it's not like us to nitpick...

Rodriguez: Yet, come July, it was back down to $18. And so we began very happily buying it again. But in the last four or five weeks, it just collapsed — to the point where it's trading at around $10 today.

OID: It dropped by more than 40% almost overnight? What happened?

Rodriguez: That's a very good question. We checked every news release, analyst report, trade magazine, you name it. But nothing was there. An analyst we spoke with couldn't explain it either — aside from saying that *all* of the steel-related equities had taken a hit.

So we contacted the company and asked whether they'd released anything that we weren't aware of since their second quarter earnings release. And they said that they hadn't. In fact, the only news was very *good* news. Shortly after we spoke with a company representative, they announced that they'd just signed the largest contract in the company's history.

Therefore the company's fundamentals are *better* than they were five or six weeks ago. And yet the stock is down 30-40%. It's a total disconnect. So we just concluded that when the market took other cyclicals down beginning in late July, it took Oregon Steel along with it — despite the fact that it was *already* very cheap.

OID: It sounds like it. In your letter, you say that Oregon Steel's earnings are depressed by a strike, but could be $3.50 to $4.00 within two or three years. Assuming you're right, it may be dirt cheap today.

Rodriguez: I think so.

OID: But it doesn't look like other stocks in its group fell nearly as much. And stocks don't fall that much for no reason.

Rodriguez: One of Oregon Steel's specialty products is the pipe that's used to construct natural gas pipelines. So part of the explanation why their stock cratered may have been a steep decline in the price of natural gas — from something north of $2.00 to down around $1.80 — during that same period.

OID: Down from the $2.50 area earlier this year and as much as $4.50 in late 1996.

Rodriguez: Natural gas prices are down a lot. So people may fear that those declines could result in future natural gas pipeline projects being postponed or canceled. And that *would* be a *big* negative. I say that because their pipeline products are highly profitable — in part because they're made from an unusual type of specialty steel that's required in order for those pipes to withstand corrosion from the elements as well as the natural gas itself.

OID: It's potentially a big negative, but you don't worry about it?

Rodriguez: Not at all. We have natural gas *shortages* in this country — at least we do in the lower 48 states. And that's why we're going to have to bring it down from our northern neighbor. Therefore, it's very hard for me to see how those pipeline projects aren't going to happen — however much investor psychology may suggest otherwise.

OID: Doesn't a very strong dollar hurt them, too?

Rodriguez: A portion of Oregon Steel's business is exposed to international competition. So that is a factor. In fact, when power outages forced them to shut down their Portland plant earlier this year and they had to augment their supply of steel slabs, they bought steel slabs from Asia — despite the significant transportation costs involved. So it will have some impact.

But transportation costs do insulate them somewhat.

OID: And limit the geographic area in which they can compete to some distance around each of their mills.

Rodriguez: That's right. Also, Oregon Steel adds more value to its products than you might think. In fact, 60% or more of Oregon Steel's product line by volume consists of high-grade, high-quality, specialty-type steel and rail. And

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roughly half of the *other* 40% of its sales aren't all that exposed. Thus, really no more than 20-30% of their sales are directly exposed to foreign competition — or really all that much to *domestic* competition, for that matter. So they aren't as commodity-oriented as you might think.

And that not only serves to insulate them somewhat from foreign competition, but it expands their margins and geographic scope. For example, their gas pipeline capacity is essentially fully committed through the end of next year. And believe it or not, that's only factoring in the business from the *first* phase of the contract they just signed.

I DON'T THINK THIS IS A LOUSY BUSINESS AT *ALL*.
WE EXPECT IT TO HAVE VERY ATTRACTIVE RETURNS.

Rodriguez: But I don't mean to imply that there hasn't been lots of bad news in the last two or three years — because there's been *plenty*. For example, virtually the entire workforce at their Pueblo, Colorado mill — roughly 1,060 workers in all — walked out on strike last October. So Oregon Steel has had to cope with the reverberations of that strike ever since including replacing and training an entire workforce and dealing with mechanical problems — some of which they believe were caused by sabotage.

OID: Sounds lovely.

Rodriguez: So one result of the strike was that the company incurred additional overhead and inefficiencies that result whenever a company is forced to start over from the bottom of the learning curve.

And the strike was only one of their *many* problems. They also completed a state-of-the-art mill in Portland — an extraordinarily flexible mill which they refer to as their "Combination Mill". But as they were working the bugs out, they suffered a raft of problems — problems that resulted in it unexpectedly being shut down for a prolonged period. In addition, they experienced the extensive power outage that I mentioned earlier.

OID: Is this a long or a short?

Rodriguez: Not surprisingly, all of those problems resulted in production bottlenecks which forced the company to offer a different — and, as you might suspect, a far less profitable — product mix than they would have otherwise. Then, on top of everything else, they got hit by a softening market — both in terms of price and demand — for some of their primary products.

But you're going to experience that kind of thing whenever you're bringing on a very complex new mill. It's basically just a part of the game...

OID: In the steel business, I imagine so. It sounds like it fits Charlie Munger's description of a lousy business as one that gives you one bad choice after another.

Rodriguez: It *sounds* like it. But it's misleading. Those kinds of things do happen often in this business. But some of their problems were the result of the company bringing a major new mill onstream, incorporating opportunistic acquisitions that they acquired at very attractive prices, upgrading their production capacity and their production flexibility and lowering their costs. And I'm actually *glad* that they had those problems — because otherwise I probably wouldn't have gotten the opportunity to increase our stake as much as we did.

OID: So far, so bad. But why, then, do you sound like you're near tears when you say that?

Rodriguez: I'm not saying that Oregon Steel is the best business in the world. But it's earned high margins historically and very decent returns on invested capital. And we expect the company to earn very attractive margins and returns over the long term. For example, I don't see why they shouldn't be able to get their operating margins back up to 10% or 11%. And that wouldn't be bad for the steel business — or *most* businesses, for that matter.

Lots of people believe that earning high returns in the steel business is essentially impossible. But if you look at Nucor's [NUE/NYSE] results over the past 35 years, you see that it *isn't*.

OID: Yeah. It looks like Nucor's earnings have nearly doubled nine times in 33 or 34 years — which would mean they've grown about 20% per year for the period. And they've done it in a surprisingly steady fashion.

Rodriguez: Nucor has done a truly phenomenal job. It has a 20% share of the U.S. steel market — or as they think of it, they have 80% of the market left to take over.

OID: How similar are Oregon Steel and Nucor?

Rodriguez: Both Nucor and Oregon Steel are in the same business broadly defined — they're both mini-mills. However, Nucor manufactures commodity-grade products. For example, it just lowered the price on hot rolled steel by about $30 a ton. Therefore, Nucor is far more exposed to international competition.

Oregon Steel makes specialty steels in the plate area that go into welded pipe for natural gas transmission. They're one of a handful of companies producing that product in the U.S. So I think it's a *better* business.

OID: So you're saying Oregon Steel's business is better than Nucor's!?

Rodriguez: I think so. For example, one of the areas within the energy industry that's expected to experience the fastest growth looking out three to five years or more is natural gas exploration and distribution. As you know, that's because the U.S. faces generator capacity shortages and natural gas demand well in excess of available supply.

Therefore, several major pipelines are either in the process of being built — or their plans are in the works — specifically to deliver natural gas from Canada to the U.S. And a direct beneficiary of that is Oregon Steel.

Also, Oregon Steel is one of only two U.S. companies that produce what's known as "head-hardened" steel — which is used in rails for railroads. There again, of course, the U.S. railroad infrastructure has been deteriorating because of the high capacity utilization of the system.

OID: All of that sounds good. But whether Nucor is attacking Oregon Steel's market niche today or not, you don't worry about it one day coveting its segment

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and taking it away?

Rodriguez: Not at all. That's not what Nucor does. Its focus has always been on the lower grades of commodity flat roll and structural steels. Nucor *has* been moving upscale. But they're still far away from the specialty-type products Oregon Steel produces. It's not going to happen — at least, I can't imagine it. They're both mini-mills, but they're in two totally different product lines.

OPERATING LEVERAGE WILL WORK IN THEIR FAVOR — AND THEIR HUGE DEBT PAYDOWNS WILL, TOO.

OID: What makes you think Oregon Steel's earnings could get up to $3.50 or $4.00 in two or three years?

Rodriguez: Based on the new capacity they're bringing on, I believe their revenues could easily reach $1.5 billion within three years — up from not much over $750 million in 1997. And Oregon Steel only has around 26 million shares outstanding. So we're talking about sales up around $60 per share.

Therefore, a net profit margin of slightly over 5% would imply earnings of $3.00 per share. And it wouldn't surprise me if they earned *$4.00* — in part because their net profit margin could be much higher and in part because they have tax loss carryforwards galore.

[Editor's note: It looked like their loss carryforwards at the Federal level at year end 1997 totaled something around $145 million — or about $5.50 per share.]

OID: Might we persuade you to look out several years and guesstimate their normalized net profit margin?

Rodriguez: That's very hard for a variety of reasons. For example, one of the many variables I don't know is just how strong the pipeline construction market's going to be — because natural gas pipeline construction looks like it could be a *worldwide* phenomenon. If so, it could be *huge* — and Oregon Steel's margins could rise to what they were in the late 1980s and early 1990s.

OID: And their net profit margin averaged nearly 9% from 1987 to 1991, but only 1.8% the last four years.

Rodriguez: That sounds about right. In part, that's because Oregon Steel is more diversified today. And the niche they were focused on then did have higher margins than the ones they've added since. So the margins they earned in those days probably aren't achievable anymore for that reason alone. But they probably wouldn't have been sustainable anyway — even if they hadn't diversified — given where margins were at that point in the cycle, etc.

I view their product diversification as a plus anyway, incidentally, because it reduces their earnings volatility and their reliance on the price of any single product line.

OID: Albeit at the expense of profitability?

Rodriguez: Probably. The difference in their margins isn't quite as dramatic if you compare *operating* margins, although they're down a lot too — from up around 15% to about 7-1/2% for the past four years. But the main reason why their operating margin is down much less than their net profit margin is that they're way more leveraged today.

In fact, one of the reasons why I believe their margins will be so much higher than they have been recently is that they're going to have huge debt paydowns.

OID: I hope so. They have more long-term debt than equity — $14 vs. $13.50. But why would you think that debt paydowns are more likely than insolvency?

Rodriguez: There's *very* little risk of insolvency here. And why do I say they'll pay down huge amounts of debt? Well, they just completed a huge capital spending program. Now they have brand new plants in Canada and Portland. Thus, they're done with the bulk of their capital spending for the foreseeable future. So we expect them to begin generating massive free cash flow and paying down debt between now and the end of this year.

They could add 150 basis points of pretax margin over the next several years as a result of debt paydown alone. Interest expense was being capitalized. But I expect it to be up around $38 million in 1998 and possibly closer to $33 million in 1999. So it's easy to see how much impact huge debt paydowns could have.

OID: Any reprieve from shoveling cash out the door would be a plus in such a capital intensive business. But huge paydowns?! If their earnings resemble what they've been for the past four years, the company will barely be able to pay its interest.

Rodriguez: That's true. But I *don't* expect their future earnings to resemble what they've earned recently. This management has had to work its way through a variety of challenges. But now they've *done* it. So they'll begin to see the benefit of operating leverage on the upside.

For example, all their plants are finally back on line and running fine...

OID: You're kidding.

Rodriguez: Not at all. Their volumes are going up. They'll be producing far greater tonnage in the second half than they did in the first half. Therefore, they'll begin to enjoy the benefits of much higher capacity utilization. And they'll also start to enjoy the benefit of *other* efficiencies — including lower SG&A thanks to having 300 fewer workers in their Pueblo plant.

Also, they'll start to enjoy much greater productivity — both because 700+ new workers will have moved further up the learning curve and because they'll have worked more of the bugs out at their new plant and they'll have moved up the learning curve in terms of operating it. So their cash flows should be accelerating from here on out.

OID: Why do I somehow find that hard to believe?

Rodriguez: Also, I told you that production problems had also forced them to compromise their product mix. Well, with those production problems behind them, they'll not only enjoy operating leverage as a result of increased *volume*, but also by virtue of returning to a more optimal *mix*.

OID: Those problems sound like they might explain the company's sub-par performance for the past year or two. But what accounts for their net profit margin having averaged less than 2% for the last four years

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— depressed pricing?

Rodriguez: That's right — plus a less favorable mix and older, less efficient mills.

OID: It looks like the company's average selling price per ton of steel products sold fluctuated around $500 per ton from 1993 through 1997 versus $600 per ton in 1991 and 1992 when its net profit margin was nearly four times as high.

Rodriguez: That sounds right. As you point out, Oregon Steel's average selling price has ranged between $500 and $600 per ton thus far during the 1990s. But it's been near the bottom of that range for the past five years. Steel pricing has been eroding — and remains depressed — particularly in the commodity segments.

But I'm not expecting them to enjoy higher pricing right away for several reasons. First, they're just now getting orders for some of their products — such as their pipeline products. And those won't show up right away — probably not until the early part of next year. Plus, they're experiencing increased competition from overseas on some of their commodity-grade products. However, higher pricing will eventually give their earnings a boost.

Also, because their output is less commodity-oriented, their pricing has generally held up far better than Nucor's.

OID: I see what you mean. A company press release dated July 27th says their average selling price in the second quarter was $558 versus $508 last year. And as you suggest, they did it with far greater output — nearly 70% higher — of high-priced specialty steel. And its average selling price was actually up — to $695 per ton versus $664 per ton last year.

Rodriguez: There are other offsetting factors, too. Oregon Steel's primary raw material — and the primary raw material of mini-mills generally — is scrap steel. And because there are fewer mini-mills in the West and Midwest to absorb the supply of scrap, the West had been exporting its surplus to the Pacific Rim. However, with the virtual collapse of economies throughout Asia, that surplus has grown and driven down the price of scrap by about $30 per ton.

And a decline in their primary raw material is an element that I don't think most market observers have yet factored into their expectations for this company.

THE BEST CASE SCENARIO IS MOST LIKELY,
BUT THE WORST CASE WOULDN'T BE SO BAD.

OID: Might you briefly explain what led to the strike and a nutshell summary of what's going on there?

Rodriguez: Oregon Steel acquired a company called CF&I about five years ago for its rail production operation — which they weren't yet in at the time. They bought it out of bankruptcy for about $30 million and then invested another $200 million in the business.

OID: Ah, the joys of capital intensive businesses...

Rodriguez: The strike is about various issues. However, one of the critical issues is that the union wanted Oregon Steel to make good on the predecessor company's pension liabilities to its older retirees.

Well, Oregon Steel — quite appropriately in my view — said no. And the workers went on strike last October. So the union is suing the company to try to force it to make good on the predecessor company's liabilities.

OID: It doesn't sound like you expect the company to lose the lawsuit or be destroyed by the strike.

Rodriguez: No. I believe it's a low probability event. Those benefits were a liability of the predecessor company, not Oregon Steel. So you have to feel sorry for the retirees. But the company they worked for is no longer in existence. Sadly, in effect, they chose to work at the wrong company — and it's gone. Old CF&I disappeared in bankruptcy along with essentially all of its liabilities — post-retirement and pension liabilities included.

Fortunately for those retirees, should the union lose, they wouldn't be left out in the cold entirely — because the Pension Guaranty Board would pay them half the benefits other U.S. steelworkers receive on average.

OID: Half a loaf is better than none.

Rodriguez: Absolutely. But I think union negotiators failed to appreciate that principle. They didn't appreciate the fact that were it not for Oregon Steel investing another $200 million in the plant, their members wouldn't even have had those 1,000+ jobs.

OID: In effect, they looked a gift horse in the mouth.

Rodriguez: Exactly. Perhaps they finally realized it because after the company hired replacement workers and moved along with its business, union negotiators offered to have its members come back to work — but only after they'd been out on strike for several months. And by then, the company had already replaced 700 of the strikers and only had 35 openings left. So company representatives told the union that they'd be happy to fill those openings with union members.

But the union turned down that offer in effect saying, "It's all or none." So Oregon Steel said, "We choose none. You didn't strike about members' working conditions. Therefore, we're talking about an economic strike — and we have the right to hire permanent replacement workers."

OID: And you think the company is correct.

Rodriguez: I do. The union claims that the strike was *not* about economic matters. But it's clear to me that it was. If demands that a company fulfill the liabilities of its predecessor aren't economic, then I don't know what is.

Also, the company even sought to have the issue determined by arbitration and the union turned 'em down.

OID: What does that tell you?

Rodriguez: Well, a recent *Wall Street Journal* article described some of the difficulties the steelworkers' union is experiencing. Its membership has been declining now for decades. So I believe the motivation for the strike and the lawsuit had nothing to do with the merits of the case — rather that it was based on the union thinking it had to take an aggressive stance to justify its existence. And I

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expect the decision in the courts to ultimately reflect that.

OID: But didn't one of Oregon Steel's press releases mention that the National Labor Relations Board [NLRB] had already ruled against the company?

Rodriguez: It did. But that was an early ruling. Oregon Steel appealed it. And I'm told that the NLRB has a tendency to rule in favor of labor. So it wouldn't surprise me if the NLRB were to rule against them again. But whatever its final ruling, unless both parties are satisfied with it — which seems unlikely — it'll be appealed and settled in the courts.

And I'd assess the odds of them ultimately losing in the courts as being very low — probably well below 10%.

OID: What's the worst case scenario here?

Rodriguez: The worst case scenario would be for the court to ultimately rule that Oregon Steel is indeed liable for those pension liabilities and that the strike was about non-economic matters. In that case, the company would have to assume the pension liability and pay the strikers.

But even then, they'd only be responsible for paying the strikers who actively sought employment what they would have earned on the job at Oregon Steel less what they actually earned. So I don't think it would be disastrous in any case. But the company hasn't put out a number. And I'd rather not mention one right now either since it's currently before the NLRB and likely to be litigated.

But I don't think the worst case scenario would change my thesis. At most, it might force them to take out a loan to pay it off. Granted, it might put them into technical default of their existing debt covenants. But I think they'd be able to deal with that...

OID: Assuming that their lenders were rational.

Rodriguez: That's right. Also, it's important to consider that any such judgement would very likely be three years or more down the road.

OID: How do you know that?

Rodriguez: The wheels of justice grind slowly. It's hard for me to imagine it not taking at *least* that long. And as I explained earlier, three years from now, I expect them to be much less leveraged with much higher earnings.

By the way, it's not in the union's interest to bankrupt them even if they could — because then they could void the collective bargaining agreement and become non-union anyway. So bankruptcy would be in *no* one's interest.

PERCEPTION AND REALITY ARE VIRTUAL OPPOSITES — WHICH SPELLS TERRIFIC VALUE IN OUR BOOK.

OID: How well managed is this company?

Rodriguez: It's been very well managed historically.

OID: It looks like it. Oregon Steel's sales have grown from $80 million in 1985 to $1 billion this year. And it doesn't look like management's been a bit bashful about repurchasing shares. It looks like they shrunk their share count by nearly 80% from 1985 to 1989, although the count seems to be up about 40% since.

Rodriguez: That sounds about right. They were hit with a big strike in 1984. And as a result, the union was decertified shortly thereafter and Oregon Steel became a non-union company — which they remained until they bought the CF&I plant.

And the reason why their shares are up subsequently is that the company issued about 6 million shares in 1996 to help fund their Combination Mill.

OID: Are they as efficient as anyone in this business?

Rodriguez: I think that's a pretty safe bet based on the operating profits that they've generated historically. Think about it. Despite all the challenges they faced, look how well they've done...

OID: How well?! Net profit margins below 2%?!

Rodriguez: Forget how much money they *made*. That they managed to make *any* money under those circumstances is no small feat. Most companies would have reported large *losses*.

OID: So management's shown its mettle — and proven that it's truly steeled itself to the task.

Rodriguez: I think they're *very* efficient operators — and becoming more efficient all the time. I mentioned that I thought Oregon Steel was well over 90% likely to prevail in the courts. Well, if they do, they won't have to fire the replacement workers they hired during the strike. And they would wind up, in effect, as a totally non-union shop. And if I'm right, they'll enjoy greater flexibility — which translates, among other things, into greater productivity and lower costs per ton of output.

And an indication of what I mean by that — as well as why I think they're well managed — is what they did with their Pueblo plant. Nine months ago, it was operating near 100% of capacity with 1,000+ employees. Today, once again, it's operating near 100% capacity — however, with closer to *700* employees. Don't you wonder what those other 300 people were doing?

OID: As I recall, Charlie Munger has said something to the effect that old employees usually don't retire — they just quit working and keep drawing paychecks.

Rodriguez: I think there's a lot of truth to that. So even if Nucor *were* to enter their segments, there's no reason I can see to think that they'd be any more efficient.

More likely than Nucor *competing* with Oregon Steel — assuming I'm right and it winds up becoming non-union — would be for Nucor to *acquire* it. But, granted, that's unlikely to happen either since Nucor prefers to grow its operations *de novo*...

OID: Because the odds of successfully imparting its corporate culture is higher that way.

Rodriguez: That's right. On the other hand, it has been looking to get a foothold in the western U.S. It's even looked for land around Portland. And Oregon Steel has excess property at its Portland mill site. So by buying Oregon Steel, Nucor would establish a geographic objective and gain entree into two of the most attractive niches

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within the specialty steel industry — namely, the energy and railroad areas.

Again, the odds of such a combination happening are probably low, but it looks to me like it would make sense.

OID: I gather that Nucor is a non-union shop.

Rodriguez: Totally. Nucor doesn't want to take on unionized employees in its employee mix. Incidentally, mini-mills tend to be non-union, whereas the other players tend to be unionized.

OID: How much does that account for Nucor's success?

Rodriguez: That's an important part of it. Another important part is its use of incentives tied to productivity and a carefully cultivated corporate culture.

Oregon Steel, incidentally, utilizes a similar approach. All their employees participate in profit sharing incentives which depend upon how successfully their mills operate.

OID: On the other hand, even though there's been insider buying and no insider selling lately, insiders don't seem to own very much of the company at all.

Rodriguez: That's misleading — because, as I recall, this management is heavily incentivized with stock options. Plus, a large chunk of the stock — about 7-1/2% of its outstanding shares — is owned by their ESOP (employee stock ownership plan).

OID: What, then, could turn it into a mistake?

Rodriguez: That's a good question. The only way that I could imagine Oregon Steel's stock price remaining anywhere near today's level or going lower would be for there to be a much more severe economic contraction than we had in 1990-91 along with energy prices collapsing and pipeline contracts being postponed. But even then...

Analysts have reduced their 1998 estimates down to something between 85¢ and $1.00. And the market perception given the current stock price seems to be that its operating outlook will deteriorate badly — and, perhaps, even that it won't be able to sustain its dividend.

But for all of the reasons that I've mentioned, that's hard for me to imagine. So the market perception and the reality as I see it could hardly be more different. They're virtual *opposites* of each other. Therefore, if Oregon Steel isn't a terrific value anywhere *near* today's stock price, then I don't know what is.

A LOW RISK WAY TO PARTICIPATE IN AN INDUSTRY ALMOST CERTAIN TO HAVE ENORMOUS GROWTH.

OID: Maybe Arrow Electronics?

Rodriguez: Good answer.

OID: When you told us about it, it was selling up around $25 — adjusted for a subsequent 2-for-1 split. And you said that you'd paid as much as $23 or $24.

Rodriguez: That sounds about right.

OID: But here we are more than two years later — with Arrow's sales having grown more than 30% and its stock price is down nearly 40% to around $14.

Rodriguez: Yep. In fact, Arrow's [ARW/NYSE] down more than *half* from its $36 high. And we thought the valuation was getting a little stretched at $36. But we didn't sell it for several reasons — including the fact that we view it as a long-term holding.

OID: Apparently, GEICO's Lou Simpson didn't disagree entirely. According to Portfolio Reports, GEICO bought Arrow at much higher prices — as did Arrow insiders and the company itself via share buybacks. And I believe it showed you buying more, too.

Rodriguez: Absolutely. As I told you before, we'd like to own this one for a long time.

OID: It looks like you get much more for your money today — although there is $6-7 more per share of long-term debt today than when we spoke in '96.

Rodriguez: Earnings-wise — at least for now — you get less. But I think it's a *much* better bargain today.

OID: Could you refresh our memories on Arrow and give us a quick update?

Rodriguez: Sure. Arrow Electronics is the world's largest distributor of electronics. And as I told you, what's happening is that electronics manufacturers are relying increasingly on electronics distributors and less and less on their own sales forces. The way it typically works is that the manufacturer assigns the distributor customers below a certain size or something of that sort.

In particular, the leading distributors have been the greatest beneficiaries of that trend because manufacturers generally prefer dealing with either a single distributor or a small number of distributors to dealing with umpteen different distributors if they don't have to. Other things being equal, it's much easier that way because their logistics are much simpler. Thus, as the largest distributor in the world and the one with the greatest geographic reach — with distribution not only in the U.S., but also in Europe and the Far East — Arrow stands to be a prime beneficiary.

OID: Sounds familiar.

Rodriguez: Plus, I think electronics distribution is an attractive business. It does have its capital requirements. And those capital requirements have increased over the last few years. There's been heavy pricing pressure in the semiconductor area lately, of course. However, for much of the last two years — at least in some product categories — demand outstripped the available supply. And between the resulting shortage of product and the increasing popularity of EVA [Economic Value Added] analysis — one tenet of which is to keep working capital at a minimum (just-in-time inventory and so forth) — electronics manufacturers started to push more and more of their inventory risk onto their distributors.

OID: What risks exactly have the manufacturers been pushing off? In other words, who gets stuck with the so-called "nonrecurring" inventory writedowns?

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Rodriguez: The distributor has to *buy* the products, but it gets a price guarantee from the supplier to be reimbursed if its price subsequently declines.

OID: So the distributor isn't left holding the bag unless the manufacturer bites the dust.

Rodriguez: Exactly — although, again, the capital requirements and credit risk do rise proportionately. Also, if a product a distributor is warehousing declines from $10 per unit to, say, $7, Arrow gets a $3 per unit credit from the manufacturer, but it doesn't get its $3 in *cash*. It gets it on its next purchase. So there's also a time-value-of-money issue. But at least the distributors are *mostly* insulated from inventory writedowns.

OID: Which sounds like a major plus.

Rodriguez: It is in my view. Also, despite the fact that the capital requirements have increased recently, they're still far less than those of most technology firms. As I told you last time, we think of Arrow as being almost an electronics mutual fund. It enables us to participate in the worldwide growth of the electronics industry, in effect, without having to bet on any single technology. We get a diversified base of suppliers and customers.

So given the risks in technology companies generally, we think the electronics distribution business is clearly one of the lowest risk ways to participate. In effect, it's a way for the chickenhearted investor to participate in the enormous future growth of electronics around the world.

ARROW'S NEGATIVES ARE MOSTLY *SHORT* TERM.
OVER THE LONGER TERM, THEY'LL BE BIG *POSITIVES*.

Rodriguez: As you may recall, we first got into Arrow when it bought Anthem Electronics — which, at the time, we'd owned for about 10 years. And Steve Kaufman — Arrow Electronics' CEO — has done a wonderful job since.

OID: Whatever investors seem to think — and despite the fact that their earnings have been going nowhere for the past several years.

Rodriguez: What you're seeing today is the *downside* of that business. Of course, Arrow has a large exposure to semiconductors.

OID: Nearly two-thirds of its sales and inventory according to its annual report...

Rodriguez: Like I said. And as everyone knows, there's been heavy pricing pressure in that area lately. Plus, Arrow's been investing heavily in infrastructure internationally — particularly in Europe. And the fruits of those investments haven't really begun to come through. So that's been a negative, too.

Also, of course, since its stock was up in the $30s, Arrow's suffered the fallout from Asia. I've been warning clients about its potential impact since last fall — saying that the full impact wouldn't start to be felt until the second quarter of 1998. So now we're starting to feel it. And one of the industries to really get nailed happened to be technology — with one of the worst hit areas so far being semiconductors.

OID: And I believe I read that Arrow Electronics is the largest electronics distributor in Asia, too.

Rodriguez: That's right. And not only has there been a slowdown in the semiconductor industry and fallout from the Asian economic crisis, but there's even been a slowdown in the *computer* business. So all of those factors have been negative in the short run.

But in the long run, there's no question in my mind that electronics is still a growth business. And eventually we'll have another cycle in computers and other types of electronic products.

OID: Next you'll say the same thing about Asia...

Rodriguez: You've got it. Meanwhile, Arrow has a very manageable level of debt. Over the last 15 years, it's held up very well in tough times. In 1989, for example, which was another terrible year for electronics distributors, split-adjusted it only lost 5¢ per share on a book value of slightly over $3.00.

OID: And it looks like it had roughly twice as much long-term debt relative to sales as it does today — although it did have bigger losses in '86 and '87 when long-term debt was closer to four times today's level.

Rodriguez: That sounds right. So it's held up well in the past. As you say, it's less leveraged today. And I'd argue it's more diversified, too. So there isn't any question in my mind that Arrow's going to be a *survivor* and, therefore, that it'll get to enjoy the other side once the operating environment gets more hospitable.

OID: As you've told us before, buying survivors during tough times is one of your favorite themes.

Rodriguez: Exactly. And, therefore, I've typically bought distributors when their stocks have gotten down around book. Rarely do they go much *below* book value because of the value of the assets on their balance sheet.

OID: And I see that Arrow's book value is around $15.

Rodriguez: Correct. So I thought it might become a teenager. We were adding to our stake in Arrow at $21 or $22, but only as a toe tickler — to get our feet wet. Frankly, I figured that given the very difficult environment, it was probably headed into the teens.

But with book up around $15, I think the downside is probably pretty limited in any case. And the price wouldn't have to get much lower to motivate me to increase our position another 50-60%.

OID: I think I can understand why. In 1997, when Arrow earned $2.05, its net profit margin was 2.6%. Had it achieved the 3.1% to 3.4% net profit margin that it did during each of the prior five years, its earnings per share would have been closer to $2.50.

Rodriguez: That's right — although I do suspect that Arrow will average something less than 3% over a full cycle when you factor in the bad years, too.

OID: And Value Line estimates 1999 sales per share

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20% higher than 1998 — or up around $98 per share. If so, Arrow's normalized earnings per share may be up near $3.00 — whatever they earn next year.

Rodriguez: You've got it.

OID: In which case Arrow may be selling at as little as 5 times prospective normalized earnings!?

Rodriguez: Correct. After all, when Arrow was selling at $36, it was in the context of earnings estimates around $2 — and of future earnings being up near $2.50. So it looked like it'd be a $50 stock in relatively short order.

Of course, instead of earnings going to $2.50, they appear to be on their way to earning $1.50 or less in 1998 — primarily for the reasons I've mentioned. Again, I don't have any idea whether Arrow will earn $1, $2 or anything else in 1998 — or any given year, for that matter.

OID: There's no need to be exact. Two decimal places will be fine...

Rodriguez: But over a typical cycle, I suspect that Arrow's operating margin will average 5-7%.

OID: Which appears to have historically translated into net profit margins of 2-3%. And, if so, Arrow's normalized earnings for next year would be something between $2 and $3.

Rodriguez: Correct on both counts. But its net profit margin could wind up averaging 3% or *more.* Its profitability is in a state of flux for several reasons: First, its business mix is changing. For example, its Gates/Arrow segment is a leading distributor of computer systems and a value added reseller. And that business tends to have lower margins, although it has higher turnover, too.

Also, Arrow's been doing some things in Europe in terms of integration, rationalization and so forth that should reduce its operating expenses going forward and, thereby, improve its profitability somewhat. But I really don't know exactly how to quantify the probable impact.

IT'S UGLY TODAY IN THE SEMICONDUCTOR AREA, BUT ELECTRONICS DEMAND WILL BE EXPLOSIVE.

Rodriguez: More important, there's no question that there's been an enormous overexpansion of capacity in the semiconductor area — whether you're talking DRAM or logic chips or gate arrays.

OID: Say what?

Rodriguez: Because capital was so easy to come by, there's excess capacity today in virtually every segment of the semiconductor industry. That's why Marty Whitman's been buying semiconductor equipment companies. Because there's so much excess capacity, these companies' backlogs are going to go through the floorboards for awhile. And, therefore, their stocks are getting *trashed.* So it's definitely ugly today in the semiconductor industry.

OID: With the prospect of more of the same, I imagine, if the U.S. economy goes from slow growth to recession.

Rodriguez: That's right. But if you overlay a graph of revenue growth within the personal computer area over revenue growth in other consumer electronics products, you see a very clear inverse relationship. In other words, when consumers are spending lots of money on one, they aren't spending much on the other.

And if you stop and think about it, it makes sense. For example, if a household has $2,000 available to spend, in recent years, it's spent that $2,000 on a *computer.* And it's had very little left to spend on other electronics.

OID: Assuming you're right, why would that change?

Rodriguez: It's going to change for *several* reasons. First, there hasn't been much in the consumer electronics area outside of computers that was very sexy.

By contrast, consumers have been able to buy themselves one hellacious computer for $1,000. Therefore, given $1,000 or $2,000 they have available to spend, what have they spent it on? The answer has been computers. But given compelling offerings in consumer electronics, they'll spend it *there.*

OID: I think I've heard that line before. Come to think of it, I think I heard it from you...

Rodriguez: Retail sales of consumer electronics have been moribund over the last seven years. But sometime in the *next* seven years, a major changeover is going to occur in TVs and other home entertainment products.

OID: Why do you say that with such conviction?

Rodriguez: First, home entertainment technology will be converting from analog to digital. And as TVs become digital, computers — which are *already* digital — will be integrated with digital TVs. In effect, they'll blend together.

Current digital TVs *aren't* compatible with computers. However, I can't believe that there won't be some kind of converter box or any number of other products along those lines that will allow that conversion to occur — especially with the cost of data storage declining to virtually nothing.

OID: It sounds like you know a bit about the area — and we don't. But that sounds reasonable.

Rodriguez: It's something that I've been thinking about for quite awhile. Along that same line, did you know that a single High Definition TV uses 500 microprocessors?

OID: Five hundred — in one TV!?

Rodriguez: Five hundred. When Dennis [Bryan] and I heard that number, we were as amazed as you are. As I recall, there are fewer than *10* microprocessors in the average present day TV. So those developments and others are virtually guaranteed to ignite another electronics cycle. And it's hard for me to imagine that the beneficiaries of that cycle won't include companies in the electronics and semiconductor area.

OID: It helps shed light on Marty Whitman's comment about the world going digital and on why he wants to own selected semiconductor equipment companies.

Rodriguez: I obviously agree with Marty about the world going digital. However, I think it's still too early to buy the semiconductor equipment companies. If the U.S.

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doesn't go into a recession, I think he'll come out fine. But if it does — say in the next 12-18 months — it wouldn't surprise me if those companies were to fall a lot more.

OID: And reading between the lines, I gather that a recession is exactly what you're expecting.

Rodriguez: You know I'm a bottom-up investor...

OID: Then just between us bears.

Rodriguez: Let me put it this way: We're now in the eighth year of economic expansion. What are the odds that we go 10 years without a recession? That seems unlikely. So it looks like a better than 50/50 shot to me that we get a recession sometime during the next 12-18 months. Then, again, I'd have said the same thing a year ago, too.

OID: There's no doubt in my mind that you'll be right one day...

Rodriguez: But semiconductor equipment companies and the economy aside, as home entertainment products blend together with the computer, clearly the impact on the supply/demand equation for semiconductors and other electronic products will be quite dramatic.

I KNOW *WHAT* WILL HAPPEN, BUT NOT *WHEN*.
SO I WANT LOW RISK AND LOW EXPECTATIONS.

Rodriguez: So, I think I know *what* will happen. But what I don't know is *when*. I don't know whether the glut of semiconductor capacity will last only a year or two or whether we'll suffer through it for six or seven years.

So I compensate for that uncertainty a couple of ways. First, I chose relatively conservative ways to participate — like Arrow. And, second, I lowball my expectations.

OID: So you'd probably do fine even if Arrow's profitability were to wind up being a third or so less than it has been recently.

Rodriguez: Correct. Arrow's just a fine company and a low risk way for us to participate in the growth that's virtually certain to occur in that area.

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OID: And a pretty cheap way, too.

Rodriguez: A *very* cheap way.

OID: One thing I can't reconcile.... Arrow looks like it grew sales per share 26% per year from 1968 to 1980, but only 4% per year since — largely because shares outstanding rose 1000%+ during the latter period. What's the story there?

Rodriguez: That's a good question. I'm not sure why that was. I don't think it's a management issue — because Kaufman's been there for the better part of 20 years.

But from 1982 to 1988, the electronics industry was convulsive. And it's been consolidating ever since. In fact, it's been consolidating for the past 25 years. Therefore, if you believe as I do that the electronics industry has a very bright future — and I think it's hard to imagine otherwise — the survivors will reap the rewards.

OID: Again, that sounds like a familiar theme.

Rodriguez: It's my favorite. So Arrow's been one of the industry's leading consolidators. It's thus become the #1 electronics distributor in the world — which is reflected in its profitability. Its margins have basically doubled. And its returns are a lot higher...

OID: Not to mention more stable.

Rodriguez: Exactly. So Arrow's been investing heavily in acquisitions and infrastructure. But most of those are now behind them. For example, they've been expanding very aggressively in Europe. When will those investments begin to pay off? If we're entering a recession, it could be five years before they pay off.

But once the electronics cycle does pick up again, then they'll begin to reap the rewards. And it wouldn't take very much of a recovery today to make the current price look very cheap.

OID: And you don't worry that future share issuances might continue to dilute those rewards?

Rodriguez: I don't. And one of the indications there, I think, is that Arrow reduced its shares outstanding by nearly 5% over the past 18 months.

OID: That does look like a plus. The only other years that they reduced their shares outstanding in the last 30 years were 1975 and 1976 — which preceded one of the best 5-7 year periods in the company's history.

AN AWARD-WINNING WEBSITE + A UNIQUE BUSINESS
+ A SUPERB CEO = A LONG-TERM KEEPER.

Rodriguez: As I mentioned, I've typically bought distributors when their stocks have sold down near book. And, again, Arrow's selling below it's book value. Well, we've also been buying *another* electronics distributor at less than 1-1/4 times book.

OID: And you haven't told us about it yet?!

Rodriguez: Marshall Industries [MI/NYSE] has a book value of about $22. And it's currently selling at $27.

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OID: Interesting. And it looks like roughly a third of Arrow's book value consists of goodwill. So Marshall looks much cheaper relative to tangible book.

Rodriguez: That's right — although the goodwill doesn't worry me since I think Arrow's been getting value in its acquisitions.

OID: On the other hand, Arrow is much cheaper than Marshall Industries relative to sales per share. But enough about what you pay. What do you get?

Rodriguez: Marshall is less diversified than Arrow product-wise. It has far more exposure to the DRAM area in semiconductors...

OID: What technophobes like us call "memory chips"?

Rodriguez: That's right. And they're almost exclusively the distributors of Japanese semiconductors and microprocessors. So with the collapse of DRAM prices over the last couple of years, they've needed huge unit growth simply to stay even revenue-wise.

OID: Isn't that just the way the cookie crumbles in this business — at least over the long term?

Rodriguez: It's been very tough — even tougher than usual in that regard. Therefore, Marshall's earnings have been — and will likely continue to be — under more stress even than Arrow. Much more of Arrow's revenue comes from the sale of microprocessors, gate arrays, specialty products and other things that haven't experienced the kind of price destruction that DRAMs have suffered. Also, Arrow does more contract manufacturing where they'll actually do what they call "kitting" — where they preassemble parts for their customers. In effect, they do some of the sub-manufacturing for their customers.

OID: Also, Marshall seems to have twice the net debt, more or less, relative to sales — although relative to tangible book it has about a third less.

Rodriguez: Marshall's actually had very little debt historically. But they just acquired a company that's sort of a mini-Marshall Industries — called Sterling Electronics. So Marshall does have more debt today, too.

On the other hand, Marshall's also more unique in a couple of ways. As I mentioned, it's the leading distributor worldwide of Japanese semiconductors. And those manufacturers produce most of the world's DRAMs. Therefore, when the market for DRAMs recovers, a lot of people are going to be beating a path to Marshall's door.

OID: And it's been earning slightly higher margins despite having only 1/6th or so of Arrow's sales.

Rodriguez: Yeah. Rob Rodin, Marshall's CEO, is truly superb. He saw the internet's potential right away and established an award-winning website [www.marshall.com] above and beyond anything else in the electronics industry. He's basically created a virtual distribution company. Believe it or not, Marshall now has one of the highest traffic sites on the internet.

OID: Super. Maybe Wall Street will decide that it's an internet play and give it the customary cybervaluation. Of course, they'll have to get rid of their earnings.

But an electronics distributor has one of the highest traffic sites on the internet?!

Rodriguez: Yeah. Their website gets a huge number of visitors. They have what I call Marshall University — where engineers can log on via the internet and compare notes on the finer attributes of certain types of electronic devices.

OID: Talk about the world belonging to the specialist!

Rodriguez: Yeah. When Rob visited us in 1993, he had his laptop with him. And he showed us Marshall's web page and said, "Mark my words. The internet is going to be one of the biggest things around in the next century." And he's absolutely right. It's changing the face of the earth. We're only beginning to see some of the implications.

OID: Value Line is guesstimating sales per share for Marshall of around $97 in 1999. And I see that its net profit margin averaged 3.8% from 1988 through 1996. Does that suggest that its normalized earnings for 1999 may be up around $3.50?

Rodriguez: Marshall won't earn anything near $3.50 next year — because its margins have been dropping. For example, its net profit margin was 1.6% last quarter. And they're still getting hit today.

OID: But on a normalized basis...

Rodriguez: Well, I haven't spoken with them yet about what they believe it's going to take for them to integrate their latest acquisition and what kind of savings they're likely to achieve as a result. However, whatever they earn next year, these franchises are quite substantial. If they weren't around tomorrow, a lot of corporations would dearly miss 'em.

OID: Aside from a lot of engineers having to join AOL, what makes you say that?

Rodriguez: They're key in the logistical operation of the electronics manufacturers. So these guys aren't going to disappear — unlike some hot technology companies like International Dittledly Widgets.

So we own about 8% of Marshall and 3% of Arrow. And I just put 'em both away, forget about 'em and hope they never get so expensive that they force me to sell 'em. I'm truly hoping to own both for a long time to come.

IT HASN'T BEEN SO GOOD FOR THE GOOD GUYS,
BUT I HAVE *MUCH* MORE CONFIDENCE TODAY.

Rodriguez: Incidentally, besides Arrow and Marshall, we've also been building a position in another company that I believe also stands to benefit from a reemergence of the consumer electronics industry.

OID: The Good Guys.

Rodriguez: You've got it. And we're playing the area in other ways, too. For example, we own 16%± of Recoton

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— which is the leading provider of consumer electronics accessories — wires, cables, speaker wire, you name it. That one was a real turkey of a holding for us for all but the last four or five months of the three years that we've owned it. Then, all of a sudden, it shot up 200%.

OID: So much for that one.
But I gather The Good Guys is not up 200%...

Rodriguez: I never know what the timing will be. The Good Guys [GGUY/NYSE] was a dog for years. Then, all of a sudden, three or four months ago, people got excited about its prospects and drove its stock up to around $15. So I *never* know when these things will work out.

OID: For a large fee, we'll tell you when we sell...

Rodriguez: I thought that move was premature. And now The Good Guys has fallen back well below $10. Hopefully, one day, we'll make some money in it, too. But as I told you last time, that could take a long time.

OID: Because, you said, a blockbuster product in the consumer electronics area was overdue, but you didn't know when it would arrive.

Rodriguez: That's right — that consumer electronics sales ex-personal computers had been depressed for six or seven years. You can see just how depressed by looking at the results of The Good Guys and its competitors.

OID: That's clearly true in the case of The Good Guys. Its margins have obviously been...

Rodriguez: *Terrible.*

OID: "Nonexistent" was the word I had in mind. It seems to be on the way to reporting a loss for the third straight year. And its sales have gone nowhere since 1996 — and almost nowhere since 1995.

Rodriguez: It hasn't been pretty. In fact, it's the only retailing stock I own that isn't up.

OID: Even worse, haven't Best Buy and Circuit City been consistently profitable? And aren't the sales of those two at least moving in the right direction?

Rodriguez: Correct. But I'd argue that when you look more closely, Best Buy [BBY/NYSE] and Circuit City [CC/NYSE] aren't doing nearly as well as investors seem to think — and that The Good Guys is on the right track.

OID: And it looks like there's been a fair amount of insider selling at Best Buy and Circuit City, whereas there's been lots of insider buying at The Good Guys.

Rodriguez: That's right.

OID: What am I missing?

Rodriguez: Well, Circuit City's results look better than those of The Good Guys in part because they enjoyed the benefits of Car Max. The idea behind it was no-haggle, volume sales of cars on a retail basis. And basically because people thought it had wonderful growth prospects, they didn't worry about the more mundane types of things — like whether or not it would ever generate earnings.

So Circuit City brought Car Max public at up around $20. And it was trading at $6 or $7 the last time I looked. But the excitement surrounding Car Max and the financial impact of bringing it public obfuscated Circuit City's numbers and muddled the perception of its results to one degree or another.

BEST BUY'S DONE WELL FOR A REASON,
BUT IT'S NOT CONSUMER ELECTRONICS.

OID: Even so, isn't Best Buy doing better still?

Rodriguez: Don't get me started on Best Buy. In my view, its valuation is absolutely ridiculous. In all fairness, it never ceases to amaze me how Wall Street bids up the price of some stocks.

OID: I see what you mean. Best Buy's stock price is up something like 10 times in less than two years.

Rodriguez: Best Buy's stock has been *explosive.* Basically, it reported a couple of quarters of positive comps and its stock went *crazy.*

OID: I gather you don't think they're that good?

Rodriguez: I really don't. Best Buy brought in some consultants a couple of years ago to tweak its box. And they're trying to meld hardware and software in one box. And by software, I mean CDs and videos. And that combination hasn't been done successfully by anyone yet. So exactly how successful their new box will be is still an open question in my view.

OID: Although it looks like it got its money's worth. Best Buy looks like it's been rocking and rolling — relative to The Good Guys, in any case — for whatever that might be worth.

Rodriguez: True. If you like sales growth, you can always buy Best Buy. On the other hand, they aren't bringing very much of their sales down to the bottom line.

By the way, another reason why The Good Guys has been a laggard is that it had to replace computers in its sales mix. What happened is that when PC prices dropped from up around $2,000 to $1,000 — as they did recently — it destroyed their margins.

And, of course, The Good Guys isn't the only retailer confronting that problem. CompUSA, for example, had similar problems. Its stock hit $37 or $38 last December. And it's collapsed, too. Because of lower computer prices, for CompUSA to report the same earnings that they did last year, they'd have to sell almost twice as many units.

OID: But why wouldn't those factors have hit Best Buy and Circuit City just as hard as The Good Guys?

Rodriguez: Because Best Buy and Circuit City have a segment that The Good Guys *doesn't.* As it turns out, sales of refrigerators, stoves and other such items within the home appliance category have been very hot. Why? Because *housing*'s been very hot. In fact, there's been a *record* level of housing resale activity. And The Good Guys isn't in that area.

Also, Best Buy and Circuit City are more diversified geographically. A large chunk of The Good Guys' stores

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are located in Southern California, which only began to exit its recession very recently — say, the last 12 months.

IF A 20% SAME STORE SALES GAIN IS ANY INDICATION, THE GOOD GUYS MAY BE ON THE RIGHT TRACK.

OID: I see that The Good Guys has now managed two straight quarters of same store sales growth including a 6% gain in the latest quarter — ended June 30th. And Gunst says it's their best comparison since 1994. Also, it looks like they've been lowering their SG&A and growing their gross margins.

Rodriguez: All of that sounds right.

OID: But Value Line says their same store sales may have declined by 20% over the past few years and that they probably need high double-digit gains in their same store gains just to get back to breakeven.

Rodriguez: The recovery of Southern California *hasn't* shown up very much in The Good Guys' results yet. And one of the reasons *why* it hasn't is that they're in the midst of reformulating and revamping their entire concept. Granted, their execution could have been better.

OID: But isn't that particularly worrisome in and of itself given that one of the big question marks has been whether this management will be able to fill the shoes of the retired founder — especially given the extraordinarily unforgiving nature of that business?

Rodriguez: I think you're right about the business. However, I have *much* more confidence in Bob Gunst today than I did when we talked about it last time.

OID: Really?!

Rodriguez: Definitely. Gunst took a hard look at the company and concluded that its retail concept and store layout were wrong — that they may have been right for the 1980s, but that they were wrong for the 21st century.

OID: And the 1990s, it seems.

Rodriguez: It took a lot of guts for Gunst to recognize the problem and stop the company's expansion program in its tracks. But he said, "Our box is wrong." And they've been formulating a new retail concept — what they call the Audio/Video Exposition store — and refining it ever since.

The one that's been open the longest has now been up and running under the new format for about 18 months. And during the first year it was open, its same store sales were up more than 20%.

OID: Wow! I see why Gunst sounds so excited about the concept in The Good Guys' latest annual report.

Rodriguez: Here's the same store, same location, but different concept — and sales rose more than 20% as did their gross margins. So, again, it looks to me as though they may be on the right track.

OID: And the odds in your view that they are?

Rodriguez: I don't think you have to know the odds given the current stock price. But if I were forced to guess, I'd say that the odds are well over 50%. And they have three Audio/Video Exposition stores today. But Gunst expects to have seven open by the end of their current fiscal year — ending September 30th.

So if they *are* on the right track and their future Audio/Video Exposition stores are as successful as their first — and the consumer electronics cycle hits and they carry the right merchandise and execute well — The Good Guys could do much better than people expect.

OID: You listed quite a few qualifiers there. But how is the Audio/Video Exposition store different from the Wow! store that you told us about last time?

Rodriguez: The Wow! store is the prototype store that The Good Guys operates jointly with Tower Records. The Audio/Video Exposition store is the *next* generation store. They're even working on an Exposition Wow! store.

They named it the Audio/Video "Exposition" store because it combines audio and video and has between three and five "expositions" — depending on the store size.

OID: My Webster's New World Dictionary defines "exposition" as "a large public exhibition or show".

Rodriguez: That's what it *is*. And as the number of the exposition rises, so does the quality of merchandise. So Exposition #1 would contain entry level products — none of which would exceed a given price. And you're able to look at a plethora of speakers, TVs, VCRs, CD systems, etc. in that price range — all of which you're able to try out and mix and match right on the spot.

You can do that with audio components today at lots of places besides The Good Guys. But you can do it with an entire home entertainment system at The Good Guys. And none of the other retailers have been able to do that so far.

NEW STORE CONCEPT MAY BE A VERY BIG DEAL — AND NOT AS EASY TO COPY AS YOU MIGHT THINK.

OID: In his latest letter to shareholders, Gunst says, "Shoppers tell us that our Audio/Video Exposition is the most customer-friendly and exciting store concept in consumer electronics retailing today." He makes it sound like he's reinvented the wheel.

Rodriguez: In some ways, he has. The Good Guys' Audio/Video Exposition store does represent a dramatic departure from the way that consumer electronics have been marketed in the past.

OID: What's the big deal — 20% same store sales gains aside, of course? And what accounts for them?

Rodriguez: It's a big deal for several reasons: First, it's a very convenient, "customer-friendly" and efficient way to shop on a one-stop-basis. Between the wide selection, the store design and the well trained personnel, you can complete your shopping about as quickly and painlessly as I can imagine it being done.

Also, when people buy systems, they tend to be less inclined to comparison shop than they are when they buy a component — because it's not as easy to *do*.

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OID: And the product is somewhat less of a commodity in the mind of the consumer.

Rodriguez: Exactly. So system sales typically generate better margins. For example, one of the fastest growing areas in consumer electronics right now is "surround sound" for the home theater. It includes six speakers — three in front, two in back and a sub-woofer that gives you the bass tone.

Once you hear surround sound, it's hard to live with the sound from a regular TV. And people can spend anywhere from $500 to many thousands of dollars on a home entertainment system with surround sound. For example, I just got finished spending nearly $30,000 on a home entertainment system in my home.

OID: I hope your clients appreciate just how far you go to know industries inside and out...

Rodriguez: I have an expert in this area on retainer, too. He's a graduate engineer who's installed systems in some of the biggest homes in Los Angeles. He told me, "You think *you're* spending a lot. I was at a home recently where they spent $300,000 on the support systems alone."

So I think consumers will spend a higher percentage of their disposable income on home entertainment. And once they experience surround sound as delivered via cable and satellite, they won't settle for anything less. They won't live with a TV with a single cheap built-in speaker. That'll be like buying a car without air conditioning or a black and white TV set today.

OID: Still, isn't every retailer — as Buffett says — looking over the shoulder of every other retailer? So even if The Good Guys discovers the proverbial audio/video fountain of youth, won't competitors just copy whatever it is they do that happens to work?

Rodriguez: That's much more easily said than done. For a consumer electronics retailer to start selling systems, what kind of a salesperson would they need? I'd argue that Best Buy has the wrong type of salesperson. While I'd prefer not to be derogatory, let me just say I wouldn't characterize 'em as high service. And Best Buy isn't tops in selection either for that matter.

OID: So Best Buy offers less in the way of service and selection, but at prices that consumers can't refuse?

Rodriguez: That's right.

OID: On the other hand, Best Buy has a killer web site — way better than The Good Guys' site.

Rodriguez: I confess to not having been on either. But why is the web site important to you?

OID: Because rich or poor, it's good to be ubiquitous. Couldn't Circuit City and/or Best Buy enjoy economies The Good Guys can't match and use their muscle to thwart its efforts to grow?

Rodriguez: I don't worry about that. There aren't significant economies of scale on equipment purchases.

OID: What about advertising economies? I noticed that The Good Guys' SG&A as a percentage of sales was higher than that of Best Buy or Circuit City, but that its gross margin was higher, too. Is that because it has a higher cost structure and higher prices?

Rodriguez: It's a bit more complicated than that. The Good Guys differentiates itself from Best Buy and Circuit City in several different ways. Not only do they offer better service and what may prove to be a better box, but they also offer superior selection. It's a different model.

OID: You mentioned last time that The Good Guys offers more SKUs [Stock Keeping Units].

Rodriguez: That's right. And that's especially true in what you might call the moderate to high-end segment. For example, you aren't going to find a Mitsubishi TV in a Best Buy. You might find four or five large-screen TVs in a Best Buy versus 15-20 in The Good Guys' stores.

And having a wider selection, higher-end products and better service does cost something. But I'd argue that you won't get the same high quality, intelligent assistance at a Best Buy.

OID: Although Value Line says in its latest report on The Good Guys that although the new format has "thus far proved successful ... we think consumers will gravitate toward the stores with the lowest prices".

Rodriguez: The jury's still out. If we have a dynamic consumer electronics cycle in the next five to seven years, everybody in the industry could be a winner. Time will tell.

THE GOOD GUYS WILL BE A SURVIVOR —
AND TO THE SURVIVORS WILL GO THE SPOILS.

OID: There seems to be a trend towards direct sales by manufacturer and distributor alike. How much of a threat do you believe that represents?

Rodriguez: You have to look at it on a product-by-product basis. For a predesignated type of product, it's a very real threat. For example, you usually know what kind of computer you want from the start. And you know what kind of software you want.

But that's less likely to be the case when you go to buy a home entertainment system. In that case, you'll probably want to listen to it hooked up to the system you're thinking of combining it with.

It's similar to suits or shoes. People generally aren't going to buy those things through the mail. They'll want to try 'em on. They may buy their *shirts* that way — because if you're a 16/34 in one shirt, you're generally a 16/34 in another. And you may buy your ties that way, too. But other types of products you'll want to try on and see how they look and feel. So people won't buy everything direct.

OID: And, no doubt, you hope The Good Guys' system approach will insulate them somewhat, too.

Rodriguez: That's right. If you know exactly what you're going to buy — say it's a Sony 36-inch TV — then you very well *may* buy it on the internet or by catalogue. But when it comes to certain types of products, you won't — especially if there's a store nearby.

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OID: Isn't one negative for retailers generally — but especially those in the consumer electronics area — that they have a very high fatality rate and that even minor errors are often punished swiftly and severely?

Rodriguez: That can happen. But if The Good Guys isn't gone by *now*... They've gone through a slow period in consumer electronics with few exciting product offerings in the entire category, the worst recession in California since the Great Depression and a reformulation of their box and their strategy. If all those things haven't knocked 'em out, I have to wonder what *would*.

Also, The Good Guys has no debt. And as I've said, they're doing some things operationally that look intelligent and correct to me.

OID: On the other hand, this story sounds familiar.

Rodriguez: Yeah, I know it does — because I've been waiting for The Good Guys to turn around for *years*. And I wish I could figure it out better. But I'm afraid I'm damned with the frailty of being a sucker for a market leader with a strong balance sheet in an industry that's suffering.

OID: With 1/10th the sales of the #1 and #2 players and fading, The Good Guys is a market leader?

Rodriguez: Yeah. They're #3 in the industry. But in California, they're ahead of Best Buy and second only to Circuit City. And within the high service segment, they're the clear leader among the larger chains.

When we spoke last time, I said I was more excited about MacFrugal than I was about The Good Guys because I thought it had a lot more pain to endure in California before we would get paid.

OID: And yet you were buying The Good Guys then — and you've bought more since.

Rodriguez: I viewed The Good Guys then in some ways as a warrant on the consumer electronics industry — and I *still* do. And you get a sense of what I mean if you look at what happened to its stock recently. When people simply got the faintest *hint* that they might want to own it, it went from $8-1/2 or $9 to $15 in the blink of an eye.

So if you wait for its business or the home electronics area to turn before buying The Good Guys, more likely than not, you'll miss it. So I just put my money in and figure that *they* can afford to wait and so can *I*.

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

Rodriguez: Well, I started buying it in 1992 or 1993. And I scaled into it over three or four years. So my average holding period so far might be around three or four years. And my average cost is just over $9.

So it hasn't been my favorite stock. But whenever I revisit my rationale, I always reach the same conclusion — that it's still sound. So it just sits there in the portfolio.

Really, all I've lost so far is opportunity cost — the time value of my money.

OID: Only because you have a wonderful constitution. Less fortunate shareholders might have to factor in the cost of psychotherapy or antidepressants...

Rodriguez: It doesn't bother me to wait around awhile for my payoff so long as I believe it's worth the wait. Again, one of my favorite mantras is that half of *winning* the game is just *surviving*.

OID: As Bill Ruane is fond of saying, "To win the race, you have to finish it."

Rodriguez: Exactly. And as long as the odds of getting put out of the game are very low — as I believe they are in the case of The Good Guys — I'm *happy* to wait.

Also, something that people tend to forget is that if you're around after most players have been destroyed, you get to reap the *rewards*.

OID: To the survivors go the spoils.

Rodriguez: Exactly. And I believe it's likely that within five years, maybe less, we'll see an upswing of some magnitude within the consumer electronics cycle. And whenever it may arrive, I expect The Good Guys to be one of the survivors who's still around to collect the spoils.

OID: It doesn't look like it would take very much of an upswing to make today's price look mighty cheap. If they were able to get their net profit margins up near 2% — which they regularly exceeded before 1992 — they'd be earning up around $1.30 per share. And that's assuming today's sales — which I gather from your comments you believe to be quite depressed.

Rodriguez: Exactly. For example, if they managed to increase their revenue base from today's $900 million level up to, let's say, $1.5 billion, then a 2% net profit margin would translate into earnings per share north of *$2.00*.

And under those circumstances — if The Good Guys were to execute like that — then their stock wouldn't be anywhere near $7 for long. To the contrary, it could be a $30-40 stock. So it could very easily be up 4-6 times.

We'll just have to wait and see. It's been dead money for three or four years now. However, even if it were to take another three or four years — or even five years — for us to get a meaningful upswing in consumer electronics and The Good Guys to get it right, we could still wind up with a pretty decent compound annual return.

I KNEW INDUSTRY CONDITIONS WOULD GET *TOUGH*, BUT I DIDN'T REALIZE THEY'D GET *THIS* TOUGH.

OID: I hate to kick a money manager when he's down, but I also noticed you buying one we talked about last time that hasn't exactly been a stellar performer.

Rodriguez: I don't think you're a heel for wanting to revisit Reebok [RBK/NYSE]. But it's not a shoe-in today — because they clearly haven't been able to get a foot up on their competition.

OID: You said it was the biggest position you'd ever taken in FPA Capital as measured by cost.

Rodriguez: Our average cost in Reebok is up around $30. So we're down more than 50% at cost.

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OID: You can count on us to rub it in — especially since Portfolio Reports shows you buying more since.

Rodriguez: I appreciate it.

OID: But let's start with the simplest questions first: Why haven't you given that position the boot? And why have you been stepping deeper and deeper into it?

Rodriguez: That's a good question and a tough one. An even *tougher* question is why I didn't sell it when it got north of $50. I still ask myself that. And I wish I had a good answer.

Part of the answer, I think, is that I was stupid and part of it is that I didn't realize just how bad the down part of the cycle was going to be. Obviously things aren't going very well...

OID: For Reebok or the industry....

Rodriguez: That's right. Retailers are really cutting back on inventory. It's even backed up on Nike — which has unloaded *tons* of shoes into the secondary marketplace at huge discounts. So that's really disrupted the market.

And, of course, Asia's had a seriously negative impact on its results last quarter. Therefore, for all those reasons, Reebok and the rest of the athletic shoe industry have a lot of capacity and inventory that they built up for a market that isn't there — at least for now.

OID: So it's hard times in the athletic shoe industry.

Rodriguez: *Very* hard times. For example, within the last few weeks, Venator — the parent of Foot Locker (formerly known as Woolworth) — even began discounting some of Nike's new models in an effort to generate traffic. Well, that shocked a lot of people because it's unheard of for *anyone* to discount first run Nikes.

OID: Why is that such a big deal?

Rodriguez: The reason why that could be a problem for the branded shoe companies is that if Venator does it, other retailers may do it, too. If they do, because Nike's at the top of the food chain, there could be a domino effect — where the industry winds up in a full-fledged price war and other shoes get discounted *more*.

Also, some fear that the discounting could cheapen Nike's image and, thereby, damage its standing — and the standing of other brands in turn — with the consumer. And all of that's happened over the last month or so.

OID: Which may explain why the shoe industry and shoe retailers both have took big hits recently.

Rodriguez: I think so. And, in fact, we're looking at some of the athletic shoe retailers as we speak.

OID: Somehow I knew....

Rodriguez: In fact, last November, I thought things would get very bad for Nike and Reebok. And I thought that one area's pain might be another's gain — that an environment of oversupply might put athletic shoe retailers in a better bargaining position to take some margin out of the hide of the manufacturers.

OID: Part of your rationale for Arrow Electronics, Marshall Industries and The Good Guys, no doubt.

Rodriguez: That's right. So I took a look at the athletic shoe retailers. And one company that popped up on my screen was Footstar. So I visited the company. And I thought they were doing a nice job, although they were having a tough time. Incidentally, the stock was trading around $24 at the time — which was very cheap.

But when I looked at the other athletic shoe retailers — whether it was Finish Line or anyone else — every single one planned to expand its square footage by 20-25% per year. So I thought, "They're all adding lots of square footage in a market growing 3-5% per year at best. Hmm. Sounds like a prescription for disaster to me. I think I'll just sit it out and wait for the penalty to hit."

OID: For a shake-out among the retailers.

Rodriguez: Right. So Nike gets hit. Reebok gets hit. Meanwhile, Footstar goes from $23 to $45 and Finish Line goes from $11 to $23 or $24.

But now the penalty's finally hit at the retail level — at least it has for most of those companies. And we're just beginning to take another look at that area. But we're not far enough along to tell you about those yet.

OID: You're entitled to save a thing or two for clients. That's one...

Rodriguez: So I knew that the athletic shoe industry would be facing tough times. However, I didn't realize that they'd get *this* tough.

I KNEW IT WOULD BE BAD TIMES FOR REEBOK,
BUT I WISH I'D KNOWN IT WOULD BE *THIS* BAD.

OID: You said last time that you thought Reebok was unlikely to lose contact with its arch rival share-wise — that it could probably remain in Nike's tailwind.

Rodriguez: That's right. I thought retailers would migrate back to Reebok — if for no other reason than to avoid relying 100% on Nike.

For example, last year, I was talking to a small group after participating in a panel discussion on that very topic. And I said, "I know the consumer is voting with his dollars, but I can't imagine a retailer wanting to be that dependent on one manufacturer. That would make me uncomfortable."

Well, it turns out that one gentleman in the crowd owned a small chain of athletic shoe stores. And he said, "When Nike's share of our total sales got north of 60%, the bells went off. I just decided that we couldn't afford to have that situation prevail over the long term. We better diversify our sources of supply."

And I hoped Reebok would be the beneficiary of that.

OID: Isn't that thesis looking increasingly tenuous?

Rodriguez: What's upset that applecart for now is Nike unloading huge amounts of inventory and Reebok's very poor execution. Reebok lost market share badly over the last two years at the same time Nike gained share. So, yes — the odds of Reebok losing contact with Nike certainly do seem far higher today. There's no question about it.

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OID: In fact, it's been suggested to us that the odds of Reebok catching Nike are probably far more remote than the odds of it being displaced from the #2 spot.

Rodriguez: I think that's clear. In fact, in terms of total *apparel* sales, Reebok's *already* been displaced from the #2 spot. The worldwide apparel market in 1997 was an estimated $76 billion with share broken down as follows: Nike had 8.9%, Adidas had 6.2% and Reebok had 4.1%.

OID: What about in terms of athletic shoes?

Rodriguez: In athletic shoes, Reebok's still #2. And it remains larger than Adidas by a factor of about two. But Nike is now nearly three times larger than Reebok. The 1997 share figures for athletic shoes were as follows: Nike had 37%, Reebok had 13% and Adidas had 6%.

So Reebok does seem to be losing contact with Nike — both in apparel and athletic shoes. It's already lost the #2 spot to Adidas in apparel. And it's no longer the shoe-in that it once was to remain #2 in athletic shoes.

OID: Which of those figures is more important to you — their share in apparel or athletic shoes — and why?

Rodriguez: I'm more concerned about market share in athletic shoes because it tends to have higher margins than apparel generally. So athletic shoe market share probably represents more *profitable* business.

OID: Presumably, your rankings are based on aggregate sales. However, I'm told that the figures are very different on a category-by-category basis.

Rodriguez: Oh, yeah. In 1997, Nike accounted for upward of *60%* of athletic shoe specialty retailers' sales — for companies like Finish Line, Foot Action, etc.

OID: Wow! But why is Nike's share so much higher in the specialty stores than it is overall?

Rodriguez: Because the specialty stores tend to focus more on the hot-selling items. For example, they tend to be more fashion-oriented than department stores. And specialty athletic retailers get a higher percentage of the newer models — in part because they commit to sell higher volumes and in part because that's where people go to buy leading edge athletic equipment generally.

So it's the specialty athletic shoe retailers who provide the shoe manufacturers with the biggest profits and highest margins. And it's those same specialty retailers who set the tone.

OID: That makes sense.

Rodriguez: And Reebok simply missed their markets. They abdicated the high end — the $100+ shoe offerings — to Nike. And one result was a huge drop in the perceived "sports authentic-ness", if you will, of Reebok in the mind of the consumer.

There again, I expected the competitive landscape to worsen. But I wish I'd known it was going to be *this* bad.

NIKE'S A FINE, WELL MANAGED COMPANY,
BUT REEBOK AIN'T CHOPPED LIVER.

Rodriguez: As you may recall, we sold Nike in 1996 — in April or May — most of it at $43 or $44 per share. And the reason why we sold it wasn't because Nike's not a fine company or very well managed — because, obviously, it's both. I just thought the stock price was discounting too many positives.

[Editor's note: Rodriguez first told *OID* subscribers about Nike in our March 6, 1989 issue with it trading at a split-adjusted price of about $4 per share. We understand, however, that he actually began purchasing it in 1984 at a split-adjusted cost of only about *$1* per share!]

Rodriguez: I just couldn't rationalize holding onto it at 25 times earnings by assuming that it should sell at 35 times earnings since it was on the way to being a great global company a la Gillette or something of that sort.

OID: GEICO's Lou Simpson seems to think otherwise given his purchases of Nike. And I hear he has a partner who knows a thing or two on that score...

Rodriguez: You'll get no argument from me there. However, I didn't think Nike's earning power could hold up. I just thought it was unsustainable — along with its margins and its market share. So the question I asked myself was where those things were likely to bottom out. And when I did, my conclusion was that Nike simply didn't offer a margin of safety.

But Nike reported earnings of $1.89 in fiscal 1996 (its fiscal year ends May 31st) and $2.68 in fiscal 1997. And its stock went up another 75% after I sold it. It peaked at around $76 ten months later. So I clearly sold too soon.

OID: My heart goes out to you. Those 40-50 baggers must be rough...

Rodriguez: But in fiscal 1998, its earnings collapsed to $1.38 — nearly 40% less than they were in fiscal 1997. However, up until a few weeks ago, Nike was still trading at the price where I sold it. And I'll tell you — it had me scratching my head and asking myself, "Am I missing something here?!" The trading price of the security and the fundamentals of the underlying company simply *diverged*. But finally, over two years later, Nike is trading below my selling price.

And it looks to me, frankly, like the main reason why Nike's even selling for as much as it is today is because of a "We love Nike" attitude on Wall Street.

OID: Although, of course, that attitude is not altogether without foundation.

Rodriguez: That's true — although a few years ago, there was a "We *hate* Nike" attitude on Wall Street and a "We love *Reebok*" attitude. But, as you know, I've always said Nike is far superior to anyone else in the industry.

OID: We can vouch for you there.

Rodriguez: My concerns were mostly valuation-based. Nike, for example, has about 288 million shares outstanding and very little debt. So with it's stock at $43 or $44, its enterprise value was up around $12 billion. Even today, its enterprise value is still around $10 billion.

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FIRST PACIFIC ADVISORS'
BOB RODRIGUEZ
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In contrast, Reebok has 57 million shares outstanding and about $450 million of net debt. So its enterprise value is well below $1-1/2 billion — or less than 1/9th as much.

And what do you get in each case? Well, you get revenues of $9-1/2 billion with Nike versus $3-1/2 billion with Reebok — or 2-1/2 to 3 times as much. So should Reebok sell at less than 1/9th the valuation of Nike?

OID: I guess that depends on what the future holds.

Rodriguez: Good answer. But it was hard for me to believe that Nike was worth $13 billion. And it's hard for me to believe that Reebok *isn't* worth quite a bit *more* than $1-1/2 billion. Thus, given the choice, I'll take Reebok. And, frankly, I still don't want to own Nike today.

But people who've owned Nike have done a lot better than I have owning Reebok for awhile now. So I suppose that they've been more right than I've been so far.

BLOODY THOUGH THEY MAY BE,
REEBOK'S BRANDS HAVE LEGS.

Rodriguez: However, I continue to believe that Reebok's difficulty is another case of "This too shall pass." After all, it wasn't long ago that Fila was the shoe-du-jour. It roared out of nowhere. Its stock went up like a rocket — from down around $10 in early 1994 to more than $100 in the middle of 1996. I believe its high was $106-7/8.

But Fila's fashion-oriented and not sports-authentic. So I thought, "This won't last." And it didn't. Today, it's back at $10. So it's fallen over 90% from its high. And nobody even *talks* about it anymore. Fila's share got as high as 5% at one point. But today it's below that and headed south. Fortunately for Reebok, it's stumbled and represents considerably less of a competitive threat today.

OID: So you don't worry about Fila or anyone else displacing Reebok from the #2 spot in athletic shoes.

Rodriguez: I don't.

OID: Even Adidas? Two shoe stores we visited told us that Adidas was a very strong player in running shoes — for men and women.

Rodriguez: Adidas has been successful in terms of pushing forward and taking share. And it has a very good reputation internationally — especially in Europe and, obviously, in soccer. Plus, it's far more sports-authentic in the consumer's mind than Fila.

And Adidas seems to be doing almost everything right. But it may have more fashion content than people think — because their three stripes are very trendy today.

OID: That's an interesting point.

Rodriguez: And what's trendy can change on you very quickly. Reebok has a far better business base — because it's far more diversified and, thus, much more stable. For example, they have a product area they call their "Classics." As the name implies, they don't have as much fashion content. So they have a longer product shelf life.

And over the last year and a half or so, Bob Prather of Bull Run Corporation has acquired about 20% of Rawlings.

OID: Are you trying to change the subject?

Rodriguez: That doesn't sound like such a bad idea. But I'm actually trying to make a point. Bob recently visited me. And he told me a story related to Rawlings that I think is also applicable to Reebok. He was visiting someone at a marketing consulting firm and asked them, "What would it take to develop the consumer recognition that Rawlings currently has?" The answer he got was, "Probably $400-500 million spent over a couple of years."

So Bob threw its annual report across the guy's desk and said, "Take a look at this annual report." Well, the consultant flipped through it and had one fond memory after another of using Rawlings' products as a youth — some of which he shared with Bob.

OID: Yeah. At Berkshire's latest annual meeting, Buffett said that he and Charlie are fond of companies "long on nostalgia." He said such companies have "character." I think of it as goodwill. But whatever you call it...

Rodriguez: Exactly. Anyway, when the consultant realized that its enterprise value was around $150 million, he was *shocked*. (And believe it or not, it's well below that today.) So he queried other members of his staff and got similar reactions — again, most of it along the lines of, "My God! You couldn't *begin* to develop a consumer name like Rawlings has for $150 million."

OID: If you don't want to talk about Reebok any more, just say so. I'd certainly understand why...

Rodriguez: One of the hardest things any company has to do to be successful is to achieve brand recognition. And Reebok's *done* that. It basically has *worldwide* brand recognition across several different product categories. You couldn't even begin to build its brand recognition for anything *near* $1-1/2 billion.

Therefore, to be able to buy a company with its worldwide brand recognition for well *below* $1-1/2 billion with well over $3 billion of sales!? Reebok's *very* cheap. There's no question about it.

And there's lots of value in Reebok's *other* brands — in Rockport, Ralph Lauren and Polo. For example, Rockport isn't exactly a second-rate brand either.

OID: I read somewhere that not only has Reebok's Rockport division been gaining market share, but that its manager was recently selected as Footwear News Retailer of the Year or something like that.

Rodriguez: Angel Martinez is *very* impressive. He's built the Rockport division to sales of $513 million in 1997 up from $447 million in 1996 and $368 million in 1995. So it's becoming a significant company.

OID: About $9 for each of Reebok's 57± million outstanding shares. And the growth doesn't sound like it's been too shabby...

Rodriguez: Not at all. So I find it very hard to imagine either of those brands disappearing within the next two or three years.

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OID: I won't ask you about four or five years...

Rodriguez: And there's been some talk about the possibility of Rockport being spun off. So there's more than one valuable franchise within this company.

And I guess that's a long way of saying I'm still hoping that Reebok's business can be resuscitated — and that it wouldn't surprise me if it could be resuscitated because of the serious franchise within its brands.

IN THE EVENT OF AN ATHLETIC SHOE PRICE WAR, IT'S UNLIKELY THAT REEBOK WOULD BE A CASUALTY.

OID: Although it looks like they've been doing much more deteriorating lately than resuscitating...

Rodriguez: I think that's true. But I think to myself, "Will I stop wearing these shoes?" And the answer is no — because they're too comfortable.

OID: That's what we used to think, too. But Nikes feel more comfortable to us today. Also, based on the limited samples of Nikes and Reeboks that we've seen, the Nikes appear to us to be noticeably better made.

Rodriguez: I'm not sure that I would agree with that. Reebok did experience a problem in terms of percentage of rejects a year or two ago. However, they've since improved considerably in that area. And Nike's experienced similar problems more recently — during the last quarter or two. But I think pretty much *every* company's had that problem at one time or another — almost without exception.

Quality-wise, I have a hard time differentiating between the various brands. Whether you're talking about Adidas, Reebok or Nike, their high-end shoes are very good. Granted, over the years, I've generally preferred Nikes. And I still own a set of Nike Cross Trainers that I use when I play basketball. However, I have *five* pairs of Reeboks with the new DMX technology.

OID: What's your impression of their latest offerings? And do you think Reebok's DMX and Ultralite products will have much impact on sales?

Rodriguez: That's what we're hoping for. Potentially, their impact could be very significant. They're important product lines. But I think it's too early to know how well they'll be received or what kind of impact they'll have.

It really gets down to how they feel on *your* foot. And for whatever it might be worth, to me their DMX shoes — and I'm wearing a pair as we speak — seem to be a step up qualitatively from the shoes that Reebok's been producing the last few years.

OID: What can you tell us about their Ultralites?

Rodriguez: I understand that Reebok has primarily used the Ultralite technology in its running shoes so far — and that those shoes have gotten rave reviews in the running magazines. So now the company is moving to incorporate the technology throughout its entire line.

I haven't so much as seen a pair of those just yet. But I'm definitely looking forward to trying 'em out myself. And I'd be happy to let you know what I think once I do.

OID: Maybe we'll do a special 64-page follow-up...

Rodriguez: On the other hand, I may be too busy. However, as I mentioned earlier, industry observers fear that Venator's recent decision to discount Nikes could lead to more widespread discounting. And, if so — should the discounting become widespread — then the margins of shoe manufacturers would probably decline.

But Reebok's newest technologies (i.e., its DMX and 3D Ultralites) seem to me to be ahead of the competition. So I'm hoping the consumer agrees. If so, Reebok may be able to hold its margins better than its competitors. And, in any case, it's clear to me that Nike and Adidas have more to lose. Retailers can take more from them price-wise than they can from Reebok.

OID: Because Reebok hasn't been getting the pricing that Nike and Adidas have lately anyway.

Rodriguez: Exactly. They haven't been successful at the high end. But if Reebok's newer products catch the consumers' fancy and they do appreciate the difference, then it might experience less price erosion.

[Editor's note: Perhaps heartening in that regard, in a recent article, an industry observer noted that Reebok's DMX models were one of the few shoes not being discounted. And, as we recall, it was the only model not being discounted mentioned by name.

On the other hand, if they weren't being discounted, it could be because they were just arriving in stores and weren't yet available in quantity.]

Rodriguez: I'm not saying that they'll be successful in getting high-end premium pricing again any time soon. However, the discounts that they have to face may be considerably less than those their competitors have to face — and, once the industry recovers, less than they've faced recently. But, again, whether or not their new offerings catch the fancy of consumers is still in doubt.

OID: However, hypothetically speaking, if you were cornered by a newsletter editor and forced to guess...

Rodriguez: Your guess would be as good as mine. But given today's stock price, if it happens, it's a freebie. You're definitely not *paying* for it.

On the other hand, I think Reebok does face a real marketing challenge getting people to *try* its new shoes — because once they get a preconceived notion in mind, it's *very* hard to change.

OID: The preconceived notion being that Reebok doesn't make high-end performance shoes?

Rodriguez: Exactly. It's not impossible. For example, you can do it by spending a ton of money on marketing. But it's very tough.

WE'RE NOT COUNTING ON A MANAGEMENT UPGRADE, BUT THAT NEGATIVE'S ALREADY IN THE STOCK PRICE.

OID: I understand that there are serious concerns about Reebok's management.

Rodriguez: Very much so. As I mentioned earlier,

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one of the hard things companies have to do in order to be successful is to achieve brand recognition. And Reebok's very clearly managed to do that.

Unfortunately, the other hard part is *executing*. And management *hasn't* done a good job in that area lately. Reebok's execution, in fact, has been quite *sub*-standard — even with the introduction of their newer products.

OID: You mentioned earlier that their abdication of the high end was one of their biggest mistakes.

Rodriguez: That's right. I think it was.

OID: Is it possible that their abdication was at least in part a result of their not feeling like they had the technology to support effective high-end offerings?

Rodriguez: That could well have been their thoughts. But they've also been off the mark generally — in terms of product offerings and brand message. One of their brilliant messages, for example, was "Let you be you." What's that supposed to be about?

OID: Good question.

Rodriguez: Their marketing and merchandising and execution in general the last few years has been *terrible*.

OID: Sad, but true. A couple of 'em were so bad that they were funny.

Rodriguez: They really were.

OID: What do you think about the new guy who just joined the company as CEO of the Reebok brand?

Rodriguez: Carl Yankowski has a good resume and all. But some people may be a little bit negative — because it is going to take him time to find the bathroom.

OID: Is that because he's a slow learner or because it's well camouflaged?

Rodriguez: For the three years prior to Yankowski taking over the position, the CEO of the Reebok brand was a gentleman named Bob Meers. And he did a credible job. But he was more production-oriented. Yankowski's much more marketing-oriented. And I think Reebok needed that.

But, meanwhile, its sub-standard execution has served to raise questions about its chairman Paul Fireman. As you may recall, about three years ago, he said that if he didn't turn Reebok around within two years he'd step down.

OID: What's he saying now?

Rodriguez: He's mum on the subject. So his credibility is about shot. But it's hard for me to imagine him honoring his promise and stepping down anytime soon — although there have been rumors about Fireman possibly putting the company up for sale.

OID: I've read a snippet here and there on that score. But how serious do you think that talk is?

Rodriguez: I wouldn't be surprised if he *were* to sell. But I suspect he might not be able to get a buyer at a price at which he'd be willing to sell — given the current state of the company and the industry. For example, it's hard for me to imagine him being willing to sell at $35 a share.

OID: Where do you think he would be willing to sell?

Rodriguez: I'd guess that he'd be willing to sell the company somewhere between $45 and $50 per share — because at that price, he might feel like he was going out a winner. But I doubt that he could get that today.

OID: Who'd be a logical buyer?

Rodriguez: I don't see one, although I haven't given that issue much thought. When I look out five years, I'm not even sure that Reebok will be a public company. Whether that means they'll choose to join forces with another company or whether they'll choose to go private or whether they'll be taken over, I don't know.

But they have generated lots of cash historically. And I was hoping they'd be able to pay down most of their debt over four or five years and buy back lots of shares — in effect, perform a creeping LBO. If they could get their debt down far enough, I was even hoping they might go for the whole enchilada and take the company private.

Unfortunately, they haven't made as much progress there as I would have liked — either in terms of paying down debt or repurchasing shares — although they have been paying down their debt some.

OID: As you've described, the athletic shoe industry today is on its back. What do you think the company might fetch in a more normal environment?

Rodriguez: That's very hard to say — not only because industry conditions have been so bad, but also because Reebok's position within the industry has been deteriorating. But if Reebok were able to pay down its debt and resuscitate the company, I suspect that they might be able to demonstrate earning power of between $3.00 and $3.50 on their current base of business.

In fact, in 1996, we tried to estimate what Reebok might earn seven years down the road using a variety of different scenarios. And I think our assumptions were fairly reasonable: For example, we assumed Reebok would be able to get its operating margins back up to 10%. And that doesn't seem very aggressive given that they were up around 14-15% for most of this decade...

OID: And running 16% to 17% in 1989 and 1991. So 10% sounds reasonable.

Rodriguez: I think it is. So using those assumptions, assuming growth of 5-10% per year in sales per share and looking seven years out, we estimated that Reebok would be earning $5-7 per share.

And, obviously, were that scenario to unfold, Reebok could probably fetch a serious price.

OID: A serious price being about 1 times revenue?

Rodriguez: Probably even *more*. Meanwhile, there's no question that a significant management penalty is being incorporated into Reebok's valuation.

[Editor's note: Reebok's sales this year are expected to be in the neighborhood of $60 per share.]

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REEBOK'S NOW A GUT-CHECK TYPE INVESTMENT — ALMOST EVERYTHING THAT *COULD* GO WRONG *HAS*.

OID: Still, your valuation assumes Reebok manages a successful turnaround and heals its balance sheet by paying off its debt. What happens if they continue to slip and slide downhill?

Rodriguez: As what we *hope* is a worst case scenario, we assumed operating margins of 6% and sales growth of 5% per year. And given those assumptions, we estimated that Reebok would *still* earn approximately $3 per share — which would still be sufficient to support the current price.

So we figure our downside is probably quite limited. And we get what amounts to a free call option on the possibility that they manage to get their act together.

OID: Certainly, zero sounds pretty much like the value most investors would assign that option today...

Rodriguez: That's true. But with the stock price down at this level, I have to make a judgement about whether I think things are likely to continue going as badly as they have. And I don't think that's likely. Also, they still have a degree of control over their destiny by virtue of being able to control expenditures — even running their business at its present level.

Paying off their debt may take longer than I'd hoped But that's why I used a five to seven year time frame: I didn't know what vagaries could come into the marketplace.

OID: And now you have a pretty comprehensive list...

Rodriguez: That's about right. I feel like I have a better idea of what their trough earning power might be. Reebok's become a real gut-check type of investment. Over the last 18 months, everything that *could* go wrong *did*.

OID: Talk about famous last words...

Rodriguez: Somehow I find it very hard to imagine that so many things could ever go wrong for 'em again.

OID: Even if I were to tell you that yours truly had established a toehold position in Reebok, too?

Rodriguez: On the other hand, I could be wrong...

OID: I believe that Tony Russ of Laidlaw Capital and one of his former associates, Bob Coleman of Davis Selected Advisers, were the first to point out to us the high returns Nike and Reebok had earned historically.

Rodriguez: They have earned high returns over time.

OID: And they attributed those returns in part to those companies contracting out virtually all of their production — and thus not needing much capital.

Rodriguez: I think that's right.

OID: Do you therefore worry about ruinous competition driving margins down more or less permanently?

Rodriguez: I don't — because when I ask myself "Who's going to do it?", I figure that Adidas is out there, that Fila came and went, but that the one who's really led the pricing erosion the last six months has been Nike. And I believe they're currently testing what will prove to be the low end of profitability — which is operating margins in the 6% area. Even on a longer term basis, I suspect that those 6% operating margins will prove to be very near their lows.

And I may not know if I'm right with much confidence for a few years. But when Asia finally recovers, the U.S. economy starts to grow again and Reebok grows its sales at some hellaciously fast rate — like, say, 10% per year — even if I assume operating margins of only 6% (which is less than half of what they've been), I figure Reebok will be earning more than $4 a share within five years.

Therefore, with the stock at $16-17 per share...

OID: Below $15, actually, but who's counting...

Rodriguez: Or $14-15 — or $12...

OID: Looking ahead a few weeks...

Rodriguez: Exactly. That's how it feels. But we're not talking about a high P/E. And I would argue that the downside risk in Reebok today is a lot less...

OID: Not much more than $14-15, certainly...

Rodriguez: I suspect that it's a lot less than that. And if there *is* a lot of risk in Reebok's stock today, then there's probably a lot more risk *elsewhere*. If Reebok's isn't worth its market cap today, maybe it just dropped *ahead* of the S&P. Maybe the S&P's about to suffer the same fate — because the valuation differential is pretty dramatic.

OID: In other words, either Reebok is undervalued, the S&P is overvalued or both.

Rodriguez: Exactly. And at some price, it gets *silly*. For example, with Reebok's enterprise value well below $1.5 billion and Rockport alone worth at least $500 million — and probably much more — at Reebok's current price, we're probably paying no more than $800 million for the Reebok brand. And frankly, I find a price of $800 million for the #2 athletic shoe company in the world irresistible. So not only haven't we sold a single share, but, recently, we've even begun to buy *more*.

OID: Please accept our sympathies in advance. I look forward to following up with you about Reebok again in two or three years once it's gotten down around $6.

Rodriguez: I'll put it on my calendar.

I'M NOT AWARE OF A CHEAPER OPPORTUNITY.... AND SOMEONE'S FINALLY STIRRING RAWLINGS' POT.

OID: You also mentioned Rawlings last time. And its revenues and earnings finally seem to be perking up. Plus, there's apparently been a lot of insider buying at much higher prices. What's going on there?

Rodriguez: Its board finally got rid of the old CEO. And now it needs to improve itself further by bringing in some new blood on the board.

But I'm not aware of an opportunity today *anywhere* where you can buy a consumer brand cheaper.

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OID: You forgot to say "please", but those sound like mighty strong words.

Rodriguez: But they're true. Rawlings [RAWL/NYSE] only has about 7.7 million shares outstanding. So you're talking about a market cap of only about $80 million. And when you add its debt of about $60 million, you're talking about an enterprise value of about $140 million.

You couldn't even *begin* to develop that kind of consumer recognition and goodwill for anything near that. It would cost *way* more — again, $400-500 million according to one marketing consultant.

OID: Last time, you told us that Rawlings was one of the top ten names in the athletic products area.

Rodriguez: Exactly. And I can think of *so* many *other* products that could be marketed with the Rawlings name. So much could be done with this company.

OID: But some say, "What NIKE wants, NIKE gets." You don't think NIKE will want Rawlings' hide?

Rodriguez: I don't think that risk is that significant. In the categories Rawlings is in, they're working together. For example, NIKE produces the Rawlings Sporting shoe. They licensed it out several years ago.

OID: Very interesting. But what makes you think it's so unlikely that NIKE would ever want the whole ball of wax and decide to play hardball to get it?

Rodriguez: I think the odds of that are low. If it were going to happen, it would probably have happened *already*.

OID: And based on your comments, it sounds like it would be much cheaper for NIKE to just buy it.

Rodriguez: Exactly.

OID: As I recall, you've paid today's price and more.

Rodriguez: Yes — in one of my less lucid moments. My average cost is probably down around $9.00. However, I've paid as little as $7 and as much as $13. And today it's trading around $10-1/2.

OID: Your earlier comment about not being aware of a cheaper consumer brand opportunity today anywhere, plus the fact that you've paid over the current price leads me to suspect you think Rawlings may still be a bargain — especially with Prather stirring the pot and recently joining Rawlings' board.

Rodriguez: I can't sneak a subtle nuance by you. Certainly, I think he's a plus. And the company is getting very close to naming a new CEO.

Because my assets under management have grown so much since I bought Rawlings, it's never going to make me a lot of money. But I just can't bring myself to *sell* it — because I think it's just too cheap. So I expect Rawlings to be more of a moral victory than anything else.

OID: In other words, Rawlings may do obscenely well, but it's too small for you to take a serious position.

Rodriguez: Exactly. It's going to be interesting to see what happens the next couple of years.

THANKS TO A BREATH OF FRESH AIR, ANGELICA MAY BE TURNING THE CORNER.

OID: I gather you've also been adding to your position in Angelica. Could you give us an update there?

Rodriguez: In our last conversation, I told you that I had some reservations about the CEO at Angelica [AGL/NYSE]. Well, since we spoke, he stepped down. And he's now managing the division within Angelica that he originally headed before becoming CEO.

OID: That sounds smart. People very rarely recognize it when they're in way over their heads, much less do anything about it. Believe me, I know....

Rodriguez: I think it was a *very* smart move. Also, Angelica brought in a new CEO, Don Hubble, in December. Before joining Angelica, incidentally, he managed various manufacturing operations for National Service Industries.

I got to speak with him shortly after he took the CEO spot. And I was very pleased to learn that he's very much of a return on capital type of individual — because I think that's exactly what Angelica needs.

As I told you, I didn't think they had a good sense of where the operating profits within their health care area were coming from — in terms of the specific laundry units.

OID: Sounds familiar.

Rodriguez: But I could never confirm whether I was right or not. I just figured that with the stock trading where it was, it already discounted that uncertainty.

Well, I talked with their new CEO about that. And he said, "You're absolutely right. They *didn't* have profitability broken down by operating unit or by customer."

So there was a measurement problem. And Don came in and said, "If you can't *measure* it, we don't *do* it."

So I had a very pleasant, rewarding meeting with him. And I said I'd give him about nine months to get the lay of the land before I called him again. But that nine months is almost up. So I'll be calling him again soon.

OID: I hope he's savored each and every day...

Rodriguez: Meanwhile, Angelica's begun to take some positive actions during the last quarter or two. They've closed down some of their operations that they should have closed down earlier. By contrast, the former CEO was very reticent about closing anything.

As I told you last time, I don't consider Angelica to be one of my *best* ideas, but that I thought it was one of the lowest *risk* ways to participate in the health care area.

OID: We edited out the first part of that last time. Hopefully, it won't slip through this time either.

Rodriguez: And it only reinforced my feelings when I went to a health care symposium last year. I spoke with several congressmen, senators and the heads of various health care panels. And after a day and a half, I felt like I knew even less than I did when I arrived. I don't know how people can evaluate that industry. And, therefore, I'm

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FIRST PACIFIC ADVISORS'
BOB RODRIGUEZ
(cont'd from preceding page)

generally sitting on the sidelines in that area.

However, I do know that people aren't getting any younger and that as we age, we need more health care.

OID: Sounds like a safe bet.

Rodriguez: And the more people need those services, the more dirty laundry there'll be that needs to get washed.

OID: It's hard to argue with you on that point either. But why must you dwell on people's dirty laundry? And what makes you think Angelica will clean up?

Rodriguez: Well, during the last six months, for the first time in three years, price increases are going through. I told Don, "It makes no sense for the company to have capital deployed earning 3-4% on equity. We'd even be better off in a money market fund in that case. If we can't get a decent return on capital, why don't we just liquidate this company and do something else with the capital — whether we reinvest it or send it back to the shareholders."

And he said, "I couldn't agree with you more."

OID: That sounds like a very good sign.

Rodriguez: Yeah. It doesn't sound like he's married to the status quo. Mind you, I'd spoken with the company for the prior year-and-a-half saying the same thing — in effect, that something was fundamentally wrong — and it seemed like I was getting nowhere. So the new CEO is truly a breath of fresh air.

OID: How do you know it's not the fabric softener...

Rodriguez: Incidentally, during the last 2-1/2 years, we were approached twice and asked whether we were interested in selling our position to an acquiring entity. With Angelica at $17, I was led to believe that they'd be willing to pay up to $25. However, I told 'em that I didn't have any interest in selling.

OID: You wouldn't accept a 50% premium — even with no end to the status quo in sight?

Rodriguez: I thought we could salvage something considerably better than $25 per share over the long term.

OID: And yet thar she sits at $17 — new management and all.

TODAY, DRS' STOCK MAY BE IN THE CRAPPER, BUT THE COMPANY'S PROGRESSING JUST FINE.

OID: You told us about DRS Technologies [formerly Diagnostic Retrieval] last time, too. Could you give us a quick update there?

Rodriguez: Sure. DRS Technologies [DRS/AMEX] is a global leader in several defense technology niches already and actively acquiring others. For example, they're a leader in advanced display workstations. They have a product in that area they've had under development for several years that they call the ANUIQ-70.

OID: Catchy name...

Rodriguez: And, then, another of their global niches is high speed, digital mission recorders that go on both fixed-wing and helicopter aircraft. Plus, a recent acquisition makes them the leader in flight recorders.

OID: It's hard to imagine defense spending declining very much from today's levels, spending on high-tech weaponry not rising long-term or electronics not being incorporated in more weaponry.

But why isn't DRS likely to get swamped by much larger competitors with far bigger R&D budgets?

Rodriguez: Their strategy has been to acquire smaller companies or smaller divisions of larger companies that have been rationalizing.

OID: How does that keep them from being outspent by larger competitors?

Rodriguez: There's a whole group of small defense companies that don't have access to the capital market. So Mark Newman [DRS Chairman and CEO] takes advantage of that market inefficiency plus the resulting synergies to undertake add-on acquisitions in the defense area and other add-on acquisitions involving related technology on the commercial side.

OID: Acquisitions that would generally be too small for the major players...

Rodriguez: That's right. And I can't tell you how that protects them from their much larger competitors. Perhaps those competitors will even ultimately prevail. However, whatever he's doing seems to be working so far.

OID: I see that. DRS's sales and earnings have been growing like crazy. But its stock's in the crapper. Why the disconnect?

Rodriguez: That's a very good question — because Mark is doing a helluva job. And DRS is doing very well. So why did the stock crater? The only reason that I can come up with is that they came in a tiny bit light on their earnings last quarter. I kid you not.

But, meanwhile, Mark is working his tail off in order to make DRS a real company. Like I told you last time, thanks to Mark, the company is in the midst of an absolutely tremendous turnaround. And he just keeps making things better and better.

For example, he's been paying down debt. And that's not obvious because the company's also taken on debt to pay for acquisitions. However, absent those acquisitions, DRS' debt would be down substantially.

OID: What can you tell us about those acquisitions?

Rodriguez: They've been very interesting strategically *and* very positive financially. For example, Mark recently bought a tape head refurbishing operation in Bulgaria — in which his total investment was only about $400,000. However, for that, he got a company with 600 employees. And they earn almost nothing.

OID: If it was overhead and underpaid employees that he was after, he should have given us a call.

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Rodriguez: And included with the deal was some unbelievable amount of manufacturing space — something like 300,000 or 500,000 square feet.

OID: So he bought real estate at a discount and got a business thrown in for free. But what makes you think he's not di-worse-ifying.

Rodriguez: In part because he didn't buy the company for its real estate. In fact, besides building the tape head refurbishing business, he believes they'll be able to push a lot more product through that factory. In fact, he's looking through his existing operations to see what they can move to that area given the very low labor costs.

And he's writing it off over some very short period — something like one year.

OID: So you think the accounting may be conservative.

Rodriguez: You tell me. One year from now, that acquisition will be on their books for literally nothing.

I'm also comforted by the fact that the company recently won a contract for about $280 million of future business. And on a sales base of $150-180 million, that's a *huge* number. Plus, I believe that figure is conservatively stated.

So DRS now has a meaningful core base of business for the next seven years — around $100 million a year. And for God's sakes, the company's *market cap* is considerably less than that.

OID: So you think it may be a bargain?

Rodriguez: You might say that. Last time, I told you that we'd bought some of the company's convertible bonds. Well, we paid as little as 56% of par and kept buying them until we became the dominant owner of the company's debt — with significant stakes in both their convertible and straight issues.

Well, DRS is paying both of those off in whole or part. And the company's convertible debt can be converted into common shares at $8-3/4 per share. Therefore, we'll probably elect to convert those bonds into common shares — at least we will where account restrictions don't prohibit us from doing so.

OID: And yet, despite all those apparent positives, there doesn't seem to have been much insider buying at this company for a long time.

Rodriguez: As I told you last time, Mark's father founded the company and Mark mounted a palace coup. So his dad owned a fair amount of the stock. However, Mark owned very little. Today, he owns some shares, too — something like 270,000 shares in all — about 50,000 outright and the balance via options.

But I should probably confess that Mark and I are very close friends. So my evaluation of the company may very well be colored by that friendship. For example, I'm considering putting a bigger chunk of my own money into the company's stock, too, just so I can give Mark more grief if he doesn't do well when we're out on the race track.

OID: He races cars, too?

Rodriguez: He's a race car nut, too. We went through racing school together. He's a real Ferrari fanatic. And he doesn't own one right now. And the company doesn't pay him a whole lot in salary. So doing well enough with the company to afford a Ferrari is part of his motivation. And, of course, I regularly point out the connection.

OID: No doubt.

Rodriguez: And when he became CEO, I told him, "Don't screw it up. This will probably be the only time you'll be CEO of anything in your life — not that I want to put any pressure on you, of course."

OID: Of course not.

Rodriguez: But there is a disconnect between what DRS has been doing and the company's stock price. So if Mark keeps doing what he's been doing and its stock keeps languishing anywhere near the current price, then all I can say is that I wouldn't expect DRS to stay public for long.

CONSECO + GREEN TREE = A CAPITAL IDEA, A MACRO HEDGE AND A MATCH MADE IN HEAVEN.

OID: You mentioned earlier that you felt like investors overreacted to negative news about Green Tree.

Rodriguez: Very much so. As I'm sure you know, lower interest rates prompted a higher than anticipated number of borrowers to refinance and prepay loans within Green Tree's servicing portfolio. As a result, the portfolio value declined. And during the fourth quarter of last year, the company had to take special charges on its portfolio to reflect those higher prepayments.

OID: Although, apparently, lots of observers felt like the charges should have been higher.

Rodriguez: That's right. However, I suspect that much of the discomfort resulted from the general lack of confidence that many investors seemed to have with their accounting itself — the so-called "gain-on-sale" methodology — despite the fact that they have no choice. It's mandated under GAAP [Generally Accepted Accounting Principles].

But that didn't stop investors from driving the price of Green Tree's stock from up around $50 to less than $20. And therefore, after a lengthy reexamination of Green Tree, as you said, we concluded that investors were overreacting. So we took advantage of the decline to increase the size of our position by 65% at an average cost of less than $25.

OID: Thank you, Mr. Market.

Rodriguez: Exactly. And Conseco [CNC/NYSE] apparently agreed. They took advantage of the opportunity, as well, in order to acquire Green Tree in its entirety in a friendly transaction for .9165 shares of its own stock for each outstanding share of Green Tree.

Given that Conseco's stock was trading around $57 when the deal was announced, .9165 shares of Conseco were equivalent to roughly $52. But Conseco's stock has declined very dramatically since — to around $33.

OID: What the market giveth...

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Rodriguez: But listen to these figures: Prior to announcing the deal, Conseco had 189 million shares outstanding. So its market cap was around $10.8 billion.

Today, subsequent to the acquisition of Green Tree, Conseco has 308 million shares outstanding. Therefore, with Conseco's stock down around $33-1/2 per share, its market cap is now about *$10.3* billion.

Therefore, in effect, today you can buy the company for less than before and get Green Tree for *free*.

OID: And based on past conversations, I've gotten the distinct impression that you think Green Tree may be worth more than nothing.

Rodriguez: A *lot* more than nothing.

OID: The view of most investors about the deal seems clear. But might we get your thoughts about it and the investment merits of Conseco today?

Rodriguez: Sure. But let me tell you a funny story first. As you know, I have a long and very profitable history with Green Tree and its chairman, Larry Coss...

OID: As do some of our subscribers — thanks to you...

[Editor's note: Rodriguez first told *OID* subscribers about Green Tree in our March 6, 1989 edition with it trading at $1.33 or $1.34 (adjusted for three 2-for-1 splits). Thus, with .9165 shares of Conseco today worth $30.70, it's up about 23 times since (and it was up nearly *40* times when the deal was first announced).]

Rodriguez: Larry asked me what kind of a company I thought would make the best merger partner/acquirer for Green Tree — whether I thought it would be a bank, broker or something else. And I didn't have a good answer right away. It just wasn't obvious to me.

However, for whatever reason, at dinner one night, it dawned on me that enormous advantages would result were Green Tree to merge with a life insurer.

OID: If only you were an investment banker...

Rodriguez: So I called Larry and told him what I'd come up with and the reasons why. I said, "Don't ask me *which* life insurer because I haven't thought about that yet. However, I suspect that very few life insurers have corporate cultures compatible with yours given that most are brain dead and moribund. So that probably narrows your universe down quite a bit. And maybe you can begin to explore that option over the next year or so."

Well, that was on a Wednesday. On the following Monday morning, the announcement came out of Conseco that they were acquiring Green Tree.

OID: Wow! That Coss moves fast...

Rodriguez: So I called Larry the next day. And the first thing I said wasn't "Hello" or "Congratulations" or anything of that sort. I just said, "Larry, you SOB."

OID: Sounds like a guy thing.

Rodriguez: And he started laughing and said, "You were pretty close. You were going down the right *road*. You just hadn't gotten to the right *address*."

So, obviously, it was already in the works. And as you may gather, I think the combination is one made in heaven.

OID: In part, I imagine, because they're likely to enjoy access to capital on attractive terms most of the time.

Rodriguez: Exactly. Each enjoys excellent access to capital individually — Conseco via its insurance business and Green Tree via the credit markets that it utilizes to securitize its loans. Therefore, the combined entity should enjoy very good access to capital, lower financing costs, etc.

Also, the combination creates what I think of as a macro hedge: In an environment of rising interest rates, the fixed income portfolio Conseco maintains as part of its insurance business would take a *hit*. But higher rates should *benefit* Green Tree — because they would lead to lower prepayments within its servicing portfolio and, therefore, boost its value.

OID: In effect, one should logically buffer the other.

Rodriguez: Exactly. And were interest rates to *fall*, Green Tree's servicing portfolio would probably take a hit — because it would suffer more rapid prepayments (although its underwriting volume would probably rise, too.) But lower interest rates would very likely *increase* the value of Conseco's large fixed-income portfolio. So I think it's *quite* a neat combination.

OID: Assuming no lapse in execution.

Rodriguez: Exactly. And somewhat encouraging on that score is the fact that the cultures of Conseco and Green Tree are both very entrepreneurial and aggressive. They could scarcely *be* more similar.

Also, as you know, both CEOs have what can only be called incredibly beneficent compensation packages.

OID: So both are overpaid?

Rodriguez: I don't *care* what they make — as long as shareholders make out, too. And shareholders seem to have been doing fine. Before its most recent decline, Conseco's stock had been the sixth or seventh best performing stock on the New York Stock Exchange for the prior 12 years.

And who *cares* what Eisner makes at Disney...

OID: Or what Roberto Goizueta made at Coca-Cola. Like Buffett says, you don't mind managers getting great pay if they're providing great performance.

Rodriguez: Exactly. The idea is to be fair.

THE EVIDENCE SAYS THEY'RE IMPRESSIVE & SMART, BUT THERE'S MORE DIGGING & DUE DILIGENCE TO DO.

OID: Might you give us your thoughts on Conseco today — with the acquisition of Green Tree complete?

Rodriguez: I'm still in the process of evaluating it and deciding whether I want to hold onto my shares or not. All of the evidence to date — anecdotal and otherwise — suggests that they're very impressive operators and very smart managers. And that's very encouraging.

But I'm still doing my due diligence. And needless to say, Conseco is an extremely complicated company.

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OID: Not to mention controversial.

Rodriguez: That's true — although they are much *less* controversial than they *used* to be. One of the reasons why they're controversial is that they tweaked the noses of a lot of players in the insurance industry. But, frankly, those players *needed* to have their nose tweaked. After all, what industry was as brain dead as life insurance? And Conseco's been one of the primary players to shake it up.

On the other hand, they've made so *many* acquisitions that you can't know exactly where they stand. For example, they don't give you enough information to tell how well *reserved* they are.

OID: Yeah. I couldn't even find an insurance triangle.

Rodriguez: Neither could I. It's been a long time since I've looked at a lot of insurance companies. However, one thing that I virtually always found to be the case at financial service companies is that you would only find out how well reserved they really were *after* the fact.

OID: Like Buffett says, "You only find out who's wearing a bathing suit when the tide goes out."

Rodriguez: Exactly. How many banks were adequately reserved for Russia? The answer is none. But if you'd asked them whether they were adequately reserved a month ago, every single bank would have said they were. That's just the way it works.

OID: How did Green Tree's disclosure compare to that of Conseco?

Rodriguez: Green Tree's disclosure was better. Conseco doesn't reveal its purchase policy or deferred policy acquisition costs. And those two items together represent about $6 billion worth of assets on their balance sheet.

OID: That sounds pretty material, all right. How can they not provide that information?

Rodriguez: It's material. But it's not unusual for insurance companies not to disclose those items. You'll usually see a line in their deferred policy acquisition costs or something like that where they'll give you some kind of gobbledy gook about what they do. But you don't *know* exactly. They say they use present value assumptions, but they don't tell you what those assumptions are.

Still, over the last seven years, Conseco has never had to take a *write-off* on its deferred policy acquisition costs. So that sounds pretty good. However, I just can't know for sure without digging deeper into the numbers.

A SHREWD, CREATIVE & AGGRESSIVE MANAGEMENT — WITH MANY MILLIONS OF REASONS TO SUCCEED.

Rodriguez: Don't get me wrong. I think these guys are *very* smart. For example, they have about $30 billion of assets on the fixed income side. And three different Wall Street firms have said they don't like dealing with Conseco. Why not? "Because they know the markets too well."

Well, I think that's *good.*

OID: Of course, you're not a broker...

Rodriguez: They've been very creative on that side. Certainly, there's no question that their CFO, Rollie Dick, is a very creative, smart and ethical fellow. And he's not alone. Conseco's gathered some very talented people. And they really think entrepreneurially — which I think is good.

OID: Their annual report makes it sound like they dramatically improve the top line and bottom line of everything they buy, although an insurance triangle might offer some insight into how they've done it.

Rodriguez: I think they *have* done a brilliant job. For example, before becoming part of Conseco, Green Tree would securitize its asset-backed securities throughout each quarter. But they would always have one that would close around the end of the quarter — in the last two days. And there would always be a number of other players coming to market around that same time. So guess what? If you have a large supply coming into the marketplace, that probably does something to the pricing.

OID: Interesting.

Rodriguez: So the latest quarter was a little light. Why? The guys at Conseco decided that they weren't going to do the securitization that Green Tree usually does at the end of the quarter. And they said, "The reason why is that we've ascertained that there's too much competition in the marketplace at that time. And we have the capital and the wherewithal to warehouse it."

"So we'll hold onto those receivables and securitize 'em in the first month of the next quarter. And we estimate that we'll get an execution that's five basis points better."

So these guys are fighting for five basis points. And that's a pretty obvious and easy thing to do. But it's a shrewd move, too.

OID: It sounds like it.

Rodriguez: Something else I like is the fact that Conseco's management owns a lot of stock personally — and not with options.

OID: Although the company does finance a lot of those stock purchases.

Rodriguez: That's OK. As long as the company isn't going to *cancel* that debt, it's still real consideration.

OID: With the potential for pain and gain — very similar to that of other shareholders.

Rodriguez: Exactly. And that's the case at Conseco. They guarantee the loan that provides eligible individuals with the funds to purchase shares on the open market. But I'm told that participants are responsible for the loan unless they die or are permanently impaired. And if they leave or retire, they're responsible for paying it back — even if the stock they bought with the loan is underwater.

OID: So it's like real money. There's real downside.

Rodriguez: They're tied in on the downside. And these guys are buying stock. They've bought something like eight million shares under these programs.

OID: But didn't this management say they weren't

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finding much to their liking on the acquisition front...

Rodriguez: Before the recent market decline. Correct.

OID: Except their own — via share repurchases.

Rodriguez: That's right. But I *like* that. I'd argue that buying the devil you know is *better* than buying the devil you don't know.

OID: And it sounds like it could be a smart thing to do — if they're doing as good a job as you suspect.

Rodriguez: Plus, they know better than anyone else what's on their books. I don't know if the recent market decline brought any companies into their buy range or not. But I do know that when Conseco acquired Green Tree, they did so in the context of a very negative environment — although they may have been able to buy it cheaper still had they waited a few months. Of course, Larry Coss may not have been a willing *seller* in that case.

OID: How much of the collapse in Conseco's stock price was a reflection of disapproval of their acquisition of Green Tree — and how much was something else?

Rodriguez: Part of it, of course, was a function of the drop in financial services and insurance stocks generally. However, the stocks of lenders to less than pristine credits — so-called sub-prime lenders — have been *particularly* hard hit. Over the last few weeks, the high-yield bond market virtually shut down. Spreads really widened out. And because of their acquisition of Green Tree, Conseco got tarred with that brush, too — rightly or wrongly.

OID: I'll bite. Was it rightly or wrongly?

Rodriguez: I think *wrongly*. This isn't my estimate. But analysts expect Conseco to earn between $4.00 and $4.50 per share next year.

OID: And I understand that Conseco's management says they're comfortable with that estimate, too.

Rodriguez: That's right. So at today's price, Conseco is selling at only 7 times its estimated 1999 earnings. Furthermore, those earnings are pretty much *programmed* for the next year to 18 months. So Conseco may very well have already *had* its bear market.

OID: And aren't those earnings net of substantial goodwill amortization?

(continued in next column)

Rodriguez: Of course. I don't recall how much. However, who *cares*? The P/E is plenty low *already* — even *before* adding back goodwill amortization.

[Editor's note: Take care if you calculate this figure for yourself not to overestimate it — because Conseco has lots of amortization *other* than goodwill amortization.]

OID: You say Conseco's earnings are programmed. But couldn't they be interrupted by writedowns — particularly in their fixed-income portfolio?

Rodriguez: Not as much as you might think. Following their acquisition of Green Tree, Conseco took a massive charge and wrote its servicing book way down. Thus, if interest rates stay low or decline further and borrowers refinance and prepay their loans, Green Tree's cash flow would decline.

OID: Which was the controversy with Green Tree — that it hadn't adequately reflected loan prepayments into the valuation of its servicing receivables.

Rodriguez: Exactly. But now Conseco's written down Green Tree's servicing book so far already that they wouldn't suffer large writedowns. They almost *can't*.

In contrast, if as I suspect, interest rates *rise* and there's a *slowdown* in prepayments, its receivables will continue to generate cash. But they have almost no book value. So almost everything those things generate will flow directly into Conseco's income. In effect, those writedowns give them *tremendous* flexibility.

OID: And, theoretically, at least somewhat reduce the odds of future controversy and/or disappointment.

Rodriguez: Exactly. And their extreme conservatism in writing down that servicing portfolio makes me suspect that their balance sheet may be *generally* conservative.

Still, that's just the *flavor* I've gotten so far. I still have a lot of work to do before I'll feel comfortable saying that with any conviction. But that shouldn't take too long. For Green Tree, it only took me about three years.

OID: Our kind of timetable...

Rodriguez: Also, I believe that Conseco is generating tax losses as it integrates its acquisitions — tax losses that they can use to shelter Green Tree's income going forward. So those should be a positive going forward, too.

OID: Also, if Conseco's accounting is kosher, it seems that they dramatically improve operations they buy — both by marketing their offerings more aggressively and stripping out expenses.

Rodriguez: I don't know Conseco well enough yet to be sure if that's true or not. But I think of the combination as being not so much about expense reduction as it is about revenue growth. But obviously, there's still plenty of skepticism about the Green Tree acquisition — as reflected in Conseco's stock price.

However, again, I think the combination creates significant strategic benefits. And I think the managements at Conseco and Green Tree have *both* done brilliant jobs.

OID: Didn't both manage compound earnings growth of something like 30% per year for the past decade?

Rodriguez: Something like that — that's right.

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OID: On the other hand, as Buffett and Munger say, extremely rapid growth in the financial services area can also be a red flag since fraudulent accounting and/or foolish underwriting practices can make firms look like financial service equivalents of Wal-Mart or Home Depot — right up to the day they go bust.

Rodriguez: True. Conseco definitely has its negatives. It bothers me, for example, that the vast majority of analysts who follow Conseco have positive ratings on it. That's a far cry from the late 1980s and early 1990s when perhaps the two companies with the greatest short interest in their stocks may have been Conseco and Green Tree.

And Conseco CEO Stephen Hilbert does a far better job managing conference calls than Larry Coss ever did. Hilbert comes across *so* well — it's almost like he reaches out through the phone and grabs you by the throat.

OID: Yeah. I read where he said he planned to drown criticism of the Green Tree acquisition in black ink.

Rodriguez: Exactly. Obviously, Hilbert's very vocal and wonderfully enthusiastic. And there's no question that he's a fabulous promoter.

OID: Which, no doubt, makes you nervous...

Rodriguez: You've got it. That's *exactly* what it does — because his enthusiasm is extremely contagious. And, frankly, that *bothers* me.

Also, again, the complexity of their annual report and some of the things that they do make me anxious — especially since I don't yet have enough familiarity with their management to be confident about my ability...

OID: To know what's sizzle and what's steak.

Rodriguez: Exactly. But, again, it's reassuring there to see lots of insider buying on the open market. And *boy* has there been *that*. If you want to see something amazing, take a look at the recent insider trading in Conseco:

Among those insider purchases have been very serious purchases by five or six directors, 200,000 shares by Chief Operating Officer Thomas Kilian, 200,000 shares by Head of Corporate Development Ngaire Cuneo, 225,000 shares by Larry Coss (the founder and CEO of Green Tree), 160,000 shares by Chief Investment Officer Max Bublitz and 200,000 shares by Treasurer James Adams. And every one of those purchases, among others, occurred between August 5th and August 25th at prices between $37 and $43 per share — well above today's price.

I DON'T MIND A BRIEF STINT AS THE VILLAGE IDIOT BECAUSE THIS RACE IS A MARATHON, NOT A SPRINT.

OID: Still, as George Sertl of Schwartz Investment Counsel points out, isn't there an enormous amount of excess capital in the insurance industry today — and the financial services industry generally?

Rodriguez: There is. But unlike Conseco, there are lots of companies — in the insurance area, in the financial services industry and in lots of other industries — whose stocks are selling at or below market P/E multiples that look like value traps to me. In other words, they *look* cheap, but they really don't have very good *growth* dynamics.

I don't care if the S&P is trading at 20+ times earnings and likely to grow only 5-6% per year. I'm not interested in buying something at 12-13 times earnings if its earnings are likely to grow at 5% or 6% per year.

OID: I'll drink to that.

Rodriguez: One of the things I concluded from 1974 was that I wasn't going to be a relative value manager. Just because 80% of the people wanted to jump off a cliff didn't mean I had to jump off the cliff with 'em.

OID: No matter how much your clients might want you to make the trip and take them along.

Rodriguez: Exactly. It's funny. I was talking to a gentleman recently who's more of a relative value manager. And he said, "My *God*. I can't believe this market. It seems like everything is going to 12 or 13 times earnings — and getting *crushed*."

I said, "Now you know why I insist on *absolute* value. Over the years, I learned that once you start paying up because something's *relatively* cheap, you get hurt — because stock prices do eventually revert to the mean."

OID: Remind me to ask you what your excuse is...

Rodriguez: You don't have to *ask*. One problem that you face when you're looking for absolute values is that you're sometimes out of synch with the market. In fact, one problem I've had has been that I'm usually a couple of years ahead of the marketplace.

OID: I can relate — sorta. Actually, my problem is that I'm usually six to nine months behind.

Have you ever tried setting your calendar back...

Rodriguez: And that's a problem because when you're two or three years ahead, there's usually a discontinuity between where you are and where almost everybody *else* is.

OID: So you can be right, but look wrong a long time.

Rodriguez: Exactly. You can look like a horse's ass for a long time. That's just one of the prices you pay.

However, we tend to think in 3-5 year time horizons. More often than not, that approach has paid off pretty well. And, hopefully, it will again.

OID: It's certainly hard to argue with your results.

Rodriguez: You asked me earlier if I'd lost my touch.

OID: I hope you won't hold a grudge. I was just...

Rodriguez: Well, I'm hoping to be managing money here for the next 20 years. And I tell my associates, "If you ever get complacent, then it's time to hang up your spurs. Complacency has no place in this business — at least it doesn't if you're intent on being one of the best."

So if I ever lose my competitive edge, my desire or maybe even my *need* to excel, I'll hang up my spurs then and there no matter what's happening at the time — because I won't be any good to anybody.

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FIRST PACIFIC ADVISORS'
BOB RODRIGUEZ
(cont'd from preceding page)

I have enormous respect for John Neff. He did it so long and so well. Peter Lynch was great in his own right. But Neff stayed at the top much, much longer. And longevity in this business is no small feat.

OID: Even if Phil Carret's longevity does dwarf Neff's — and pretty much everybody else's, for that matter.

Rodriguez: But please don't get me wrong. I'm not saying I belong in Neff's class. I've been managing money for nearly 25 years. But my public track record only goes back 15 years — because the other 10 years were hidden.

OID: If you didn't hide 'em quite well enough and somebody were to find 'em, what would they think?

Rodriguez: Well, when I was with Transamerica, we had a portfolio that could take large positions — what we referred to as 13-D positions. I was one of 11 analysts. And all of us could make purchase recommendations. But there was a bit of hostility directed towards me at one point because roughly 60% of that pool was in *my* ideas.

OID: I assume you returned the money before you left?

Rodriguez: And I made no bones about it. I said, "My goal is to have *100%* of the pool invested in my ideas. Your goal should be to *prevent* me from getting to 100%. That's capitalism at its very best."

And that's very much the same thing I'm trying to do here at First Pacific Advisors...

OID: You don't want any of the firm's money to be in your associates' ideas?

Rodriguez: I'm trying to establish that intensity. And years ago, I said the key to investing successfully over the long term was not to be at the *head* of the group, but to stay *close* to the leader — similar to long-distance running. In 1991, when biotech stocks took off like crazy, our goal was to stay close. Then, when financial stocks took off, we wanted to stay close to them.

Today, it's the big caps. And we're not staying as close as I would have liked. But we're not *out* of the game either — not by a longshot.

OID: If you want out of the game, I can tell you how: First, move to New York. Second, start a newsletter....

Rodriguez: One of my goals is to have one of the best 20-25 year track records in the industry. And the only way to do that is to gain performance against my competition.

OID: Raising cash is a novel way to accomplish that — unless you think money market returns...

Rodriguez: Very few of them have wanted liquidity. So I *have* wanted it. Frankly, in the last year and a half, I'm amazed that we've been able to stay as competitive as we have given the high level of liquidity we've maintained. During the first few weeks of every one of these declines, I've always managed to look like the village idiot....

OID: Not to worry. One can learn to live with that...

Rodriguez: But now I think the odds may be moving our way. Hopefully, we'll get a difficult period for equities and our stock selection will stand up.

I had felt — and I still believe — that in the context of a prolonged down market, given the type of things we own, we might be able to pick up 1,000-2,000 basis points [10-20%] of relative performance. And we probably *have* picked up about 450 basis points versus the Russell 2000 so far.

Nobody's paying attention to that right now because the big declines in *most* stocks have been masked by the performance of the *generals*. But if these declines continue over an extended period and the elements of the companies we own come to the forefront, maybe we'll be able to lay the groundwork for some very interesting numbers.

OID: Because less of your capital will evaporate than will the capital of those around you.

Rodriguez: Exactly. And when almost nobody else has liquidity and the stress has begun to bite, not only might we be able to pick up performance on the *downside*, but maybe we'll be able to deploy our capital at that point and pick up some performance on the way *up* too.

If so, maybe we'll be able to establish an edge that'll be very hard for very many other managers to make up for a long time. Anyway, it's kind of got me *juiced*. That's one of the reasons why I *love* this business: If you're good, over a long period of time, it shows; and if you're not, it shows.

OID: That's what John Train says: In the short run, good results can be luck. However, over the long run, it's skill. I find that extremely depressing.

But whatever your macro view may be, presumably if the valuations get attractive enough...

Rodriguez: Yeah. A number of bargains have started to pop up on our screens. And we've been putting money to work in names we already own and in some new names. It is pretty spectacular right now — in terms of the magnitude of some of these declines and the rapidity with which they've come.

But this decline isn't going to be over in a few weeks. *Real* bear markets typically last about one or two years. We're just *starting* to get serious.

OID: Many thanks again for taking time to speak with us. Your ideas sound as intriguing as ever.

Rodriguez: My pleasure.

—OID

For additional information,
you may contact:

FIRST PACIFIC ADVISORS, INC.
11400 West Olympic Boulevard,
Suite 1200
Los Angeles, CA 90064

(800) 982-4372
(310) 996-5425

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

The manner in which Buffett and super-investor sidekick Charlie Munger have accomplished those returns is no less remarkable (although we won't use scarce space to tell you about it here).

We would, however, like to make two observations: First, if size is indeed the anchor of performance (and we think it is), their accomplishment is more remarkable still. Second, they did it without enormous financial leverage and, we understand, without taking large risks of any kind (relative to their capital base at any given time). To the contrary, they allude to having been too *conservative*!

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

OUR CHECKLIST ISN'T VERY COMPLICATED.
WHAT WE DO IS SIMPLE, BUT NOT NECESSARILY EASY.

A nutshell version of discounted cash flow analysis....

Shareholder: Could you explain the primary criteria that you consider when you're selecting your stocks?

Warren Buffett: Our criteria for selecting a stock are also our criteria for selecting a business. First, we're looking for a business we can understand — where we think we understand its product, the nature of its competition and what can go wrong over time.

Then, when we find that business, we try to figure out whether its economics — meaning its earning power over the next five or ten or fifteen years — are likely to be good and getting better or poor and getting worse. And we try to evaluate its future income stream.

Then we try to decide whether we're getting in with people who we feel comfortable being in business with. And finally, we try to decide on what we think represents an appropriate price for what we've seen up to that point.

Seeing the future's sometimes possible and sometimes not.

Buffett: And as I said last year, what we do is *simple*, although it's not necessarily *easy*. The checklist going through our mind isn't very complicated. Knowing what you *don't* know is important. Sometimes that's not easy. Seeing the future is impossible in many cases, in our view, and difficult in others. But sometimes it's relatively easy. And those are the ones that we're looking for.

Finally, after you complete your analysis, you have to find it at a *price* that you believe is interesting. And although there have been periods in the past when that's been a total cinch, that's *very* difficult for us today.

That's what goes through our mind.

Service station, global company — it's the same process....

Buffett: It's pretty much the same you'd think about if you were contemplating investing your life savings in a service station, a dry cleaning establishment or a convenience store in Omaha: You'd think about its competitive position, what it'll look like in 5 or 10 years, how you were going to run it or who was going to run it for you and how much you had to pay. And that's exactly what we think about when we look at a stock — because a stock is nothing other than a piece of a business....

INVESTING: THE ART OF LAYING OUT CASH NOW
TO GET BACK A WHOLE LOT MORE LATER ON.

Estimating intrinsic value for capital intensive companies.

Shareholder: When you estimate intrinsic value in capital intensive companies like McDonald's and Walgreens where a very healthy and growing operating cash flow is largely offset by expenditures for new stores, restaurants, etc., how do you estimate future free cash flow? And at what rate do you *discount* those cash flows?

Buffett: In the case of a company that's spending the cash it generates as it comes in, we wouldn't give it credit for gross cash flow, but rather for the *net* cash that it has left each year. And in order to calculate intrinsic value, you take those cash flows that you expect to be generated and you discount them back to their present value — in our case, at the long-term Treasury rate.

And that discount rate doesn't pay you as high a rate as it *needs* to. But you can use the resulting present value figure that you get by discounting your cash flows back at the long-term Treasury rate as a common yardstick just to have a standard of measurement across all businesses.

And if the company is investing its cash wisely, then even though the cash flows from those heavy expenditures would be discounted back more years, the resulting growth in future cash development should *offset* that. If it doesn't, then the company wasn't investing it wisely.

The agony, the ecstasy and somewhere in-between....

Buffett: The business is wonderful if it gives you more and more money every year without putting up anything — or [by putting up] very little. And we have some businesses like that. A business is also wonderful if it *takes* money, but where the rate at which you reinvest the money is very satisfactory.

The *worst* business of all is the one that grows a lot, where you're *forced* to grow just to stay in the game at all and where you're reinvesting the capital at a very *low* rate of return. And sometimes people are in those businesses without knowing it.

Investing — laying out cash now to get back *more* later.

Buffett: If somebody's reinvesting all their cash flow, they better have some very big figures coming in down the road because a financial asset has to give you back a lot more cash one day in order to justify your laying out cash for it now.

Investing is the art, essentially, of laying out cash now to get a whole lot *more* cash later on. And something at some point better deliver cash. In his class, Ben Graham used the example of a hypothetical company he called the Frozen Corporation — which was a company whose charter prohibited it from ever paying out anything to its owners or ever being liquidated or sold.

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

Munger: Sort of like Hollywood producers.

Buffett: Yeah. And Ben's question was, "What is such an enterprise worth?" It's a theoretical question. However, it forced you to think about the realities of what business is all about — which is putting *out* money today to get back *more* money later on. Charlie?

In some businesses, the "cash *back*" part is an *illusion*.

Munger: I do think that it's an interesting problem you raise — because I think there *is* a class of business where the eventual "cash back" part of the equation tends to be an *illusion*. There are businesses like that — where you just constantly keep pouring it in and pouring it in, but where no cash ever comes back.

One of the things that keeps our life interesting is trying to avoid those and trying to get into the other kind of business that just *drowns* you in cash....

To use earnings *before* cash requirements is absolute *folly*.

Buffett: The one figure we regard as utter nonsense is so-called "EBITDA" — earnings before interest, taxes, depreciation and amortization. The idea of looking at a figure before the cash requirements of merely staying in the same place — which there usually are...

Any business with significant fixed assets almost always has a concomitant requirement that major cash be reinvested simply to stay in the same place competitively in terms of unit sales. Therefore, to look at some figure that is stated *before* those cash requirements is absolute *folly*.

But that hasn't stopped EBITDA from being misused by lots of people to sell all manner of merchandise for years and years.

Munger: It's not to the credit of the investment banking fraternity that it's learned to speak in terms of EBITDA. The idea of using a measure that they know to be nonsense and then piling additional reasoning on top of what is a clearly false assumption ... is *not* what I consider creditable intellectual performance.

Then, once *everybody's* talking in terms of nonsense — well, it gets to be *standard*.

WE DON'T *MIND* VOLATILITY. WE EVEN *PREFER* IT IF WE'RE VERY CONFIDENT ABOUT THE BUSINESS.

If we can see the future, the money spends the same....

Shareholder: Do you differentiate between types of businesses in your discounted cash flow analysis given that you use the same discount rate across companies? For example, when you value Coke and GEICO, how do you account for the difference in the riskiness of their respective cash flows?

Buffett: We don't worry about risk in the traditional way — for example, in the way you're taught at Wharton. It's a good question, believe me. If we could see the future of every business perfectly, it wouldn't make any difference to us whether the money came from running street cars or selling software because all of the cash that came out — which is all we're measuring — between now and Judgement Day would spend the same to us.

Therefore, the industry that earned it means nothing to us except to the extent that it may tell you something about the ability to *develop* the cash. But it doesn't tell you anything about the *quality* of the cash. Once it becomes distributable, all cash is the same.

If we think we can't see a company's future, we just give up.

Buffett: When we look at the future of businesses, we look at riskiness as being sort of a go/no-go valve. In other words, if we think that we simply don't know what's going to happen in the future, that doesn't mean it's risky for everyone. It means *we* don't know — that it's risky for *us*. It may not be risky for someone else who understands the business.

However, in that case, we just give up. We don't try to predict those things. We don't say, "Well, we don't know what's going to happen. Therefore, we'll discount some cash flows that we don't even know at 9% instead of 7%." That is not our way to approach it.

Once it passes a threshold test of being something about which we feel quite certain, we tend to apply the same discount factor to everything. And we try to only buy businesses about which we're quite certain.

A higher discount rate is no substitute for understanding.

Buffett: As for the capital-asset-pricing-model-type reasoning with its different rates of risk-adjusted returns and the like, we tend to think of it — well, we don't *tend* to think of it. We consider it *nonsense*.

But we think it's *also* nonsense to get into situations — or to try and evaluate situations — where we don't have any conviction to speak of as to what the future is going to look like. I don't think that you can compensate for that by having a higher discount rate and saying, "Well, it's riskier. And I don't really *know* what's going to happen. Therefore, I'll apply a higher discount rate." That just is not our way of approaching it. Charlie?

We don't *mind* volatility. What we want is favorable *odds*.

Munger: Yeah. This great emphasis on volatility in corporate finance we regard as nonsense.... Let me put it this way: As long as the *odds* are in our favor and we're not risking the whole company on one throw of the dice or anything close to it, we don't *mind* volatility in results. What we want are the favorable odds. We figure the volatility over time will take care of itself at Berkshire.

If we're certain on the business, we *love* a volatile stock.

Buffett: If we have a business about which we're extremely confident as to the business results, we'd *prefer* that its stock have high volatility. We'll make more money in a business where we know what the end game will be if it bounces around a lot.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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For example, See's may lose money in eight months in a typical year. However, it makes a fortune in November and December. If it were an independent, publicly-traded company and people reacted to that and therefore made its stock very volatile, that would be *terrific* for us. We could buy it in July and sell it in January — because we'd know it was nonsense.

Well, obviously, things don't behave quite that way. But when we bought The Washington Post, it had gone down 50% in a few months. Well, that was the best thing that could have happened. It doesn't *get* any better than that. Its businesses were fundamentally very *non*-volatile — a strong, dominant newspaper and TV stations — but it was a volatile *stock*. That's a *great* combination in our view.

When we see a business about which we're very certain whose fortunes the world thinks are going up and down — and so its stock behaves with great volatility — we *love* it. That's *way* better than having a *lower* beta. We actually *prefer* what other people call "risk".

IN GOOD BUSINESSES, THE DECISIONS ARE *EASY*.
IN THE BAD BUSINESSES, THEY'RE *AWFUL*.

For Gillette and Coke, depreciation = maintenance cap ex.

Shareholder: You've said that most businesses need to reinvest a certain amount of cash back in their business each year just to stay in place. And you've said that the best businesses not only throw off lots of cash, but have the opportunity to reinvest it in their own businesses.

What specific techniques have you used to figure out the level of maintenance capital expenditures that Gillette and other companies need to make?

Buffett: In companies such as Gillette and Coke, you won't find great big differences between their depreciation and their required capital expenditures — although if you got into a hyperinflationary period or anything like that, you could set up cases where it wouldn't be true.

I've never given a *thought* as to whether Gillette needs to spend $100 million more or $100 million less than depreciation in order to maintain its competitive position. But I would guess that the range is considerably less than that versus its reported depreciation.

By and large, in most companies, the depreciation charge is not inappropriate to use as a proxy for required capital expenditures. And that's why we think that the sum of reported earnings plus amortization of intangibles usually provides a pretty good indication of true earnings.

Other businesses are dangerous traps — like the airlines.

Buffett: In some businesses — and airlines are a good example — you have to keep spending money like *crazy* if it's *attractive* to spend money. And you have to spend money the same way if it's *un*attractive. It's just part of the game.

Likewise, in our textile business, to stay competitive, we would have needed to spend substantial money without any likelihood of earning anything from those outlays after we got through spending it. And those kinds of businesses are real traps. They may work out — one way or another, but they're dangerous.

Some of our businesses let us reinvest and some don't.

Buffett: In See's Candy, we'd *love* to be able to spend money — $10 million, $100 million, *$500* million — and get anything *like* the returns that we get on present capital. Sadly, there isn't a good way to do it. We'll keep looking. But it's not a business where capital produces the profits.

In FlightSafety, capital *does* produce the profits. More pilots need to be trained, they need more flight simulators and so on. And capital *is* required for those profits....

At Coke, the reinvestment opportunities are *no-brainers*.

Buffett: In the case of Coca-Cola — particularly as new markets come along (like China or East Germany) — they will often make needed investments in order to build up the bottling infrastructure and rapidly capitalize on those markets just as they did in the former Soviet Union.

And you *know* that you've got to do 'em. You have a wonderful business. You want to spread it worldwide. You want to capitalize on it as quickly and fully as possible. If you wish, you can make a return on investment calculation. But as far as I'm concerned, it's a waste of time — because you're going to do it anyway. You *know* you want to dominate those markets over time. Eventually, you'll probably fold those investments into other bottling systems once the market is developed. But you don't want to *wait* for the conventional bottlers to do it. You want to *be* there.

One irony, incidentally — some of you may get a kick out of it — is that when the Berlin Wall came down and Coke was there that day with Coca-Cola for East Germany, it came from the bottling plant at *Dunkirk*.

If the decisions are pleasant and easy, it's a *good* business.

Munger: I've heard Warren say since very early in his life that the difference between a good business and a bad one is that a good business throws up one easy decision after another, whereas a bad one gives you *horrible* choices — decisions that are extremely hard to make: "Can it work?" "Is it worth the money?"

One way to determine which is the good business and which is the bad one is to see which one is throwing management bloopers — pleasant, no-brainer decisions — time after time after time. For example, it's not hard for us to decide whether or not we want to open a See's store in a new shopping center in California. It's going to succeed. That's a blooper.

On the other hand, there are plenty of businesses where the decisions that come across your desk are *awful*. And those businesses, by and large, don't work very well.

Buffett: I've been on the board of Coke for 10 years now. And during that time, we've had project after project come up to be reviewed by the board. And they always estimate the ROI — the return on investment. However, it doesn't make much difference to me — because in the end, almost any decision you make that solidifies and extends Coke's dominance around the world in a rapidly growing industry that enjoys great inherent profitability is going to be right. And you've got people there to execute 'em well.

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

Munger: ...You get blooper after blooper.

Buffett: Yeah.

From the agony to the ecstasy....

Buffett: In contrast, Charlie and I sat on the board of USAir. And there, decisions would come along — and they'd be: "Do you buy the Eastern Shuttle?" And you're running out of money. And yet, to play the game and keep traffic flows such that it will connect passengers, you just have to continually make these decisions where you spend $100 million more on some airport. You're in *agony* — because you don't have any real choice. And you also don't have any great conviction that the expenditures are going to translate into real money later on.

So one game is just *forcing* you to push more money onto the table with no idea of what kind of hand you hold. And in the other, you get a *chance* to push more money in knowing that you've got a winning hand all the way.

Charlie, why'd you buy USAir? You could have bought more Coke.

COST OF CAPITAL AS TAUGHT? IT'S INCOHERENT. CHARLIE AND I HAVE A MUCH SIMPLER APPROACH....

I don't have a good answer to a stupid question.

Shareholder: What is Berkshire's cost of capital?

Buffett: That question's puzzled people for thousands of years. So I'll let Charlie handle it....

Munger: I find the way that subject is taught at most business schools incoherent. I'm usually the one who *asks* that question and gets the incoherent answers. I don't have a good answer to what I consider a stupid question.

Buffett: We're better at stupid answers to good questions.

Munger: What's the cost of capital at Berkshire when we keep drowning in a torrent of cash we have to reinvest?

A simple test to see if we're exceeding our cost of capital....

Buffett: There are really only two questions. And they get to the same issue. However, you don't need a mathematical answer. The first is: "When you have capital, is it better to keep it or return it to shareholders?" And the answer is that it's better to return it to shareholders when you can't achieve more than $1 of value for each $1 of capital retained. That's test #1.

So our minimum cost of capital is measured by our ability to create more than $1 of value for every $1 retained. If we're keeping $1 bills that would be worth more in *your* hands than ours, then we've failed to exceed our cost of capital....

And once we think we *can* — if you pass that threshold — the question becomes: "How can we do it to the best of our ability?" Then you simply look around for the thing you feel most certain about which promises the greatest return.

With all of the stuff I've seen in business schools, frankly, I've not found any way to improve on that formula.

Don't ask the consultant if your capital needs a haircut.

Buffett: A trouble you may have [is that] many managements could be reluctant to distribute money to shareholders because they rationalize that they'll do better than they actually will. Almost any management that wants to retain money will rationalize it and say, "We're going to do wonderful things with it." That's a danger.

But I doubt that the problem would be solved by hiring a bunch of consultants to arrive at a cost of capital — because the consultants would know the conclusion management wants. "Whose bread I eat, his song I sing."

That's why in the annual report, in the ground rules, I suggest making checks on the *validity* of managerial projections. And the *check* on it is whether after three or four years the dollars retained *have* created more than that much value in increased market value for shareholders.

[If they hadn't], the presumption would be strong that management should pay out more cash to shareholders.

We don't have a use for that capital today, but we will....

Shareholder: You say a company should spend $1 on capital expenditures only if it will create more than $1 of market value. How do you determine that? Is it based on (A) historic returns on capital, (B) a qualitative judgement of a company's competitive position, (C) a quantitative projection of returns on capital or (D) something else?

Buffett: It's based on all of those factors and more. We can say that to date every dollar we've retained has been worthwhile because on balance each of those dollars has produced more than $1 of market value. Actually, a great *many* companies can say that today because things have turned out so well.

If you were to ask us whether we have a use for $1 of today's earnings that would create more than $1 in value *today*, the answer would be *no*. However, based on history, we think the prospects are better than 50% — *well* over 50% — that within the next few years we will, although there's no certainty of that.

THE HUMAN MIND TENDS TO *DISCARD* ANOMALIES. CHARLIE AND I BELIEVE THEY SHOULD BE *STUDIED*.

A couple of investment courses Buffett recommends....

Shareholder: In this era, when departments of institutions of higher learning refer to you as an anomaly, preach the efficient market hypothesis and say that one can't outperform the market, where does one go to find a mentor like you found in Ben Graham?

Buffett: I understand the University of Florida has instituted some courses — actually, Mason Hawkins [of Southeastern Asset Management] gave them a significant amount of money to finance 'em. And I believe they're teaching something other than efficient markets there.

Also, there's a very good course at Columbia that gets a lot of visiting teachers to come in. I go in there and teach

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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occasionally — as do a number of other practitioners....

I think the efficient market theory is less holy writ in universities today than it was 15 or 20 years ago — although there's still a lot of it taught. However, I think you can find more diversity in what is being offered now than you could 10 or 20 years ago. And I'd recommend looking into those two schools.

We should probably be *funding* efficient market chairs....

Buffett: But the hard-form efficient market theory has been quite helpful to us.... If you had a merchant shipping business and all of your competitors believed the world was flat, you'd have a *huge* edge — because they wouldn't take on cargo going to places where they think they'd fall off the earth. So we should be *encouraging* the teaching of hard-form efficient market theories at universities.

It amazes me. I think it was Keynes who said, "Most economists are *most* economical about *ideas* — they make the ones they learned in graduate school last a lifetime."

What happens is that you spend years getting your Ph.D. in finance. And [in the process], you learn theories with a lot of mathematics that the average layman can't do. So you become sort of a high priest. And you wind up with an *enormous* amount of yourself in terms of your ego — and even professional security — invested in those ideas. Therefore, it gets very hard to back off after a given point. And I think that to some extent that's contaminated the teaching of investing in the universities. Charlie?

Munger: I'd argue the contamination was *massive*.... But good ideas eventually thrive.

Anomalies should get *particular* attention, not be *ignored*.

Buffett: I've always found the word "anomaly" interesting because Columbus was an anomaly, I suppose — at least for awhile. What it means is something the academicians can't *explain*. And rather than reexamine their theories, they simply discard any evidence of that sort as anomalous.

On the other hand, Charlie and I believe that when you find information that contradicts your existing beliefs, you've got a *special* obligation to look at it — and *quickly*. Charlie says that one of the things Darwin did whenever he found anything that contradicted any of his cherished beliefs was that he would write it down immediately — because he knew that the human mind was so conditioned to reject contradictory evidence that unless he put it down in black and white very quickly, his mind would push it out of existence....

[Editor's note: An *enormously* important topic — relevant to virtually every facet of business and life.]

Whether he's lucky or good, Buffett's a multi-sigma event.

Munger: ...I did find it amusing: One of these extreme efficient market theorists explained Warren for many years as an anomaly of *luck*. And this theorist finally got all the way up to six sigmas — six standard deviations — of luck. But then, people began laughing at him because six sigmas of luck is a *lot*.

So what did he do? Well, he changed his *theory*: Now, he explains, Warren has six or seven sigmas of *skill*.

Buffett: I'd rather have the six sigmas of *luck* actually.

Munger: The one thing he couldn't bear to leave was his six sigmas.

I'D TEACH TO WAIT FOR THE FAT PITCH — AND NOT TO ATTEMPT THE IMPOSSIBLE.

Ben taught us valuation and lots of important lessons.

Shareholder: Both of you have said you don't think business valuation is being taught correctly at universities. As a student at Columbia Business School, that troubles me because I'll soon be joining the ranks of those teaching business valuation. My question is do you have any counsel about ... teaching techniques...?

Buffett: I was lucky. I had a *sensational* teacher in Ben Graham. We had a course there — in fact, there's at least one fellow in the audience who attended it with me — and Ben made it terribly interesting. Basically, what we did when we walked into that class was value companies.

Ben had various little games he would play with us. For example, sometimes he would [give us a whole bunch of figures about Company A and Company B and] have us evaluate them. And only after we'd finished the exercise would we learn that [Company] A and [Company] B were the same company at different points in its history.

And he played a lot of little games to get us to think about what the key variables were and how we could go off track. For example, on one occasion, Ben met with Charlie and me and nine or so other people down in San Diego in 1968. And he gave all of us a little true/false test. We all thought we were pretty smart — and we all *flunked*.

That was his way of teaching us that a smart man playing his own game and working at fooling you could do a pretty good job at it.

I'd teach students to wait for the fat pitch.

Buffett: But if I were teaching a course on [investing], there would simply be one valuation study after another with the students trying to identify the key variables in that particular business and ... evaluating how predictable they were — because that's the first step. If something isn't very predictable, you should forget it — [because] you don't have to be right about every company. You [just] have to make a *few* good decisions in a lifetime.

But the *important* thing is that when you do find one where you really *do* know what you are doing, you must buy in quantity.... Charlie and I have made a dozen or so *very* big decisions relative to net worth, although not as big as they *should* have been. And in each of those, we've known that we were almost certain to be right going in.

They just weren't that complicated. We knew we were focusing on the right variables, that they were dominant, etc. And even though we couldn't carry the figures out to five decimal places or anything like that, we knew — in a general way — that we were right about 'em.

That's what we look for — a fat pitch. And that's what I would try to teach students to do.

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

And I'd teach students what they *can't* do....

Buffett: I would *not* try to teach them to think [that] they could do the impossible. Charlie?

Munger: Yes. If you plan to teach business valuation the way people teach real estate appraisal so that after completing your course your students will be able to take any company and give you an appraisal of that company incorporating its future prospects relative to its market price, then I think you're attempting the impossible.

Buffett: Yeah. On the final exam, I'd probably take an internet company and [ask], "How much is it worth?" And anybody that gave me an *answer*, I'd *flunk*.... It'd make grading papers easy, too.

Properly taught, investing uses cases with clear lessons.

Munger: Finance properly taught should be taught from cases where the investment decisions *are* easy. And the one that I always cite is the early history of the National Cash Register Company. It was created by a very intelligent man who bought all the patents, had the best sales force and the best production plants. He was a very intelligent man and a fanatic, all of whose passions were dedicated to the cash register business.

And of course, the invention of the cash register was a *godsend* to retailing. You might even say that the industry was the pharmaceuticals of a former age.

And if you read an early annual report when Paterson was the CEO of National Cash Register, an *idiot* could tell that here was a talented fanatic — very favorably located. Therefore, the investment decision was easy.

If I were teaching finance, I'd want to use maybe 100 cases like that. That's the best way to teach the subject.

Buffett: Incidentally, we *have* that annual report. What year was it — 1894 or so? It's really a classic. Paterson not only tells you why his cash register's worth 20 times what he's selling it for, but he also tells you that you're an idiot if you want to go into competition with him.

Munger: No intelligent person could read this report and not realize that this guy couldn't lose.

OUR STOCK PRICE TODAY? I DON'T KNOW OR CARE.
WHAT IT IS 10 YEARS FROM NOW IS WHAT COUNTS.

The quickest way to review a huge number of key factors....

Shareholder: ...I'm with *Value Line*. Considering the demands on your time, how do you go about reviewing the entire spectrum of choices in the equity markets?

Buffett: Ahh. A fat pitch.... But I don't mind it at all.... I don't know what we even pay for *Value Line*. Charlie and I both get it in our respective offices. [And] we get *incredible* value out of it — because it gives us the quickest way to review a huge number of key factors that tell us whether we're basically interested in a company.

It also gives us a good way ... of periodically keeping up to date. *Value Line* covers 1,700 or so stocks ... and reviews each of them every 13 weeks. So it's a good way to make sure you haven't overlooked something....

The snapshot it presents is an *enormously* efficient way for us to garner information about various businesses.

Value Line charts are a human triumph.

Buffett: We don't care about the ratings. They don't make any difference to us. We're not looking for opinion, we're looking for facts. But I have yet to see a better way — including fooling around on the internet or anything — that gives me the information as quickly. I can absorb most of the key information about a company — oh, it doesn't take me more than 30 seconds.... And I don't know of any other system that's as good. Charlie?

Munger: Well, I think the *Value Line* charts are a human triumph. It's hard for me to *imagine* a job being done any better. An immense amount of information is given in very usable form. If I were running a business school, we would be teaching from *Value Line* charts.

Price charts are chicken tracks. But the financial data....

Buffett: When Charlie says the charts, he does not mean the chart of the price behavior. He means all that information listed *under* the charts...

Munger: Oh, yeah.

Buffett: The chart of the price action doesn't mean a *thing* to us, although it may catch our eye — just in terms of whether the business has done well over time. But stock price action has nothing to do with any decision we make. Price itself is *all* important. But whether a stock has gone up or down or what the volume is or any of that sort of thing — as far as we're concerned, those are chicken tracks. And we pay no attention to them.

But the information that's right below the chart in those [20 or so] lines: You can run your eye across that — and if you have some understanding of business, then it provides a perfect snapshot to tell you *very* quickly what kind of a business you're looking at.

Our correlation coefficient wouldn't *mean* anything....

Shareholder: It would be very helpful to know the correlation coefficient between Berkshire and the S&P 500. If you have it, would you let us know what it is? If not, would you consider calculating it?

Buffett: Well, it could be calculated, but I don't think that it would have much meaning. We don't think anything that relates to trading volume, historical stock price, relative strength — *any* of that sort of thing — does....

And bear in mind that I used to eat all that stuff up back in my teens. I used to make calculations based on that stuff all the time. And I prepared charts based on it, etc. But it has no place in the operation today.

Plus, it would be an historical correlation. What was doable by us in the past is *not* doable today. As I said in the annual report, my best decade ever in terms of relative performance — by *far* — was the 1950s. I don't think it was because I was a lot *smarter* then. I'm willing to accept that. But I had some edge — probably near 30% per year.

But I was working with far less money then. So it has *no* relevance today whatsoever. And it would be misleading to publish it, make calculations based on it, etc.

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BERKSHIRE HATHAWAY'S
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Publishing it would risk misleading some shareholders.

Buffett: I don't know exactly what you'd find in terms of the correlation between Berkshire and the S&P. But I know you'd find a *lot* of correlation between Berkshire's intrinsic value and that of Coke and a few stocks like that.

But I don't think that's particularly useful information. We have no objection to anyone making the calculation, but it wouldn't be something with any utility to us. And therefore, we don't want to put it out to shareholders and risk giving some of them the impression that it does.

I don't know what Berkshire's selling for — or care....

Buffett: We don't pay any attention whatsoever to beta or any of that sort of thing. It just doesn't *mean* anything to us. We're only interested in price and value. That's what we're focusing on all the time. To us, any kind of market movements have no meaning whatsoever.

I really don't know what Berkshire is selling for today. It just doesn't make any difference. I can't tell you what it was selling for on May 4th, 1983 or May 4th, 1986. And I don't care what it sells for on May 4th, 1998.

I *do* care what it sells for *10 years* from now. That's what counts. And that's where all of our focus is.

Whether we like it or not, S&P 500 returns are relevant....

Buffett: We do believe the S&P 500's returns have some meaning because it's an alternative in which people can invest. And they don't need us to buy the S&P. Therefore, unless we exceed the S&P return over time, what are we contributing? That's the way we add value. So we think shareholders *should* hold us accountable.

And actually, we might prefer they didn't because the pretax return of the S&P 500 is a mighty tough comparison for a taxpaying entity like Berkshire. Charlie?

The correlations Buffett looks for aren't very subtle ones....

Munger: Warren and I provide you with the data and we publish it in the form and on the time schedule which we would want were we in your position — in other words, if *we* were the passive shareholders. And we don't think correlation coefficients would help us.

One of the pleasant things about dealing with Warren all these years, incidentally, is that he's never talked about a correlation coefficient. If the correlation isn't *so* extreme that you can see it with the naked eye, he doesn't *bother*.

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I RECOMMEND THE "SCUTTLEBUTT" APPROACH.
YOU'LL LEARN A LOT *AND* SAVE LOTS OF TIME.

I used to do a *lot* of "scuttlebutt". You can't do too much....

Shareholder: My question involves what Phil Fisher referred to as "scuttlebutt". When you identify a business you believe warrants further investigation, how much time do you typically spend on it — both in terms of total hours and in terms of weeks or months during which time you perform your investigation?

Buffett: Well, now I spend practically *none* — because I've done it in the past. One advantage of allocating capital is that an awful lot of what you do is cumulative. So you get continuing benefits from what you've done before. And by now, I'm probably fairly familiar with most of the businesses that might qualify for investment by Berkshire.

But when I started out, and for a long time, I used to do a *lot* of what Phil Fisher calls the "scuttlebutt" method. And I don't think you can do too much of it.

But it should be the last 20%. Don't chase every idea.

Buffett: Now the general premise of why you're interested in something should be 80% of it or thereabouts. You don't want to be chasing down every idea. Therefore, you should have a strong presumption. You should be like a basketball coach who runs into a 7-footer on the street. You're interested to start with. Now you've got to find out if you can keep him in school, if he's coordinated and all of that sort of thing. And that's the "scuttlebutt" aspect of it.

But it should be the last 20% or 10%. You don't want to get too impressed by that because you want to start with a business where you think the economics are good — where they *look* like 7-footers. Then you want to go out and use the scuttlebutt approach to test your original hypothesis.

So you may reject it. But if you confirm it, you may view it more strongly. That's what I did with American Express in the '60s. And the scuttlebutt approach so *reinforced* my feelings about it that I kept buying more and more and more.

You're going to learn a *lot*. I recommend it.

Buffett: As you're acquiring knowledge about industries in general and companies specifically, there *isn't* anything like first doing some reading about them and then getting out and talking to competitors and customers and suppliers and past employees and current employees and whatever it may be. If you talk to a bunch of people in an industry and ask them who they fear the most and why, who (in Andy Grove's words) they'd use the silver bullet on and so on, you're going to learn a *lot*.

In fact, by the time you're through, you'll probably know more about the industry than most people *in* it. And that's both because you'll be coming in with an independent perspective and because you'll have listened to everything everyone says rather than listening primarily — as is all too frequently the case — to your *own* truths. And I do recommend it.

I used it (and saved time) on my American Express decision.

Buffett: Again, I don't really do much of it anymore. But I still do a little bit of it. In the annual report, I talked

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about how I used the scuttlebutt approach to help us decide what to do with our American Express Percs — which we wound up exchanging for common stock in 1994. I was using the scuttlebutt approach when I talked to Frank Olsen.

And I couldn't have talked to a better guy than Frank. He runs Hertz Corporation. He has lots of experience at United Airlines. He's a consumer and marketing guy by nature. He understands business. And Frank's a user. He pays x% to American Express at Hertz. And he doesn't like to pay out money unless it's absolutely necessary. So why was he paying it? And why was he paying more than he was on MasterCharge or Visa? And what could he do about it? Just keep asking questions.

I asked him how strong the American Express Card was, what its strengths and weaknesses were, who was coming after it, etc. He gave me a better answer in five minutes than I could have reached in hours and hours and hours or even *weeks* of going around and doing it myself.

My 1951 conversation with Davey was another example....

Buffett: [Another time I used the scuttlebutt approach was when I spoke with Lorimer Davidson about GEICO] back in 1951 when I visited him in Washington. I guess Davey explained that in that video we had this morning. By the way, I'm very grateful to him for doing that interview because that was a real effort for him. But when I spoke with him in 1951, I was trying to figure out why people want to insure with GEICO rather than with the companies that they were already insuring with, how *permanent* that advantage was, what else we could do with that advantage, etc. — there were a *lot* of questions I wanted to ask him.

And he was terrific about giving me answers. It changed my life — and it demonstrates the value of the scuttlebutt method....

BUY WHEN YOU'D BE HAPPY TO OWN IT FOREVER. SELL WHEN YOU FIND SOMETHING IMMENSELY BETTER.

We're trying to buy things that we'll want to own *forever*.

Shareholder: I think I understand how you decide when to *buy* stocks. But what criteria do you use to decide when it's time to *sell* 'em?

Buffett: The best thing to do is to buy a stock that you don't *ever* want to sell. And that's what we're trying to do when we buy a stock and when we buy a business. That's what we did when we bought all of GEICO, all of See's Candy and all of the Buffalo News. We're not buying any of those things to resell 'em. We're trying to buy a business that we'll be happy with if we own it for the rest of our lives. And we expect to do exactly that with those.

The ideal purchase — buying *more* of what you like best.

Buffett: The same principle applies in the case of marketable securities. Only you get some extra options: For example, you can add to a position.... For example, if we own 2% of a business by way of a marketable security and we like it at a given price, we can increase our interest to 4% or 5%. So that's one advantage.

Incidentally, the *ideal* purchase is something you like *already* when it's selling at a price that makes you want to go out and buy more. And we probably should have done more of that in the past....

That's one of the beauties of marketable securities. When you're in a wonderful business, you do get a chance periodically to double up on it or something of that sort. Were the stock market to sell a lot cheaper than it is now, we'd probably buy more of the businesses we already own. They'd certainly be the *first* ones we'd think about buying because they're the ones we like best.

When we sell, it doesn't mean we're *negative* — at *all*....

Buffett: But we sometimes need the money for another sector — like we did last year. And when we do, we can get the money we need by trimming some of our holdings of marketable securities. But that doesn't mean we're *negative* about those businesses — not at *all*. In fact, we believe that they're *wonderful* businesses. Otherwise, we wouldn't own 'em.

However, we might sell some or all of our stock in Company A if we need money for other things. I sold the GEICO stock that I bought in 1951, for example, a year or so later. And prior to its 1976 problems, [those shares went on to be worth] *100* or more times what I paid. But at the time, I didn't have the money I needed to do something else. So we may sell ... [for that reason].

The ideal time to *sell*....

Buffett: And we may sell if we believe that valuations between different markets are out of whack. Again, we've occasionally done a little trimming — like we did last year....

But that could well be a mistake. The real thing to do with a great business is to hang on for dear life. Charlie?

Munger: Yes. But for the sales that do happen, the ideal time [to sell] is when you've found something that you like immensely better. Isn't it perfectly obvious that that's the ideal time to sell?

THE STOCKS WE SELL *SHOULD* GO UP. WE WOULD WORRY IF THEY *DIDN'T*.

Everything we've ever sold has gone up subsequently.

Shareholder: You owned Disney once before, but you sold it. And you owned advertising companies in the '70s, I believe, and you sold them. Could you give us some insight into why?

Buffett: I'm not sure I *want* to give you any insight into that thinking.... But I'll start off with the fact that when I was 11, I bought some Cities Service Preferred at $38. And it went to $200. But I sold it at $40. So I captured $2 per share of profit.

Everything we've ever sold has gone up subsequently, but some of 'em have gone up more *painfully* than others. Certainly, the Disney sale in the '60s was a *huge* mistake. Forget about whether I should have continued *holding* it. I should have been *buying* it. That's happened many times.

I'd worry if we'd sold a bunch of things right at the *top*....

Buffett: We think that anything we sell *should* go up subsequently — because we own good businesses. And

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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when we sell 'em, it's because we need money to buy something else. But we still think they're good businesses. And we think good businesses are going to be worth more over time.

So everything I sold in the past virtually — that I can think of — has gone on to sell for a *lot* more money. And I would expect that to continue to be the case.

That's not a source of distress. But I must say that selling the Disney was a mistake. Actually, the ad agencies have done very well since we sold 'em, too. Now maybe some of that money went into Coca-Cola or something else. So I don't worry about that.

I would worry, frankly, if I'd sold a bunch of things right at the *top* — because that would indicate, in effect, that I was practising a "greater fool" approach to investing. And I don't think it *can* be practised successfully over time.

I think the most successful investors, if they sell at all, will be selling things that end up going a lot higher — because it means they've been buying into good businesses as they've gone along. Charlie?

Rubbing your nose in your mistakes is a very good habit....

Munger: I'm glad that the questioner brought up a subject that evoked humility because it is really useful to be reminded of your errors.

I think we're pretty *good* at that. We do kind of mentally rub our own noses in our own mistakes. And that is a very good mental habit. Warren can tell you the exact number of cents per share he sold at, split adjusted, and how that compares to the current price. And I think that it actually *hurts* him....

Buffett: It actually *doesn't* hurt — because you just keep on doing things.

It's instructive to do post-mortems, but more fun to dream.

Buffett: But it is instructive to perform post-mortems on everything as long as you don't get carried away with it. Post-mortems should be done on every acquisition decision and that kind of thing.

Most companies *don't* like to do post-mortems on their capital expenditures. I've been a director of a lot of companies over the years — and they usually don't spend a lot of time on post-mortems. They do spend a lot of time telling you how wonderful their acquisitions and their capital expenditures are going to be, but they don't necessarily like to look so hard at the results.

Munger: If I were ordaining rules for running boards of directors, I'd require that three hours be spent examining stupid blunders including quantification of effects considering opportunity costs.

ARE CURRENT AGGREGATE RETURNS SUSTAINABLE? LOGIC AND ECONOMIC THEORY SUGGEST NOT.

The $64,000 question....

Shareholder: Banking stocks have gone up a lot the last few years. And returns on *tangible* equity at some of the major banks that have led that consolidation have gone up a good bit more. Do you think those returns are sustainable over either the near term or the longer term?

Buffett: Well, that's the $64,000 question because returns on equity — particularly returns on *tangible* equity ... particularly in the banking sector — have hit numbers that are unprecedented. And, then, the question is, "If they're unprecedented, are they unsustainable?"

Sustained 20% ROEs are impossible — absent repurchases.

Buffett: ...We wouldn't base *our* actions on the premise of returns of 20%+ on *book* equity and much *higher* returns on tangible equity being sustainable. In the banking field you have a number of enterprises whose returns on tangible equity are getting up close to 30%.

In a system where the GDP is growing maybe 3% in real terms and something around 4-5% in nominal terms, can businesses consistently earn 20% on equity? Well, they certainly can't if they retain most of their earnings — because you would have corporate profits rising as a percentage of GDP to a point that would get ludicrous.

So under those conditions, you'd either have to have huge *payouts* — either by repurchases of shares, by dividends or by takeovers actually — that would keep the level of capital reasonably consistent because those returns couldn't be sustained....

For example, let's just say that every company earned 20% on equity and retained all of its earnings. You could not have corporate profits growing at 20% year after year and not have it become a disproportionately large part of the economy.

A continuation of these returns violates economic theory.

Buffett: It's been a better world than we foresaw in terms of returns. So we've been wrong before. And we're not making a prediction now. But we wouldn't want to *buy* things on the basis that these returns will be sustained.

We said last year that if these returns *are* sustained and interest rates stay at these levels or fell lower that stock prices in aggregate are justified. We still believe that. But those are two big *ifs*. The *particularly* big if, in my view, is the one about returns on equity and tangible equity. The belief that those returns can be sustained, certainly, goes against classic economic theory.

Returns have been aided by a revolution in attitudes....

Munger: I think a lot of the increase in return on equity has been caused by the increase in popularity of Jack Welch's idea that if you can't be a leader in a business, then get out of it. And if fewer people are in a business, then returns on equity can go up.

Also, it got more and more popular to buy in shares — even at very high prices. And if you can thereby get equity low enough, you can make return on equity whatever you want. So, in effect, we've had a slow revolution in corporate attitudes.

But Warren's right. If you have massive accumulation of retained earnings, you can't have a continuation of present levels of return on equity.

And revolution-aided returns can only go so far....

Buffett: And it's an interesting question.... If you

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BERKSHIRE HATHAWAY'S
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had 500 Jack Welches — if they were cloned — and one of them were running each of the *Fortune 500* companies, would returns on equity for American business be *higher* or *lower* than they are at present?

If you had 500 sensational competitors, they could all be *rational*. [If they were run by Jack], they *would* be. And they'd be smart. And they'd keep trying to do all of the right things. But there would be a self-*neutralizing* effect. It would be just like having 500 expert chess players or 500 expert bridge players. If they all got together and competed against one another in a tournament, there would still be a lot of *losers*.

So it's not at all clear that if American managements were all dramatically better that returns on equity would be much better. Returns might very well be driven *down*.

One of the secrets of life is weak competition.

Buffett: To some extent, that's what can happen in securities markets. It's *way* better if you have a 100 I.Q. and everyone else has an 80 I.Q. than if your I.Q. is 140 and everybody else *also* has a 140 I.Q. [One of] the secret[s] of life is weak competition.

Somebody said, "How do you beat Bobby Fisher?" The answer was you play him any game except chess. And how do you beat Jack Welch? Play him any game except business, although he's a very good golfer, too. I saw him a few months ago after he shot a 69 at a *very* tough course. He manages to play 70-80 rounds of golf a year and come in below par occasionally and still do what he does at GE. He's a great manager.

But [I'm not at all sure that having] 500 Jack Welches would mean higher returns or make stocks more valuable.

In one *important* respect, earnings quality has gone *down*.

Shareholder: What is your evaluation of the quality of earnings in the U.S. right now?

Buffett: Charlie and I feel that in several respects — but in one *important* respect — the quality of earnings generally in the U.S. has gone *down*. And that one important respect is stock options. It's not because the policy's changed, but because it's become more significant.

There are certain companies that we've evaluated for possible purchase where based on our calculations, the earnings are maybe 10% less per year per share than reported. And that isn't necessarily the end of the world, but it does result in a significant valuation difference. And it's not reported under standard accounting.

So we think the quality of earnings as reported by a company with significant stock option grants every year is dramatically poorer than one where that doesn't exist. And a lot of companies fall in that category.

SHARE BUYBACKS AT COKE WILL BE A PLUS.
WE CAN'T SAY THAT ABOUT *ALL* REPURCHASES.

Coca-Cola is probably *the* best large business in the *world*.

Shareholder: Is there a price at which it becomes inappropriate for a company to buy back its own stock? For example, with Coke selling at about 40 times earnings, is that a smart place for the company to deploy its capital?

Buffett: Well, certainly 40 times earnings sounds like a very high price to pay when you buy back stock.... However, I would say this: Coca-Cola's been around what — 112 years now? And there are very few times in that 112 years, if any, when it would *not* have been smart for Coca-Cola to have been repurchasing its shares.

In my view, among businesses I can understand, Coca-Cola is probably *the* best large business in the *world*. I mean it is a *fantastic* business.

We'll be better off if Coke consistently repurchases shares.

Buffett: We *love* it when Coke repurchases shares and our interest goes up. We owned 6.3% of Coca-Cola in 1988 when we bought in. We increased our stake a little bit a few years later. But if they had not repurchased shares, we probably would own about 6.7% or 6.8% of Coke now. As it is, we own a little over 8%. [And that increase in our percentage stake is thanks to its stock] repurchases.

There are going to be about a billion 8-ounce servings of Coca-Cola products sold around the world today. And 8% of that represents about 80 million servings, whereas 6.8% would represent 68 million servings. Therefore, thanks to Coke's repurchases, we have roughly an additional 12 million servings attributable to the account of Berkshire Hathaway being sold around the world. And Coca-Cola is earning a little over a penny per serving. That gets me kind of *excited*.

All I can tell you is I approve of Coke repurchasing its shares. I'd a lot rather have 'em repurchasing shares at *15* times earnings. But while I've looked at other ways to use capital, I still think it's a very good use of capital. And maybe the day will come when they can buy their shares back at 20 times earnings. And if they can, I hope that they'll go out, borrow a lot of money and buy a *ton* of it back at those prices.

I think we will be better off 20 years from now if Coke follows a consistent repurchase approach.

There *are* repurchases that we *don't* approve of.

Buffett: I do *not* think that's true for many companies. I think repurchases have become in vogue and are done for a lot of silly reasons. So I don't think everybody's repurchase of shares is well reasoned at all. We see companies that issue options by the ton and then they repurchase shares much higher.

I started reading about investments when I was six. And I think the first thing I read was, "Buy low, sell high." But these companies, through their options, sell low and buy high. They have a different formula than I was taught. So there are a number of repurchases we *don't* approve of.

But when we own stock in a wonderful business, we like repurchases even at prices that may give you nosebleeds. It generally turns out to be a good policy.

And it's possible for even great companies to overpay....

Munger: Well, in any company, the stock could get to a price so high that it would be foolish for the corporation to repurchase its shares. You can even get into *gross* abuse. Before the 1929 Crash, the utilities were madly buying their own shares as a way of promoting [their] stock

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

higher. It was like a giant Ponzi scheme. So there are all kinds of excesses possible.

But the really great companies that buy back shares — well, even at high prices that can be wise. The alternative of buying in shares is always an opportunity cost to be compared with alternative investments available.

Buybacks aren't bargains they *were*, but they're still best.

Buffett: Our interest in GEICO went from 33% to *50%* without us laying out a dime — because GEICO was repurchasing its shares. We've benefited *substantially*. But we benefited a lot more, obviously, when prices were lower. Our interest in The Washington Post Company has gone from 9 and a fraction percent to 17 and a fraction percent over the years without us buying a single share.

But [The Washington] Post or Coke or any number of companies don't get the bargains in repurchasing their own shares today that they used to. But we still think that it's probably the best use of money in many cases.

TWO BLUNDERS: NOT BUYING PHARMACEUTICALS AND NOT REPURCHASING OUR *OWN* SHARES....

We may have missed the boat by not repurchasing shares.

Shareholder: ...You said you like it when wonderful companies like Coke repurchase their shares. Well, I own shares in a wonderful company — and that's Berkshire. Should I be hoping you buy *your* shares back?

Buffett: Well, it's interesting. We should have — *perhaps* we should have — bought some shares back. But, usually, at the time, we could have bought something else that *also* did very well for us. Maybe when we were buying Coke, we could have been buying our own shares back.

To some extent, there hasn't been much trading in it. But I think it's a valid criticism to say that we have missed the boat at various times by not repurchasing shares. We'll see what we do in the future. If it looks like the best thing to do with our money, it's what we should be doing.

In the past, I probably haven't been optimistic enough with respect to Berkshire relative to other things that we could do with the money. However, the money we spent buying the GEICOs and all of that has turned out to be a good use of money, too.

Leveraging up to buy back shares was never an option....

Buffett: And we've never wanted to leverage up. That's just not our game. So we've never wanted to *borrow* a lot of money to repurchase shares. We might advise *others* to do it, but we wouldn't — it's not our style.... We've got all of our money in Berkshire — along with virtually all of our friends' and our relatives' money. Therefore, we never felt that we wanted to leverage up this company like it was just one of a portfolio of 100 stocks.

But it's a valid criticism to say we haven't repurchased shares when we *should* have. And it's also a valid criticism to say we've issued some shares that we shouldn't have....

Munger: I'd agree with *both* comments.

We plain *blew* it on pharmaceuticals....

Shareholder: A few meetings ago, you said that diversification serves as protection against ignorance, that if you aren't ignorant you don't need it, and that it only takes three great companies to be set for a lifetime.

I invested in three great companies: Coca-Cola, Gillette and Disney. Since then, I invested in a fourth — Pfizer — without asking you. What do you think about the pharmaceuticals industry? And do you feel that there are great companies in that industry?

Buffett: We just plain *missed* on pharmaceuticals.... It *was* within our circle of competence to identify the *industry* as one likely to enjoy very high profits over time, but it *wasn't* to pick a single *company*.

However, we probably should have recognized the fact that some sort of group purchase might have made sense. But we didn't do anything about it. We did buy one pharmaceutical company a while back, but it was peanuts.

Munger: Yeah, we stupidly *blew* that one.

Buffett: We'll blow more, too.

HIGH PAST RETURNS MAY EXCITE INVESTORS, BUT IT DOESN'T MEAN HAPPY FUTURE RETURNS.

Two fundamental factors have driven stock prices....

Shareholder: How much do you attribute the gains enjoyed by the stock market these past years to the baby boomer generation investing for their retirement?

Buffett: Personally, I would not think that that's had much to do with it. I think the two big factors — well, there are *three* big factors that pushed stock prices up. First, there was the improved return on equity. That was a fundamental factor.... Second, there was the decline in interest rates. And that was a fundamental factor.

And bull markets feed on themselves: buying begets buying.

Buffett: Finally, [the mere fact that] stock prices [are] advancing *itself* brings in buying. It doesn't go on forever. However, it creates its own momentum to a certain extent.

So two of the factors are fundamental. And the third is a market-type factor — the fact that bull markets feed on themselves. And I think you've seen some *evidence* of that. But I don't think that any single specific factor— you know, the 401K factor or whatever it may be — was overwhelmingly important in creating market price movements.

Money poured into funds, for example. But I think that was because people had a very favorable *experience* with those funds. And that does bring investors along. People want to be on the train. I think, incidentally, that many of them have *very* unrealistic expectations.

But *past* experience doesn't mean happy *future* returns....

Munger: The general investment experience in the last 18 years in common stocks has been *awesomely* high by *any* past standard. Isn't that right, Warren?

Buffett: Since 1982, you've had a 10-fold increase, more or less, in the Dow and probably a similar increase in

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BERKSHIRE HATHAWAY'S
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the S&P. And a huge amount of money has flowed into mutual funds during that time — and more and more participants entered the market all the time.

There are people coming into the market every day because they feel that they missed the boat or they're coming in heavier than they came in before simply because they've had a pleasant experience.

And past experience does not *mean* much in terms of what you should expect from your investments. You'll do well in your investments because you own or bought things at the right price and the businesses behave well from that point forward.

Munger: You won't have 18 *more* years of 17-18% per annum [returns]. That we can virtually guarantee.

A material factor we *don't* include in the annual report....

Shareholder: How much time do you spend playing bridge on the internet?

Buffett: Uh, oh!... We don't include that in the annual report, but it may be a material factor. I probably spend at least 10 hours a week — and maybe a little *more*. I don't get any better by doing it either — which rather disturbs me. But it is a lot of fun.

And it has to come out of my *reading* time. I don't think it's hurt Berkshire yet. However, that may be because we're in a slow period generally. If the market goes down a lot, I promise to cut back on my bridge.

Charlie and I spend the same amount of time goofing off....

Buffett: Charlie?

Munger: Well, I probably play three or four hours a week. But I don't play on the internet.

Buffett: He plays a lot of golf, though. Fess up, Charlie.

Munger: *Oh*, yes.

Buffett: I think we spend about the same amount of time goofing off.

YOU DON'T GET PAID FOR *ACTIVITY*. YOU GET PAID FOR BEING *RIGHT*.

It's been slim pickings in equities for a long time....

Shareholder: You made a comment that if the market fell, you'd spend less time on the internet.... That comment reinforced my impression that ... you've possibly been investing less in the last 12 months.

If I'm right, what does it say about waiting for value? How long are you willing to wait?

Buffett: Well, you're correct that we haven't found anything to speak of in equities in a good many months. As for how *long* we wait, we wait *indefinitely*. We're not going to buy anything just to buy it. We will only buy something if we think we're getting something attractive.

And, incidentally, if stocks generally were 5% cheaper or 10% cheaper, it wouldn't change anything materially.

Valuations (and future returns) aren't exciting in any case.

Buffett: But we have no idea when this period ends. As I've said, these valuations could turn out to be perfectly appropriate if returns on equity stay where they are or rise and interest rates stay where they are or decline.

But even then, today's prices wouldn't have been mouth-watering in the least. We wouldn't feel like we'd missed anything even if returns *did* stay where they are — because even if these valuations turn out to have been OK, they *still* won't produce great returns from here in our view.

You don't get paid for *activity* — only for being *right*.

Buffett: That doesn't mean we couldn't have a *tremendous* market in the *short* term. Markets can do anything. If you look at the history of markets, you see everything under the sun.

But we have no time frame. If the money piles up, then it piles up. And when we see something that makes sense, we're willing to act very *fast* and very *big*. But we're not going to act on anything if it doesn't check out.

You don't get paid for *activity*. You only get paid for being *right*. Charlie?

Periods like today can seem like you're having teeth pulled.

Munger: To experience an occasional dull stretch in our buying is no great tragedy in an investment lifetime. And *other* things may be possible in such an era, too. It isn't like we have a quiver with only one arrow.

Buffett: We've sat through periods like this before. The most dramatic one, I think, was in the early '70s. And it doesn't seem all that long a period when you look back at it, but it seems *extremely* long when you're living through it — similar to when you're having a tooth pulled or something.

But what can you do about it? Businesses aren't going to perform better in the future because you got antsy and decided that you had to buy something. So we'll wait until we find something we like.

And we'll *love* it when we can catch that big whale — because, after all, that's our style.

ONE THING I KNOW: IF THEY DIDN'T SEE IT *COMING*, THEY WON'T SOLVE IT PERFECTLY RIGHT AWAY.

We'll be fine with Y2K. The weak link is *government*.

Shareholder: In your opinion, what effect will the year 2000 compliance issue have on the U.S. stock market and the global economy?

Buffett: Well, I get different reports on 2000. But the main report I hear — and you wouldn't want to rely on me, but you can rely on our managers — is that Berkshire's in good shape. It's going to cost us some money, but not a *huge* amount, to be prepared for 2000.

For the companies on whose boards I serve, I hear some reasonably good-sized numbers. But they're in the respective annual reports....

I'm told by people who know a lot more than I do that the weakest link may be governmental units. They seem to think that in terms of where they stand today relative to where they need to be by 2000, certain areas of national, state, local and *foreign* governments are well behind the

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curve relative to the commercial sector. But, again, that's not an independent judgement of mine.

Ask your telco about 100-year volume discounts....

Buffett: I should probably pass along a warning someone pointed out to me: That person suggested that one should be very careful about making a phone call at five seconds before midnight at the millennium — because you might very well get charged for 100 years.

One of the reasons why we stick with simple things....

Buffett: It'll be *interesting*. I don't think it'll effect Berkshire in any material way. And I have the feeling that the world will get past it very easily. But it is expensive for some companies and *very* expensive for governments....

Munger: I find it interesting that there *is* such a problem. It was *predictable*, after all, that the year 2000 would arrive.

Buffett: We could have told you that back in 1985 actually — although we didn't welcome it, you understand. That's not Berkshire's style.

But it is fascinating when you stop and think about it — that a whole bunch of people with I.Q.s of 160 could *develop* such a problem. However, here we are. And that's one of the reasons why we stick with simple things.

TECHNOLOGY IS AN 8-FOOT BAR I CAN'T CLEAR. AND NO MATTER HOW I MIGHT TRAIN, I *STILL* COULDN'T.

How do our filters deal with *technology*? They filter it *out*....

Shareholder: Last year, you said that you used filters in your mind to help you quickly analyze businesses. How do those filters take account of the very fast changes in technology and the way that businesses communicate with their customers to take orders and things like that?

Buffett: Well, we do have filters. And sometimes those filters are very irritating to people who check in with us about businesses — because we really *can* say "no" in 10 seconds or so to 90%+ of all of the things that come along simply because we have these filters.

First, we want businesses that we can understand. And that filters out a *lot* of things. Second, we want 'em to be good businesses.

How do our filters deal with fast changing technology? Very simply. If something has a significant technological component or we think future technology could hurt its business as it presently exists, we look at it as something to *worry* about. And it won't make it *through* our filters.

Our filters are intended to protect us from our own limits.

Buffett: But we have some filters in regard to *people*, too. We want businesses that are being run by people who we're very comfortable with — which means people with ability and integrity.

And we can do that very *fast*. We've heard a lot of stories in our lives. And it's amazing — you can become quite efficient in probably getting 95% of the ideas through in a very short period of time that *should* get through....

Munger: Yeah. We have to have an idea that is (A) a good idea and (B) a good idea that we can understand. It's that simple. So our filters are filters against consequences from our own lack of talent.

Buffett: And those filters haven't *changed* much over the years either....

For high-tech companies, I *can't* look ahead 10 years....

Shareholder: There seem to be great values in the technology sector that meet *most* of your investment criteria with the exception of *simplicity*... — things like IBM, Microsoft, [Hewlett Packard] and Intel. Have you ever considered investing in companies in this sector in the past and would you ever consider doing so in the future?

Buffett: Well, the answer is no. And it's probably been pretty unfortunate — because I've been an admirer of Andy Grove and Bill Gates. And I wish I'd translated that admiration into action by backing it up with money.

But ... when it comes to Microsoft and Intel, I don't know what that world will *look* like 10 years from now. And I don't want to play in a game where the other guy has an advantage. I could spend all my time thinking about technology for the next year and *still* not be the 100th, 1,000th or even the *10,000th* smartest guy in the country in analyzing those businesses.

In effect, that's a 7-or 8-foot bar that I can't clear. There are people who can, but *I* can't.

However hard I might train, we'd *still* be disadvantaged.

Buffett: The fact that there'll be a lot of money made by somebody doesn't bother me really. There's going to be a lot of money made by somebody in cocoa beans. But I don't know anything about 'em. There are a whole *lot* of areas I don't know anything about. So more power to 'em.

I think it would be a very valid criticism if it were possible that Charlie and I, by spending a year working on it, could become well enough informed so that our judgement *would* be better than other people's. But that wouldn't happen. And no matter how hard I might train, I *still* couldn't. It would be a waste of my time. Therefore, it's better for us to swing at pitches [that are easy for *us*]....

Munger: Whatever you think you know about technology, I think I know less.

Buffett: That's probably not true, incidentally. Charlie understands some things in the physical world a lot better than I do.

WHY SHOULD WE BOTHER WITH EIGHT-FOOT BARS WHEN THE ONE-FOOT BARS PAY JUST AS WELL?

GM was Charlie's biggest holding. He even made money.

Shareholder: Do you have any interest in investing in the auto industry? And if you're not interested, what could change your mind about investing in it in the future?

Buffett: As regards the auto industry, Charlie was big in General Motors in the early-'60s. Right, Charlie? Wasn't it your biggest commitment?

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BERKSHIRE HATHAWAY'S
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Munger: That's right. I had a temporary delusion. Luckily, it passed.

Buffett: You made *money* on it. It's interesting for us to follow. Many years ago, it was *the* dominant factor — the overwhelming factor — in the economy. It's diminished a fair amount since, but it's still a very important industry.

But we've never understood the autos better than others....

Buffett: It's the kind of industry anyone *can* follow. You have experience with the product and everyone in this room understands in a general way the economic nature of the industry. But we've never felt that we understood it better than *others*.

We've seen a lot of companies at very low multiples — sometimes at prices that in hindsight look very attractive. But we never felt we knew who among the auto companies five years from now would have gained the most ground relative to where they are now or gained the most ground relative to what the market expects. That knowledge just isn't given to us. Charlie?

Munger: I agree.

If our predictions have been better, here's why....

Shareholder: What makes a company's P/E ratio move up relative to other companies in its industry? [And] how can we as investors find companies and industries that will grow their relative P/E ratios *and* their earnings?

Buffett: When people become more enthusiastic about a specific business, they'll often bid up its stock and its P/E ratio relative to the P/E ratios of *other* companies. So, in effect, relative P/E ratios move up because expectations about the prospects of a company or industry improve relative to their expectations for other securities....

Munger: I think he also asked how you *forecast* these improvements in price/earnings ratios.

Buffett: That's *your* part of the question, Charlie.

Munger: Around here I would say that if our predictions have been a little better than other people's, it's because we've tried to make fewer of them.

You're paid no premium for degree of difficulty in investing.

Buffett: We also try not to do anything very *difficult*. You get paid just as well.... This is not like Olympic diving where if you can do a very difficult dive, the payoff is greater — if you do it well — than if you do some very simple dive.

That's not true in investing. You're paid just as well for the most simple dive as long as you *execute* it right. So there's no *reason* to try three-and-a-half somersault dives when you get paid just as well for just diving off the side of the pool and going in clean.

So rather than trying to set some Olympic record by going out and jumping over seven-foot or eight-foot bars, we look for one-foot bars to *step* over. And it's very nice — because you're paid just as well to step over one-foot bars.

IF SOMETHING KEEPS YOU AWAKE AT NIGHT, GET IT CORRECTED AND GO BACK TO SLEEP.

A question Buffett always asks....

Shareholder: ...I'm a partner in a consulting business. And we tell clients and potential clients that we design solutions for what keeps them awake at night. Mr. Buffett, as an investor, what keeps *you* awake at night?

Buffett: That's a good question and one, incidentally, which I *always* ask the managers of our subsidiaries — as well as the managers of any new investment. I want to know what their nightmare is.

In Andy Grove's book — *Only the Paranoid Survive* — he talks about the silver bullet for a competitor: "If you had only one silver bullet, which competitor would you fire it at?" And it's not a bad question.

Given our earthquake early warning system, why worry?

Buffett: Your question's a little broader.... I'd say — and I think I speak for Charlie, too — that we really *don't* worry. We just do the best we can.

When we have capital to allocate, sometimes it's very *easy* to do and sometimes it's almost *impossible*. However, we're not going to stay up at night and worry about it — because the world changes.

If we *were* worried about something in the business, we'd *correct* it. We could lose a billion dollars on a California earthquake. But I'm not really *worried* about it — although I do have a sister in the audience who lives in California and have told her to call me quickly if the dogs start running around in circles or anything.

But if you're worried about something, the thing to do is to get it corrected and get back to sleep. And I can't think of *anything* that I'm worried about at Berkshire.

That doesn't mean I have any good ideas as to what we should be doing with a whole lot of money that we have around. But I can't do anything about that except keep looking for things that I might understand.... And if they aren't there, they aren't there. We'll [just] see what happens tomorrow or next week or next month or next year.

The only thing that keeps Warren up? A family illness.

Buffett: Charlie, what are *you* worried about?

Munger: Well, in the 37 years I've been watching you, I would say [that] what makes you not sleep at night is an illness in the family. Short of that.... He likes the game; *I* like the game; and even in periods that might look tough to *other* people, we think it's a *lot* of fun.

Buffett: It's a *lot* of fun....

[Editor's note: Based on your editor's conversations with Buffett, it would certainly seem so. As he's observed, the stock market is periodically gripped by periodic bouts of fear and greed and he and Charlie try to be fearful when others are greedy and greedy when others are fearful.

So we once asked him if he'd ever truly been fearful as an investor and, if so, about what. To our amazement, he said no — as an investor, he'd never experienced fear even *once*.]

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We define "tough times" a little different than most.

Buffett: We [do] define tough times differently than other people. Our idea of tough times is periods like *now*. We don't feel like it's tough times when the market's going down a lot or anything of the sort. In fact, we're having a *good* time then. I don't want to make us sound like undertakers during a plague, but it makes no difference to us whether the price of Berkshire is going up or down.

We're trying to figure out ways to make the company worth more money years down the road. If we can figure that out, the stock will take care of itself. And usually when the stock is going down, it means *other* things are going down and we have a better chance to deploy capital. And that's our business. So you will not see us worrying.

WE VIEW TYPICAL DUE DILIGENCE AS *DIVERSIONARY*.
WE DON'T DO IT — AND IT WOULDN'T HAVE HELPED.

Due diligence ignores factors that are 99% of dealmaking.

Shareholder: When most companies do acquisitions, they feel the need to do a great deal of legal due diligence — things like reviewing leases and checking into things like undisclosed environmental liabilities, threatened litigation. But you've said that you feel no need to do those things. Have you ever been burned by your approach?

Buffett: We've been burned only when we've made mistakes in judging the future economics of a business — which has *nothing* to do with due diligence. We regard what people *usually* refer to as due diligence as boiler plate in most cases. It's a process big companies go through — and feel that they *have* to go through.

But they're ignoring (oftentimes, in our view) what *really* counts — which is evaluating the people that you're getting into business with, the economics of the business, etc. And that is 99% of dealmaking.

I can't recall a single time due diligence would have helped.

Buffett: You may run into an environmental liability problem perhaps one time in a hundred — or a bad lease. I just *ask* them about that: "Do you have any bad leases?" That's the easiest way to do it. And I could read 'em all and look for all kinds of buried flaws and that kind if thing. But ... that's not the problem.

We've made *lots* of bad *deals*. For example, we made a bad deal when we bought a department store operation back in 1966. However, that mistake had *nothing* to do with due diligence. What we were wrong about was the *economics* of the business.

But the leases didn't make a difference. That sort of thing wasn't important. In fact, I can't recall a *single* time that what other people generally refer to as due diligence would have enabled us to avoid a bad deal....

Munger: I can't either.

Buffett: No — in over 37 years.

I regard traditional due diligence as terribly *diversionary*.

Buffett: The idea of due diligence at most companies is to send lawyers out, have a bunch of investment bankers come in and make presentations and things like that.

And I regard that as terribly *diversionary* — because the board sits there entranced by all of that, by everybody reporting how wonderful this thing is and how they've checked out the patents and all of that. But, meanwhile, all too often, nobody's focusing on where the *business* is going to be in 5 or 10 years.

And the diligence will be delivered whether it's due or not.

Buffett: Business judgement about economics — and people, to some extent, but primarily business economics — is 99% of dealmaking. As for the rest — people may go into it for their protection. Too often, they do it as a *crutch* — just to go through with a deal that they want to go through with anyway. And, of course, all of the professionals *know* that. So believe me — they come back with the *diligence* whether it's due or not.

But we're not big fans of that. And I don't know how many deals we've made over the years. But I can't think of anything where traditional due diligence would have had a *thing* to do with preventing mistakes or anything like that.

Munger: No.

The people we deal with may not disclose the *good* things.

Munger: We've even had surprises on the upside — on the *favorable* side — from time to time.

Buffett: Yeah. That's true. The kind of people who we've generally dealt with have usually told us the bad things first and the good things *after* we've made the deal.

We made a deal with a fellow in Rockford in 1969 — Gene Abegg — when we bought the Illinois National Bank and Trust Company. And I made *that* deal in a couple of hours.

And for the next *10 years*, whenever I went over there, he'd tell me about a hidden asset — like a property we owned that wasn't on the books. Basically, it had a lot of assets that he hadn't *told* me about. It was like buying a coat and finding cash in the pockets.

And that's the kind of people we *generally* work with. And no one so far has violated our faith....

NOT ONLY CAN CHARLIE AND I BE *REPLACED*,
BUT OUR SUCCESSORS MAY DO *BETTER*.

Our successors may do *better*. In fact, they're better *now*....

Shareholder: Everybody in this room's gotta be wondering the same [thing]: Who, in your opinion — *both* of you — is the next Warren Buffett?

Buffett: Charlie, who's the next Charlie Munger? Let's try *that* first.

Munger: There's not much *demand*....

Buffett: I don't think there's only one way to succeed in life. Our successors in due time may be different in many ways — and they may do *better*.

We have a number of people at Berkshire — some of whom are in this room today and some of whom you saw on that screen this morning prior to this annual meeting —

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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who are *leagues* ahead of Charlie and me in *various* kinds of abilities. There are many different talents.

There are all *kinds* of things Charlie and I could never do.

Buffett: For example, we've got a fellow in this room today [Bob Hamman] who's probably the best bridge player in the world. Charlie and I could work on our bridge night and day. And if he were to spend 10 minutes or so a *week* working on it, he'd [*still*] play better bridge than we would.

[Editor's note: We had the pleasure of having dinner with Hamman the night before the annual meeting. And not only did he tell us the same thing, but he said that it was essentially *impossible* for anyone to develop the skills necessary to be a world class bridge player — no matter how brilliant they might be and how hard they might work — if they haven't done so by their early 20s at the latest.]

Buffett: There are all *kinds* of intellectual endeavors that for one reason or another, one person's a little bit better wired for than another. For example, we have people running our businesses that Charlie and I couldn't run *remotely* as well. So there are many different talents.

We don't do *much* — only two things....

Buffett: We're only responsible for two functions.... First, it's our job to keep able people who are already rich motivated to keep working at things where they don't need to do it for financial reasons. It's that simple.

That's a problem any of you could think about. And you'd probably be quite good at it if you were to give it a little thought. You could figure out what would cause *you* to work if you were already rich and didn't need a job. Why would you jump out of bed and be excited about going to work that day? And we try to apply that to the people who work with us.

And others can allocate *capital*.

Buffett: Secondly, we have to allocate capital. And these days we have to allocate a lot *more* capital than we had to allocate a decade ago. That job is very *tough* today. But sometimes it's very easy. And it will be easy again at times in the future and it will be difficult at other times.

But there are *other* people who can allocate capital. And we have [some of] 'em in the company.

YOU WANT TO BE THE NEXT WARREN BUFFETT? STUDY ACCOUNTING, LEARN BUSINESS & SAVE EARLY.

First, study *accounting*. Second, get exposure to *business*.

Shareholder: What recommendations would you make to a teenager to help him prepare for his future and have a chance to become as successful as you?

Buffett: Well, if you're interested in business, I definitely think you ought to learn all of the *accounting* that you can by the time you're in your early 20s. Accounting is the language of business. That doesn't mean it's a perfect language. So you have to know its limitations along with all of its other aspects. But I would advise you to learn accounting.

Also, I'd advise you to get exposure and experience in a number of *businesses* — whether it's part time, full time or anything else — because there's nothing like seeing how businesses operate to build your judgement. When you understand what kind of things are more competitive and what kind of things are less competitive and why things work as they do, all of those things add to your knowledge.

And *read* a lot — especially accounting and business....

Buffett: Finally, I'd do a lot of *reading*. I'd do a lot of reading about investments; and I'd get as much business experience as I could. And I'd talk business with people *in* business to find out what they think makes their operation tick and where they have problems and why. Just kind of sop up knowledge every place you can.

And if it turns you on, then you'll do well at it. Different activities grab different people. And if business is what grabs you, my guess is that you'll do well. And if you understand business, you'll understand investments — because investments are simply business decisions in terms of capital allocation. In any case, I wish you well....

And underspend your income — especially early....

Munger: Yeah. There's also the little matter of underspending your income year after year after year.

Buffett: Which we have *mastered*.

Munger: That really works — if you keep *at* it.

Buffett: Charlie started having children at a very rapid rate which makes it harder.

However, [each dollar] that you save before you get out and start having a family is probably worth $10 later on — simply because you *can* save it. The time to save is [when you're] young. You'll never have a better time to save really [than] pre-formation of your family — because the expenditures come along then whether you like it or not. So put the money aside early.

I was very lucky. I didn't have to pay for college. In fact, I probably wouldn't have *gone* if I had. Therefore, I was able to save everything that I made in my teens. And those dollars have multiplied quite a bit.

On the other hand, when I began selling securities, the money I made was taken up by family needs. So start saving early.

WE'RE STUCK WITH A TAX-INEFFICIENT STRUCTURE, ALTHOUGH THERE ARE MITIGATING FACTORS, TOO.

Our structure is very disadvantageous tax-wise.

Shareholder: Could you talk about double taxation and how that impacts Berkshire's investment philosophy?

Buffett: Well, we're structured very *poorly*. If we were going to start all over again and do most of the things we've done, we would probably not do it in corporate form as we've done it....

Our stake in Coca-Cola has a market value of about $15 billion. Those shares cost us closer to $1-1/4 billion. So if we were to sell those shares — and we're *not* going to, but if we *were* — we would incur a capital gains tax of about $5 billion. So, when sold, that $15 billion position would decline to $10 billion of net after-tax proceeds.

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

Also, that $10 billion is reflected in Berkshire's value today. So if you bought your Berkshire when we bought our Coke and sold now, you'd pay a *second* tax in turn in reflection of the appreciation in Coca-Cola that's taken place *after* tax at the Berkshire levels. So having a corporation in between you and the securities is a very disadvantageous way to own securities.

Munger: We have no cure for the corporate... tax.

It's gotten worse — *and* better — recently....

Buffett: And it's become a *bigger* disadvantage since the individual capital gain tax rate went to 20% given our corporate capital gain tax rate of 35%. If we realize $1 of gains on a stock, it immediately becomes 65¢. And if you buy and sell Berkshire, taxes take another 20%. So that 65¢ becomes *52¢* — whereas if you owned the stock directly, you'd be left with *80¢*.

When we owned GEICO on an unconsolidated basis, there was even one *more* layer [of taxation deducted] because GEICO paid a tax on its capital gains, too.

It's just a fact of life with us. And we're *stuck* with it.

Buffett: If Berkshire operated as a partnership, we wouldn't face that disadvantage. I ran Buffett Partnership for many years. And we paid only a *single* tax — at the individual level. Therefore, to the extent that we own marketable securities — and we own a *lot* of them — and to the extent that we have a lot of profits, our stockholders own securities in a disadvantageous way. Relative to owning securities directly or through a partnership, corporate ownership is disadvantageous.

How you're structured does make a real difference. Our corporate form creates a very real drag on performance compared to what it would be if we were a partnership. And we have no plans to do anything about it. We *couldn't*, probably, if we wanted to. We've had it all these years. And, usually, once you get into a given structure, you're kind of *stuck* with it....

Lloyd's syndicates, for example, didn't have that problem. Insurance companies that operate in Bermuda may not have that problem to the same extent. And, certainly, partnerships don't have that problem to the extent they own securities. But it's a fact of life with us. We're going to pay a lot of taxes.

Granted, there are mitigating factors....

Munger: We have no fear of taxes. But it *is* a big disadvantage for the indirect owner of securities.

To the extent your holding periods are very *long*, the real mathematical disadvantage shrinks. And, so far, we've largely surmounted the problem that way.

Buffett: We also have *float* which helps us own them. And that's a *big* plus. We might not have been able to get the float we have if we hadn't operated in corporate form. So that's a mitigating factor, too. However, we prefer to have mitigating factors without anything to *mitigate*.

Munger: Amen.

But we don't own the businesses we own for *tax* reasons.

Shareholder: Mr. Buffett, if a portion of your portfolio were tax exempt — perhaps via a 401K-type plan in the U.S., an RSP-type plan in Canada or something of that sort — would you trade it more actively?

Buffett: If there were *no* capital gains tax, I don't think it would make much difference in what we do. It certainly wouldn't cause us to get trade happy.

We own the businesses we *want* to own. We don't own 'em because taxes have restrained us from selling 'em.

In fact, paying taxes has never really *bothered* me....

Buffett: As I mentioned earlier, I'm fairly sure that we'll pay at least a billion dollars in income tax this year. We might not, but it looks that way to me.

And I could do things that would at least *defer* — and, certainly by doing nothing, I could *avoid* paying that billion, or a good *bit* of ... it — call it $800 million of that billion. But that's not a big factor to me. It's never been a big deal to me. I paid my first income tax at age 13. So I guess I got brainwashed. It doesn't bother me to pay taxes.

Net, personally, I think I'm *under*-taxed in relation to what the society's delivered to me. I don't send along any extra payments to the IRS or anything, but I do feel that way. There's nobody I'd like to trade places with because their tax situation's better than mine.

So it would not increase my trading activity.

WE'RE HOPING TO GROW BERKSHIRE A LOT, BUT WE *DON'T* HOPE TO GROW *HEADQUARTERS*.

Trade lots of little pieces for a little higher stock? Nah....

Shareholder: Would you share your thoughts with us on tax-free spin-offs to shareholders in general. And, particularly, do you believe that a materially higher value would be ascribed to one of your operating companies in the public arena than is ascribed to it as part of Berkshire?

Buffett: Well, there have certainly been times in Berkshire's history when certain of its components might well have sold at higher multiples as individual companies than the amount they contributed to Berkshire's value, although I don't think that would be the case today.

But our reaction to spin-offs would be that even if we thought there would be some immediate market advantage, it would have no interest basically to us. We *like* the group of businesses we have as part of a single unit at Berkshire. We hope to *add* to that group — and we *will* add to it — over time. And the idea of creating a lot of little pieces because we could get a little more market value in the short term just doesn't *mean* anything to us. Charlie?

Our overhead ratio's 1/250th that of many mutual funds.

Munger: Plus, they'd add lots of frictional costs and overhead. And I don't know of anybody our size who has lower overhead than we do. And we *like* it that way.

Buffett: Yeah. Our after-tax cost of running the operation has gotten down to a *half* a basis point of capital. In contrast, many mutual funds are at 125 basis points. That means they have 250 times the overhead ratio — overhead relative to capitalization — that we do.

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BERKSHIRE HATHAWAY'S
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Our #2 and #3 businesses will be the result of opportunity.

Shareholder: You've said your insurance operation is the most important business in Berkshire's portfolio. First, is that true? And second, what are #2 and #3?

Buffett: We said that Berkshire's insurance business would be its most important business by far years ago. And it's proven to be so. Obviously, it got a big leg up when we purchased the part of GEICO that we didn't already own. So insurance as far as the eye can see will be by *far* the most significant business at Berkshire.

Which businesses will be #2 and #3? Well, in terms of earnings, FlightSafety is #2. But we don't *think* of 'em that way. We know our main business is insurance. But we have a lot of fun out of *all* of our businesses. I had a great time at Borsheim's yesterday and at Dairy Queen.

Over the next 10 years, what ends up being the second or third or fourth largest will be an *accident* to some extent that will be determined by *opportunity*.

In the past, we've bid on certain businesses that were sold in negotiated transactions that could have been very large businesses if they'd become part of Berkshire. And we'll do that kind of thing again in the future.

No strategic planning department or even a strategic *plan*.

Buffett: We have no predetermined course of action *whatsoever*. We have no strategic planning department. We don't even have a strategic plan. We react to what we believe to be opportunities. And if it's a business we can understand, particularly if it's *big*, we'd *love* to make it #2....

Munger: I would *also* like to state very proudly that we have no mission statement.

Buffett: It's hard to think of anything we *do* have.

We hope to grow a lot, but *not* at *headquarters*....

Buffett: I'm sure you all know this, but we've never had a *consultant*. We try to keep things pretty simple. We still have 12 people at headquarters. About 40,000 people now work for Berkshire. And we hope to grow a lot. However, we *don't* hope to grow at *headquarters*....

[Editor's note: They aren't kidding. We're told that Berkshire's staff prepares for the annual meeting and all of the related events and administers them all by themselves (in addition to their regular duties) — down to the film shown before the annual meeting (produced by Treasurer Mark Hamburg) and even its vocals (sung by Director Susie Buffett).]

OUR PEOPLE FILTERS ARE VERY IMPORTANT.
AND WE'VE HAD VIRTUALLY *NO* MISTAKES THERE.

The Buffett approach for evaluating honesty....

Shareholder: What do you look for in determining whether a person is honest or not?

Buffett: Well, that's a good question. Generally, Charlie and I can do pretty well with the situations we see. But we have to have some evidence of behavior in front of us. And I would say even that there are some occupations where we might expect to find a higher percentage of people who behave well than in others.

But if we *work* with someone for a few months or more, I think we can have a pretty high batting average in terms of anticipating how they behave. At Salomon, I think I was able to separate out those who I felt very good about from those who I was a little more nervous about fairly quickly among those I worked with actively.

But how do you spot it precisely? Maybe you leave your lunch money out on the desk and see what happens.

Some (like Tom Murphy) bend over *backwards* to be fair.

Buffett: We *like* people — the great example is somebody like Tom Murphy who's bending over backwards all the time to make sure you get the better end of the deal.

That doesn't mean they aren't competitive. If you play him a golf game for either money or seashells, he wants to win in the worst way. But there are people who just don't take credit for things that they didn't do. In fact, they give you credit for some of the things that maybe *they* did. And you can get a feel for it over time.

Charlie, do you have any quick guidelines on that?

You can have the qualities and reputation you want.

Munger: I think people leave track records in life. So somebody your age should figure that by the age of 22 or 23, he'll have left quite a track record — and the world will be able to figure you out. So I think track records are *very* important in life.

And if you start *early* trying to have a perfect record in a simple thing like honesty, you're *well* on the way to success in the world.

Buffett: Gianni Agnelli [former chairman of Fiat] one time told me: "When you get older, you have the reputation you deserve." He said, "You can get away with it for awhile. But by the time anybody gets to be 60 [years old] or so, they very probably have the reputation they deserve."

And it's true — you may not be able to kick a football 60 yards or something of that sort. But you *can* have the reputation you want. And if you list all the things you admire in others, you'll find out that almost all of them are qualities that *you* can have if you just set out to *do* it.

Didn't Ben Franklin do that, Charlie?

Munger: Oh, sure. I always say that the best way to *get* what you want is to *deserve* what you want....

We need sellers to provide management because we *can't*.

Shareholder: Mr. Buffett, you have an ability to motivate people who have a lot of money to keep working. What do you look for to figure out who those people are?

Buffett: That is a *key*, *key* question — because when we buy businesses, we don't have managers to run them. We're not buying them that way. We don't have a lot of MBAs around the office....

Shareholder: Thank *God*!

Buffett: Yeah — that I do know. And I have not promised anyone at headquarters that they're going to have all kinds of opportunities to do things out in the field.

So as a practical matter, we need management *with*

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BERKSHIRE HATHAWAY'S
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the businesses that we buy. And three times out of four or thereabouts, the manager is the owner and is receiving tens of millions — maybe hundreds of millions — of dollars. So they don't have to work.

The key question: Is it the *business* they love or the *money*?

Buffett: So we have to decide if it's the *business* that they love or the *money*. We're not making a moral judgement — Charlie may, but I'm not.... However, it's very important for us to know which of the two is the primary *motivator*.

And, then, all we do is avoid doing anything ... that diminishes their love of the business or makes conditions so intolerable that they'll *come* not to love it. We have people working for us with *no* financial need to work at all. Yet they probably outwork 95% or more of everyone else. Why? Because they love smacking the ball. And we've had *extremely* good luck identifying those people — the people who love their business.

We've also managed to identify the *other* people in the proposals they've sent us — where we felt that they liked the money better than the business. In many of those cases, we felt that they were kind of tired of the business.

They might promise us that they'd continue to run it. And they'd do it in good faith and all. But six months or a year later, they'd think, "Why am I doing this for Berkshire when I could do whatever else it is I *really* want to do?"

We've had virtually *no* mistakes in that respect.

You can't bat 1.000, but you *can* recognize the extremes.

Buffett: I can't tell you exactly what filter we put 'em through to avoid that situation. But if you've been around, you can have a pretty high batting average when it comes to reaching the right conclusion in that situation — just as you can about other aspects of human behavior.

I'm not saying that you can take 100 people and take a look at 'em and analyze their personalities or anything of the sort. But I think when you see the *extreme* cases — the ones that are going to cause you nothing but *trouble* and the ones that are going to bring you nothing but *joy* — well, I think you can identify those pretty well. Charlie?

Munger: Yeah. Actually, I think it's pretty simple: There's integrity, intelligence, experience and dedication. That's what human enterprises need to run well. And we've been very lucky in getting this marvelous group of associates to work with all these years. It would be hard to do *better*, I think, than we've done....

THE SCARCE COMMODITY IS TALENT. SO WE *WANT* 'EM TO DO IT THEIR WAY.

When somebody's a .375 hitter, we leave well enough alone.

Shareholder: Mr. Buffett, do you have the managers of your non-public operating investments submit annual business plans? If so, do you formally meet with those managers to track their progress against those plans?

Buffett: That's a good question. We meet with one or two annually and one semiannually. But we have no formal system whatsoever and never will. We don't demand any meetings of *any* of our managers. We have no operating plans submitted to headquarters. Some of our companies use operating plans themselves and some don't.

They're all run by people with terrific records. And they all have different batting styles. But when managers are career .375 hitters, we're not about to tinker with their styles just because they hold the bat a little differently, use a different weight bat or anything of the sort. We just believe in letting them do currently and in the future what's worked so successfully for 'em in the past.

There's more than one way to get to business heaven.

Buffett: Different people have very different styles. I've got *my* own style. Some of our managers like to talk things over. Others like to go their own way. Some have a by-the-book approach. Others wouldn't dream of operating that way. Most prepare monthly statements. Others don't. And that's fine with us. What we want is good *managers*.

There's more than one way to get to heaven — at least there is to get to *business* heaven. And we have a number of managers who've found different ways to get there.

Talent's what's scarce. So we *want* 'em to do it their way.

Buffett: We have *certain* requirements simply because we're a public company — SEC requirements and Internal Revenue Service coordination, for example. However, we've never imposed anything from the top down on *any* of our operating managements.

We have some people running companies who have MBAs. And others have never seen a business school. The scarce commodity is *talent*. So when we find talent and they have their own way of doing things, we're *delighted* to have 'em do it. In fact, we're *more* than delighted. We *want* 'em to do it their way....

We centralize *money*. Everything else is *de*centralized.

Munger: Yeah. We've decentralized power in our operating businesses to a point just short of total abdication... Our model's not right for everybody, but it's suited us and the kind of people who've joined us.

But we don't have criticism for others — such as General Electric — who operate with plans, compare performance against plans and all that sort of thing. That's just not *our* style.

Buffett: Yeah. We centralize *money*. Everything else is pretty much *de*centralized.

I can't improve Al's decisions. So why should I try?

Buffett: I don't know whether you met him or not, but Al Ueltschi is here today. He started FlightSafety in 1951. And I don't know what he'll spend on simulators this year, but it could *easily* be $100 million.

But if I spent hours with him, I couldn't add 1/*100th* of 1% to his knowledge about how to allocate that money. It'd be ridiculous. It would be a waste of time on his part and an act of arrogance on mine. I have no worries about how Al allocates the money. And FlightSafety is unusually capital intensive relative to most of our businesses.

If they can't cut it, we replace the manager, not the system.

Buffett: I get into the details of some of our businesses more just because I've worked with the person

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BERKSHIRE HATHAWAY'S
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running things a long time and I enjoy it. For example, Ajit and I talk nearly every night about reinsurance. And I'm not improving the quality of his decisions at all. But it's an interesting game and I like hearing about it and he doesn't mind talking about it. So we talk it over. But that's just a matter of personal chemistry.

As we add managers, *we*'ll adapt to *them*. We've adapted our accounting systems to a degree to them, although there are requirements from the SEC and the IRS.

Our managers know their businesses. And they know how to run 'em. If they didn't — which hasn't been the case — then we'd do something about the manager. We wouldn't try and build a bunch of systems.

LARGE COMPENSATION PER SE ISN'T THE PROBLEM. WHAT CAN BE OBSCENE IS WHEN IT'S *IRRATIONAL*.

I have no beef with paying lots of money for performance.

Shareholder: My question doesn't pertain to Berkshire. But would you explain the justification for the exorbitant salaries, bonuses, perks, directors' fees and other benefits that most corporations are paying?

Buffett: We have no quarrel with our subsidiaries paying lots of money for outstanding performance — because we get it back 10 or 20 or 50 to 1. Similarly, in public companies, we think that there have been — and are today — managers who've taken companies to many, many, many billions of dollars of market value more than would have happened with virtually anyone else.

Sometimes they take a lot of money for doing it. And, sometimes, as with Tom Murphy at Cap Cities, they don't. His performance justified *huge* sums. But he'd tell you that he had all the money he needed and that he didn't care to *take* what the market might bear. It just wouldn't have made a difference to him.

What bothers me is *irrational* compensation. It's *obscene*.

Buffett: In *my* view, the most egregious examples [don't] involve the biggest numbers. What bothers me the most is when companies pay a lot of money for mediocrity. And that happens all too often.

But, again, large sums per se don't bother me. I'm not saying whether an individual should want to take those large sums or not. But I don't mind paying lots of money for performance. After all, it's done in athletics and it's done in entertainment.

What bothers me is *irrational* paying systems. And I'm particularly bothered when average managers take really large sums. I'm bothered when those managers design or have designed systems which are very costly to the company — maybe partly to make themselves look good because they want huge options themselves.

So they distribute huge numbers of options widely throughout the company. And they design a system that is illogical *company*-wise because they want one that's illogical for them *personally*. Therefore, lots of 200 hitters and people who *wouldn't* attract a crowd as an entertainer have worked it out — the system's evolved in such a way — that many of them earn huge sums. I think that's *obscene*.

But it isn't going away any time soon.

Buffett: But there isn't much you can do about it. The system feeds on itself. Managers at one company look at other companies' proxy statements. And every CEO says, "If Joe Smith is worth X, I have to be worth more." And they tell the directors, "You certainly wouldn't hire anybody who was below average. Therefore, how can you pay *me* below average?" Then the consultants come in and ratchet up the rewards.

And it's not going to go away. As with campaign finance reform, the people with their hands on the off switch are the beneficiaries of the system. And it's very hard to change a system when the guy whose hand is on the switch benefits enormously and, perhaps, disproportionately *from* that system. Charlie?

We didn't follow the standard procedure for compensation.

Munger: Yeah — exactly. Commodore Vanderbilt behaved even better than the folks at Berkshire. He didn't take any salary at *all*. He thought it was *beneath* him as a significant shareholder to take a salary. However, that idea went to the grave with him.

Buffett: We pay our directors $900 a year. But I tell 'em that on an *hourly* basis they're making a fortune. (We don't work 'em that hard.)

But when we established that $900 per year, Charlie and I didn't think it through — that they set *our* salaries. So we haven't followed the standard procedure which is to load it on the directors so the directors will load it on you.

The effects of irrational compensation will be widespread....

Munger: I do think it will have pernicious effects on the country in its entirety as management pay keeps escalating because I think you're getting a widespread perception that the very top corporate salaries in America are obscene. And it is not a good thing for a civilization when the leaders are regarded as not dealing fairly with those for whom they are stewards.

As for the compensation consultants who advise them on those salaries — well, all I can say is that for them prostitution would be a step *up*.

Buffett: Put him down as undecided.

BECAUSE OUR MANAGERS DO WHAT *THEY* DO BEST, BUFFETT CAN FOCUS ON WHAT *HE* DOES BEST.

We never tell a sub's manager which vendor to patronize....

Shareholder: After you bought Dairy Queen, I heard that they put Coca-Cola into all the stores. But yesterday, when I went into Nebraska Furniture Mart, they said that they don't take American Express. Do you encourage your subsidiaries and the companies in which you own stock to use each others products? Or do you leave it up to each respective management?

Buffett: That's a good question. And it tells you something about how Berkshire operates. Borsheim's and See's take American Express. The Furniture Mart doesn't. We want the manager of each subsidiary to run their business in the way they think is best for their operation.

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BERKSHIRE HATHAWAY'S
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If Harvey Golub (who happens to have done a sensational job at American Express) wants to have his representatives talk with anybody at any of our operations, we'd be all for it. But we'll never tell a subsidiary manager which vendor to patronize or anything of that sort.

The operation's *their* responsibility. That's how we *like* it....

Buffett: Once we start making those decisions for our managers, *we* become responsible for the operation and they're no longer responsible for the operation. And *they're* responsible for their operations.

That means that they get to make the call, that it's up to them to do what's best for their subsidiary and that it's up to any other company that wants to do business with their operation to prove to them *why* it's best....

That's the Berkshire approach. I think, on balance, our managers *like* it that way — because they're not going to get second guessed and nobody will go over their heads.

I get letters all the time from people who are trying to jump over the heads of our managers. And they want us to tell them that this advertising agency should be used or that product, etc. But that doesn't work at Berkshire. They deal with the managers of the businesses. And they're not going to get around 'em. Charlie?

Munger: I *love* hearing that. It gives Warren lots of time to read annual reports at headquarters.

I have a good time investing, but if I had to choose *one*....

Shareholder: I have a hypothetical question: The Justice Department rules that Berkshire must split into two parts.... You can ... keep your marketable securities — Coke, Gillette, Disney, etc. — or your insurance and private businesses. Which do you ... keep and why?

Buffett: That's an easy question for me. I'd choose the operating businesses any time — because they're more *fun*. I have a good time with the investments, too. But I like being involved with real people in the businesses where they're a cohesive unit that can grow over time.

I *wish* we owned all of Disney or Coca-Cola or Gillette, but we aren't going to. So if I had to give up one, I'd give up the marketable securities. But that's not going to happen. And we're going to be happy in both arenas..., I look forward to being in *both* arenas for the rest of my life....

Munger: Well, I'd be in a *helluva* fix if I weren't in the same arena.

(continued in next column)

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Buffett: We'd *both* be in a helluva fix.

FOCUS ON THE UNIMPORTANT OR UNKNOWABLE
AND YOU'LL MISS THE THINGS THAT *REALLY* COUNT.

If it's not important and knowable, we don't think about it.

Shareholder: What is your outlook for the world financial business environment and the U.S. position in terms of economic competition in the next decade?

Buffett: Well, you've asked two very big questions. But I'm afraid you're going to get very small answers.... No disrespect intended, but we don't *think* about those things very much. We're just looking for pieces of businesses. Frankly, our views on those subjects in the past haven't been any good anyway.

We try to think about things that are both *important* and *knowable*. There are important things that are not knowable. In our view, your questions fall in that category. And there are things that are knowable, but not important — and we don't want to clutter up our minds with those.

We ask ourselves: "What's important and knowable? And what among those things can we translate into some kind of action that's useful for Berkshire?"

There are all *kinds* of important subjects that Charlie and I don't know anything about. And therefore, we don't think about 'em. Our view about what the world will look like over the next 10 years in business or the state of U.S. competitiveness — we're just no good [at that].

Some things we think we *do* know....

Buffett: We *do* think we know something about what Coca-Cola's going to look like in 10 years — or what Gillette, Disney or some of our operating subsidiaries are going to look like in 10 years. We care a *lot* about that. We *think* a lot about that. We want to be *right* about that.

If we're right about that, then the other things become less important. And if we're focusing on those other things, then we'd miss a lot of big things.

You could always find a reason *not* to buy Coca-Cola....

Buffett: I've used this example before. But Coca-Cola went public in — I think it was — 1919. One share cost $40. But in the first year, it went down a little over 50%. At year end, it was down to $19. There were some problems with bottler contracts, there were problems with sugar — various kinds of problems.

And if you'd had perfect foresight, you'd have foreseen the world's greatest depression staring you in the face. The social order even got questioned. You would have seen World War II. You would have seen atomic bombs and hydrogen bombs. You would have seen all *kinds* of things. And you could have always found a reason to *postpone* buying that share of Coca-Cola.

If you took your eye off the ball, you missed a great ride.

Buffett: But the *important* thing was to see that they would be selling a billion 8-oz. servings of beverages a day this year — or some large number — and that the person who could make people happy a billion times a day around

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

the world ought to make a few bucks off *doing* it. So that $40 share that went down to $19, I think, with dividends reinvested would be worth well over $5 million today.

If you developed a view on these other subjects that in any way forestalled your acting on this more important, specific, narrow view about the future of the *company*, [then] you would have missed a great ride. So that's the kind of thing we focus on. Charlie?

Munger: Yeah. We're not predicting the *currents* that will come — just how some things will swim *whatever* the currents may be.

GREAT HISTORIC EVENTS DON'T LEAVE ME A CLUE, BUT I LIKE *OUR* GLOBAL BUSINESSES JUST FINE.

Anticipating the impact of big events is *very* hard....

Shareholder: Your teacher and mentor, Ben Graham, changed his valuation standards over time — in part because the environment changed.

Today, the world is a much different place than it was in 1989 when the USSR collapsed. With free enterprise expanding and accelerating around the world, might the resulting expansion of world trade lead to a reevaluation of historical measures or, maybe, even our investments?

Buffett: Well, I doubt it. However, I also don't know.... All *kinds* of events happen. And anticipating their impact [is] ... *very* difficult.... It's very difficult to isolate any single variable in a complex economic equation. And how the world will work 10 years from now or what returns on equity will be at that time — I don't know *what* all the variables will be that impact on that.

Obviously, people are very bullish about those returns — or something like them — continuing. But in making such projections, I wouldn't rely on the Cold War having ended or any political or economic development.... When I look at great historic events, nothing I see gives me much of a clue as to which ones would signal major changes in the profitability of American business.

Increasing world prosperity will aid Cokes and Gillettes....

Munger: You raise a very interesting question: If the rest of the world becomes very much more prosperous — as it will with the spread of the free enterprise system — which investments are likely to do best? I'd argue that the Cokes and Gillettes [of the world] are likely to be helped by a great increase in prosperity in what is now the Third World. And I'm not so sure that's true of all businesses.

Buffett: We like our international businesses. Our three top holdings all have a major international aspect to them. Really, in aggregate, they're *dominant* internationally. And there's no question in my mind that Coke — and Gillette and American Express, for that matter — will grow faster outside the U.S. And that's built in to our evaluation of those businesses. But I felt that way *before* 1989, too.

Nobody does it better. And no one is *going* to do it better.

Buffett: It's hard to evaluate how the ball will bounce around the world. But it's a plus to have products such as those that Gillette and Coke have which have demonstrated that they travel *extraordinarily* well around the world. You know that people crave those products.

And no one in those fields is going to find a way to do it better than those two companies. Plus, they're selling inexpensive products. So all those things are going for us.

But in terms of predicting how stocks generally sell or the future profitability of American business generally, our opinions aren't worth much.

THE TRICK? GET MORE QUALITY THAN YOU PAY FOR. AND IT'S JUST THAT SIMPLE, BUT IT'S NOT EASY.

A 3-5 year time frame is too close to the greater fool theory.

Shareholder: I've been to three annual meetings. And I've heard you say great things about Coke every year. But as far as I know, you haven't bought any more shares of Coke over the last three years.

If an investor has a relatively short time frame — say 3-5 years — how much weight do you think one should give to quality versus price?

Buffett: Well, I wouldn't advise you to *think* that way. If you have a 3-5 year time frame — if it's really that short — I think you're leaning towards the greater fool theory.

[The question to ask yourself when you're thinking about any investment is how you'd feel about investing your family's entire net worth into it and owning it forever.] We basically believe that when you're talking about quality, [you're talking about] the level of certainty you have that a business will perform as you *expect* it to perform over a very long period of time.... And that's the kind of business that we like to buy.

Quality vs. price? We want quality *and* a comfortable price.

Buffett: How much weight should one give quality vs. price? All I can say is we like to pay a comfortable price. And that depends to some extent on interest rates. But for the last year, we haven't been able to find the kind of businesses we like at prices that we find comfortable.

We don't find 'em uncomfortable in the sense that we have no desire to *sell* the ones we already own. But we're not comfortable *buying* 'em at their current prices either.

The trick is to get more quality than you pay for in price.

Buffett: We added to our position in Coke one time about — I don't know — five years ago or thereabouts. And, conceivably, we'll add again. However, it's also conceivable that we would *subtract*. And that's how we feel about most of our businesses.

We did make a decision [along those lines] last year: We thought bonds were relatively attractive. And therefore, we trimmed certain holdings and eliminated a small holding in order to make a bigger bet on bonds. Charlie?

Munger: Yeah. You asked about quality versus price. The investment game *always* involves considering both quality and price. And the trick is to get more quality than you *pay* for in price. It's just that simple.

Buffett: But not *easy*.

Munger: No, but not easy.

— OID

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GARDNER INVESTMENTS'
TOM RUSSO
(cont'd from page 1)

IF THE COMPANIES AND THEIR PRICES ARE RIGHT, THE THEMES WILL TAKE CARE OF THEMSELVES.

Global markets and commodity markets are in turmoil.

Tom Russo: As I write this, many global financial markets are in turmoil. Dollar-based investors' holdings in emerging market equities and debt have declined by 90% and more over the past 18 months. Recently, fast-growing economies of Asia, Latin America, Eastern Europe and South America have been slowing dramatically. Commodity prices of all kinds (e.g., oil and gas, pulp, paper, timber and metals) have fallen sharply — in some cases to 20-year lows — in response to weakened demand. El Niño storms that plagued much of the world have seemingly sired offspring that now roil investment markets.

Investors seemed to think this time *would* be different.

Russo: Not very many months ago, I encountered questions from a growing number of sources about whether "this time around" American investors would face "different" prospects. The argument that this time around would be different seemed to placate U.S. investors' fears that uncertainties in other regions of the world would somehow affect their capital. Reasons cited were many:

First, Asia's economic downturn would result in such excess capacity that products would arrive at our shores at ever-lower prices, increasing American purchasing power. Second, economic turmoil abroad would lead flight capital to U.S. equities, debt and the U.S. dollar in search of a safe haven — driving up the values of all three....

Third, the wondrous effects of technology would lower our operating costs, enhance our productivity and insulate our economy from any downturn. (By the way, this last point seemed to receive daily confirmation in the market where shares of software, hardware and, most dramatically, internet companies advanced relentlessly — despite struggles in foreign markets and the share prices of companies in prosaic industries such as energy, aerospace, basic manufacturing, homebuilding supplies, etc.).

But it's looking less and less different today.

Russo: Events of the last few weeks, not surprisingly, have silenced questions about whether "this time around will be different." Both major U.S. market indices (the Dow and the S&P) have beaten full retreats — with both off nearly 20% from year-earlier highs and both down for the year (roughly 4% for the Dow and slightly less for the S&P). Broader U.S. indices (the Nasdaq and Russell 2000) are also down for the year — 4% and nearly 20%, respectively). Foreign markets have in many cases retreated even farther — especially emerging markets.

We're happy to pass up the parties *and* the hangovers.

Russo: As an investor, I prefer not to spend my time and energy on such thematic concerns as whether and why this time around differs from previous investment eras. Rather, I prefer to focus on finding opportunities where prospects for cash-flow returns from our investments are available at low prices relative to prevailing interest rates. Keeping my attention riveted on the business prospects of our existing positions and of prospective new investments and trying to avoid companies for whose prospects markets demand too high a price keeps my investment research more focused on what is knowable and important.

This keeps us from enjoying periodic booms. However, it's also sheltered us from the busts that so often follow when the investment "themes" run out of steam. That's been as true year-to-date as it's been in prior booms and busts related to prior themes. (Note that it wasn't long ago that the "Asian Tigers" theme encouraged so much U.S. capital to flow into those then-booming markets)....

How? By paying low multiples of quality earnings.

Russo: First, we remain focused on companies selling at below-average multiples of their price-to-cash earnings. That's historically kept us out of Asian markets — where the promise of fast growth came only at the price of expensive P/E multiples.

Second, we focus on companies whose earnings convert to cash in a fairly steady, predictable manner. This emphasis on cash earnings helped us avoid recent financial calamities involving companies whose reported "earnings" proved misleading due to vagaries of acquisition-related accounting.

And by buying powerful, recession-resistant franchises.

Russo: Third, we focus on companies whose products enjoy demand which is buffered from the sharp swings economic cycles create for the demand of the products of most companies. For example, people rarely defer decisions to eat cereal, read newspapers, drink, smoke, etc., based on declines in the growth of GDP.

If economic trouble persists, consumers may substitute or switch one brand or product for another. Nonetheless, companies with strongly branded products or powerful franchises — e.g., a monopoly newspaper — tend to be better able to combat such pressures.

Fourth, we've long benefitted from offsetting patterns of returns offered by our non-U.S. investments — which largely consist of European and Canadian companies....

WE DON'T WANT TO ADD NEW HOLDINGS IN HASTE AND REPENT FOR WHAT WE BOUGHT IN LEISURE.

At our companies, there's a lot to like....

Russo: I like our companies. I like their managements. In many instances, those managements are sizeable shareholders who think first and foremost about building shareholder value. I like their products.

But who wouldn't like the thought of providing so many daily essentials. We serve breakfasts. We deliver news daily — both through newspapers and television. We provide entertainment of all sorts. We help with daily financial matters — banking, brokerage and insurance. And we serve food, beverage and tobacco products to people all over the world on a daily basis.

I like their business prospects — both in domestic and foreign markets. I like their geographic range and diversification. I like their honest accounting and the fact

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GARDNER INVESTMENTS'
TOM RUSSO
(cont'd from preceding page)

that their reported profits convert fairly quickly to cash. Finally, by and large, I like their current market valuations despite, in many instances, the significant appreciation that they've enjoyed over the years of our involvement.

It's not surprising, therefore, that in the face of enormous financial turmoil in markets around the world that my investors have seen little, if any, portfolio activity. The fact remains that I like what we have, I like how our businesses have been managed to build shareholder value, and I like our forward-looking prospects — even in the face of changed circumstances around the world.

We're looking hard, but we don't want to di-worse-ify.

Russo: That's not to say that there aren't intriguing new opportunities for investment. Indeed there are. Countless fine domestic companies have seen the prices of their shares halve over the past 12 months. And businesses abroad — adjusted for collapsing currencies — have fallen even farther.

And the search for new portfolio investments has intensified in this environment as I continue to seek ways to commit our remaining cash balances. Nonetheless, our hurdles remain high to insure that investments added to our portfolio, despite the "for sale" prices in today's market, indeed do increase the long-term value of our holdings....

FIRST, LET ME GIVE YOU THE *BAD* NEWS — WE OWNED FINANCIAL SERVICES COMPANIES.

I believe Travelers and Morgan still have what it takes....

Russo: Following my own preference for hearing the bad news first, I offer you the following comments on our financial services holdings — given their recent pull-backs — even though our financial services positions are not nearly as large as our core holdings in food, beverage, tobacco and media companies.

Travelers and Morgan Witter Discover have fallen dramatically over the past several weeks — reflecting broad concerns regarding potential trading exposure to Russia, Asia and emerging markets and fears about the loss of future activity should investment markets pull back indefinitely. Given its recent acquisition of Citibank — whose business franchise abroad, particularly in developing markets, is unmatched — the market particularly fears Travelers' double exposure.

But I believe Travelers and Morgan Witter Discover remain interesting. Both possess strong global franchises. Both are managed by owners with significant personal wealth tied up in their own shares. Both have substantial cost-savings steps ahead resulting from merger economies. And both stand prepared to repurchase shares in the face of the market's despair over their immediate prospects.

Whatever the market says, the General Re deal will help.

Russo: Berkshire Hathaway is in the midst of merging with preeminent reinsurer General Re in a deal which will wed Berkshire's investment prowess with that of General Re in insurance sourcing and underwriting. While not directly comparable, Berkshire's experience following its "takeover" of GEICO shows the power available from such combinations.

However, for now, arbitrage activity surrounding the stock-for-stock merger along with concerns over recent declines in shares held by Berkshire — e.g., Coca-Cola, Gillette, etc. — have pressured Berkshire's share price.

I'm confident the General Re deal will build Berkshire's value and that future portfolio investments by Berkshire's soon-to-be-enlarged portfolio face better, not worse, prospects in light of today's stock market declines.

And things are better at Wells, not worse....

Russo: Wells Fargo shares have participated in the broad retreat of commercial banking shares despite prospects that its merger with Norwest will allow it to extract economies and continuing sharp improvements in the economy of its core California banking region....

In effect, the recent pull-backs in the share prices of our financial services companies leave them trading at what I believe to be reasonable values.

INVESTORS MAY *SELL* U.S. NEWSPAPERS, BUT THEY PROBABLY SHOULDN'T....

Investors *may* sell newspapers in fear, but they *shouldn't*.

Russo: Having performed extremely well in 1996 and 1997, our domestic newspaper company investments have had relatively flat stock market performances in 1998 — despite continued success in advertising lineage and revenue growth.

Two fears have been behind such flat performances in our U.S. holdings: fear of rising newsprint prices and fear of the potential impact an economic slowdown could have on advertising demand.

But in foreign markets, additional newsprint capacity has come on-stream just as economic slowdowns have reduced the demand for local newsprint. Therefore, that excess low-cost newsprint capacity remains available — and threatened increases in the price of newsprint have largely remained more threat than reality.

Advertising revenue growth rates, on the other hand, have slowed in part so far year-to-date. However, that slowdown is only relative to the very high growth rates that they've enjoyed over the past several years.

Our newspapers would love to buy back their stock cheap.

Russo: Also, many of our newspapers remain in the midst of consolidating delivery forces and reducing their costs through the closure of evening papers, etc. — all steps which are destined to improve operating margins. Furthermore, most of our U.S. newspaper companies are strong financially, cash rich and anxious to take advantage of major sell-offs in order to repurchase their shares.

Thus, I remain comfortable with our major holdings in

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GARDNER INVESTMENTS'
TOM RUSSO
(cont'd from preceding page)

Central Newspapers and E.W. Scripps and lesser positions in several other North American newspaper companies.

Growth remains strong in Europe — *very* strong at Telegraaf.

Russo: Our major international newspaper holding, Telegraaf, has enjoyed extremely robust trading conditions year-to-date. I visited with its management this summer and came away convinced they were enjoying a strong year for advertising.

Europe's economies are experiencing considerable growth following a prolonged period of lower interest rates. The Netherlands is in the midst of a rate-induced boom resulting in sharp increases in advertising, particularly personnel advertising — a field Telegraaf dominates.

And late last week, Telegraaf reported sharp rises in mid-year operating income (up 35%) and net income (up 47%) on the back of sharply higher advertising revenues. Moreover, like its U.S. counterparts, Telegraaf continues to take steps to improve its operating efficiencies — most recently closing an evening newspaper based in Amsterdam once they decided merging with the dominant morning paper wouldn't unduly risk circulation or ad revenues.

Its price is still dirt cheap — even *before* stock buybacks....

Russo: Telegraaf's appreciated nearly 25% year-to-date and more than five times since we first invested in it. However, its enterprise value remains less than five times its earnings before interest, taxes, depreciation and amortization [EBITDA].

That represents a considerable discount — both to its domestic and international peers. Moreover, Telegraaf has enormous excess reserves of cash and other investments which could be profitably returned to shareholders via share repurchases if and when Dutch corporate laws so permit and Telegraaf's management becomes convinced of the wisdom of such repurchases.

COMCAST'S STOCK PRICE IS UP SUBSTANTIALLY.
BUT SO IS ITS *VALUE* — E.G, NOTE THEIR BUYBACKS.

Comcast's stock is up, but so are its reported earnings....

Russo: Comcast remains our major holding in the cable/broadcasting/media arena. Comcast recently announced record operating results for its second quarter — though the full benefit of those results did not convert directly to reported profits as a result of growing losses in its affiliated businesses (e.g., Sprint/PCS).

Comcast remains prepared to monetize non-operating holdings as evidenced by discussions underway to monetize Sprint/PCS. Comcast has realized value over the past few years in similar fashion through the sale of its holdings in Teleport in return for shares of AT&T, through sale of its stake in a United-Kingdom-based cable TV operation, etc.

While Comcast's shares have appreciated substantially since our initial investment in late 1996, events continue to unfold in the cable television business that support our continued investment. Recent acquisitions by private buyers of major cable companies have taken place at ever higher levels.

Mgm't's shareholder-value oriented — & buybacks prove it.

Comcast continues to grow its own cable operation through the purchase of large adjacent systems (cf., recent Jones Intercable acquisition). Comcast continues to expand its high-speed-data Internet activities in partnership with @Home. Comcast's cable retailing venture — QVC — continues to expand in its home market, in new markets abroad such as the United Kingdom and Germany and in new channels such as the Internet-based iQVC.

Given their considerable investments in the business — both on a reputational and a net-worth basis, I remain convinced that the Roberts family runs Comcast with shareholder value in mind. The recent announcement of a $500 million share buyback program confirms their willingness to take advantage of market uncertainties when their share price falls below their intrinsic value.

TOBACCO'S COME A LONG WAY IN THE PAST YEAR.
— AND A SETTLEMENT WOULD BE A PLUS, TOO.

A series of victories for tobacco — first, regulation-wise....

Russo: Tobacco investments remain an important part of my investment activities. Despite the turbulent political, regulatory and increasingly hostile environment which such investments have faced over the past 18 months, Philip Morris remains our major holding in this category based on its valuable global tobacco, food and beverage franchises and its shareholder-minded management.

Since my last letter, I had the chance to spend time with Philip Morris senior management — a welcome event since they've scaled back their investor communications as they work towards a comprehensive Federal settlement of litigation claims.

Philip Morris Chairman Geoffrey Bible confirmed to me how far the company and industry have come in the past 12 months via a series of hard-fought legal victories:

For example, on the regulatory front, a Federal court reversed prior decisions that had authorized the FDA to oversee tobacco. A Federal court in Virginia also ruled that the EPA's efforts to restrict workplace smoking were based on faulty science — thus removing support for the most zealous anti-smoking measures.

A still unbroken record of victories in individual lawsuits....

Russo: On the individual-lawsuit front, upper courts overturned widely publicized plaintiff verdicts that had awarded plaintiffs' damages in the Florida jurisdiction which has proved to be so inhospitable to the industry.

[Editor's note: We understand one of the reasons why Florida's been so inhospitable to the tobacco industry is its adoption of a novel legal framework which provides for the award of damages to a plaintiff in the event of *any* contribution to an injury no matter how small — even 1%.

If so, plaintiffs could sue nearly *anyone* — McDonald's for "peddling" high fat food and contributing to higher cholesterol levels and, therefore, heart disease; Coca-Cola for "promoting" caffeine usage and thus increasing the incidence of cancer; media/publishing companies for

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GARDNER INVESTMENTS'
TOM RUSSO
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"glamorizing" drug use, violence or anything else, etc.

But, as Constable Partners' John Constable observed in our June 30, 1988 edition, cigarette firms may actually have *less* exposure than most companies thanks to Congress having required them to include very specific warnings on their packages for more than 30 years.]

Russo: These reversals leave the industry with a now unbroken record of defense against individual suits.

There's even growing resistance against class-action suits.

Russo: On the private class-action front, numerous jurisdictions — including Florida and New York State — have decertified suits against tobacco defendants finding that tobacco-related personal-injury suits are ill-suited for class actions given the predominance of individual issues over common issues and the unmanageability of such large class actions.

Even much-discussed state Attorneys General suits seeking recovery for Medicare/Medicaid payments allegedly made for tobacco-related health care costs have encountered growing resistance. Indiana and Washington are but two states which have recently thrown out such claims on the part of state Attorneys General. Nine states have dismissed similar claims filed by unions on behalf of their members for similar medical claims.

The industry has slowly and constantly argued that constitutionally protected legal defenses must remain available even to unpopular defendants — such as the tobacco industry today. And their efforts have succeeded in laying to rest many of the industry's worst fears.

Tobacco settlement would be a plus. It almost *can't* hurt.

Russo: The industry nevertheless continues to pursue efforts to enter into an all-encompassing settlement with all state Attorneys General to remove ongoing threats and disruptions from such remaining lawsuits and provide greater certainty in the domestic cigarette marketplace.

Costs for such a settlement would increase consumer prices for tobacco products and reduce their affordability, particularly among the youngest smokers whom all agree should be discouraged from smoking. Though increases in retail prices to fund such settlements will not be available to underwrite future growth in the industry's profits, the protection from potentially-bankrupting suits provided by such a settlement ought to increase the market's valuation of the U.S. tobacco industry. (Any increase in valuation would be positive — as Philip Morris' domestic tobacco business is afforded nearly no value whatsoever at today's share price!)...

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And Philip Morris ain't just domestic tobacco anymore....

Russo: On top of the progress underway on the political front, Philip Morris continues to benefit from improvements in operating results outside its profitable core domestic tobacco segment. The most notable area of profit improvement has been domestic food and beverages where Philip Morris, via its Kraft and General Foods lines, is the largest food company in the United States.

Benefits from merging marketing, sales and distribution operations at Kraft and General Foods have released cost savings and generated growth in sales volumes as a result of a more unified company-wide approach towards marketing Philip Morris' product portfolio of leading consumer food brands. Kraft remains one of the few food companies generating meaningful volume growth — (i.e., over 3-1/2% per quarter for the past 11 quarters) — which has resulted in operating income growth and margin expansion (margins now exceed 18%).

And Philip Morris' international tobacco business continues to enjoy both broad volume and profit growth — even though recent strength in the U.S. dollar has somewhat reduced growth in reported profits due to adverse translation effects.

When the legal threat lifts, so will buybacks and stock price.

Russo: On balance, the increased possibility that uncertainties in domestic tobacco will abate, the enormous market leadership enjoyed by Philip Morris' domestic tobacco operation, growth in Kraft's domestic profitability and strong growth in its international tobacco segment afford Philip Morris visibility in future cash earnings the likes of which few other companies in the world enjoy.

Therefore, the moment that uncertainties relating to negotiations with state Attorneys General are removed, Philip Morris will likely begin to direct its cash earnings, considerable corporate liquidity and borrowing power into a significant share repurchase program to take advantage of today's unwarranted, low valuation of its shares.

It's been a mixed bag for our other tobacco-related holdings.

Russo: While Philip Morris' shares have remained essentially unchanged during 1998, shares in our other cigarette manufacturers — Rothman's and Tabak — are up modestly. Rothman's is up, in part, on the back of a recently announced $18 extraordinary dividend.

Our shares in tobacco industry suppliers, on the other hand, have performed poorly year-to-date. Shares of Dimon, for example — the world's second largest provider of leaf tobacco to the industry — have fallen sharply as a result of market dislocations caused by the Asian crisis.

In effect, because Asian buyers have been unable to obtain trade-related financing for leaf purchases — all of which, by the way, are U.S. dollar-denominated — shipments to them have been postponed and/or canceled. The resulting increase in its inventories has increased its borrowing costs. And reduced operating levels have

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GARDNER INVESTMENTS'
TOM RUSSO
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lowered its margins.

Thus, in response to a lower near-term profit outlook, its shares have fallen. But at today's price, they trade at an attractive multiple of operating cash flow and provide a dividend yield of nearly 7%. So despite its adverse trading performance of late, I believe its shares offer adequate prospective returns to justify our continued involvement.

OUR FOOD & BEVERAGE HOLDINGS REMAIN ON TRACK — AND WEETABIX'S VALUATION IS *ESPECIALLY* TASTY.

A 15% dividend increase bodes well for future progress....

Russo: Our holdings in the food and beverage industry (apart from Philip Morris' Kraft division) have by and large performed well throughout 1998:

U.K.-based breakfast cereal producer Weetabix recently announced a 15% hike in its final dividend for the year ended July 1998. In years past, dividend increases have tracked growth in operating performance.

Discussions with the trade support my belief that 1998 was another good year. Weetabix enjoyed continued strength in 1998 — both in its European cereal sales and in its U.S. sales of health food products that predominantly go to market under the trade name of Barbara's Bakery. (Please visit your local health food store and try Barbara's Shredded Wheat. It tastes delicious...)

Low value, more capacity, new products & new promotion.

Russo: Although Weetabix has avoided many of the performance ills befalling industry leader, Kellogg, relative to their earnings per share, Weetabix's shares continue to trade at a substantial discount. More importantly, Weetabix continues to invest heavily in new manufacturing capability, new brands (cf., recent launch of Frutibix to considerable market success in the U.K.) and in marketing, advertising and sponsorship (1998's Weetabix British Women's Golf Tournament set records for attendance)....

And Diageo is on the right track, too....

Russo: As with Heineken, investors' early fears about an adverse impact on Guinness as a result of Asia's fall-off have been allayed due to its continued strong trading performance in Europe and North America. Moreover, Guinness has enjoyed divestiture gains and efficiencies via its merger with Grand Met last year — through which it formed a new entity, Diageo.

Diageo's new management team is focused on building shareholder value by demanding high returns on assets in its remaining businesses and seeking top dollar for divisions it's either chosen to sell or has been forced to sell. The latter was the case with the Scotch brand, Dewars, for which Diageo received a price nearly 50% above even the most enthusiastic initial estimates.

Like many European companies, Diageo is beginning the process of returning capital above what's required in ... the business to its shareholders. And although the first such distribution was in the form of a dividend share — taxable, unfortunately, to U.S. investors — future distributions will likely be via more tax-efficient, shareholder-value-accretive common stock repurchases.

A RUSSIAN EARTHQUAKE CREATES AFTERSHOCKS ON THE OPPOSITE SIDE OF THE PLANET.

A round trip in Russia covers a *huge* amount of territory.

Russo: The single most dramatic point evidenced in foreign markets today is the interconnectedness of what may seem like wholly unrelated events. Last week's Russian meltdown offers only the most recent example of just how widespread such effects can be.

The drama in Russian financial markets involves both equities and fixed income securities. On the equity side, from 1996 to 1997, Russia's primary index advanced all the way from 60 to 620. But that index has since reversed course and lost all its gains during that time and more. Having declined more than 90%, it now stands below 60.

And those returns have been worse still for any unhedged dollar-denominated investors — because the aforementioned ruble-denominated decline of over 90% translates into a decline of more than 95% when it's adjusted for the ruble's recent collapse against the dollar.

It was almost as bad in dollar-denominated sovereign debt.

Russo: On the fixed income side, losses in Russia have been similarly dramatic — even for those investing in sovereign dollar-denominated debt. For example, bonds with a par value of $100 and a coupon of 12-3/4% which were issued in July at $98 *began* the last week of August at $33 and *ended* the week in the low 20's.

It's a small world after all....

Russo: The impact of such drastic declines in emerging markets are felt in many ways around the world. U.S. hedge funds who were long Russian debt and/or equity have become forced sellers of U.S. junk bonds and U.S. small-cap stocks as well as the stocks and bonds of *other* emerging markets.

I spoke with an emerging-markets investor recently who gave me one example of this interconnectedness and explained why shares of a telephone monopoly in Brazil should decline by nearly 40% due to the "Russian crisis." As he told me, in light of Russia's near default on its dollar-denominated debt, investors raised the yield they required to hold *Brazil*'s dollar-denominated sovereign debt in order to compensate for risks of a similar crisis there.

Thus Brazilian dollar-denominated bonds, which four months ago yielded 9% and eight weeks ago yielded 11%, fell in price so dramatically last week that their yields today approach *25%*. (*In dollar-denominated yield on Brazil's sovereign debt!*).

Everything's relative — including equity prices....

Russo: With such declines in Brazil's sovereign debt, it's little wonder that Brazilian equity prices have declined. After all, equity prices are typically arbitraged against yields on long-term treasury bonds. Accordingly, equities that looked *reasonably* priced when such bonds yielded 9% four months ago look unusually *overpriced* with Brazilian bonds now yielding 25%.

The impacts continue to be felt elsewhere. With such

(continued on next page)

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GARDNER INVESTMENTS'
TOM RUSSO
(cont'd from preceding page)

trouble afflicting Brazilian and Russian bonds and equities, lenders will be less likely to commit fresh capital to Asian markets and, possibly, even reluctant to roll over *existing* loans when they come due — thus placing additional pressure on yields in those markets and, potentially, leading to further declines in those markets.

Thus, events which are seemingly as unrelated as the economic woes faced by lenders to, and investors in, Russia can have extremely far reaching consequences indeed.

IMPLICATIONS FOR THE U.S. ARE DRAMATIC, TOO — LOWER PRICES, LOWER INFLATION AND MORE.

U.S. fallout? Lower prices for commodities and goods both.

Russo: Against this backdrop, even the *U.S.* market is in no way immune from events in the emerging markets of Asia, Russia and elsewhere. Our economy and our financial markets have been affected in a myriad of ways — both good and bad. Some of them are described below:

First, commodity costs — including global prices for timber, pulp, paper and newsprint — have declined almost uniformly over the past year as a result of reduced demand from Asia and a variety of other troubled emerging markets. Second, the prices of imported, finished goods have fallen dramatically as capacity far exceeds local demand — thus resulting in pressure to export their excess production.

Also lower inflation, lower rates and a stronger dollar.

Russo: Third, the combined effect of lower commodity costs and lower prices for imports has helped restrain inflation in the U.S. This less inflationary environment — combined with the purchase of U.S. Treasury bonds by flight capital seeking, first and foremost, political safety — has led to record low yields on long-term U.S. treasury bonds.

Fourth, those less inflationary expectations and that flight capital have also led to a sharp rise in the value of the U.S. dollar — which recently hit an 11-year high against the Japanese yen and *all*-time highs against a basket of other Asian currencies.

Lower emerging markets sales = lower sales down the line.

Russo: Finally, U.S. companies whose businesses have depended on foreign sales into emerging markets have struggled to show improvements in operating results. Local demand in emerging markets for consumer products and capital equipment has collapsed.

American farmers whose crops were planted with the demand from those markets in mind have thus received sharply lower prices as a result of that reduced demand. And those lower prices have reduced the revenues and incomes of those farmers and left them unable to complete planned purchases of farm equipment from manufacturers such as Deere, Case, Agco, etc.

And consumer brand goods companies who have seen drastic declines in Asian demand now have to report back even *fewer* dollars for what remaining profits they do earn in emerging markets given those local currency declines.

THERE'S OPPORTUNITY IN EMERGING MARKETS, BUT WE'LL LEAVE DIRECT INVESTING TO OTHERS.

Today's turmoil is *good* news. It means there's *opportunity*.

Russo: A wise investor has observed that investors pay a dear price for a rosy consensus. Until recently, this was true of broad segments of U.S. financial markets. The corollary to this insight is that great values will probably only arise during periods of maximum pessimism. This is very likely true of many foreign markets today.

Global markets have truly become interconnected. And in such an environment, where the interest rates in many foreign markets have soared and the local currencies and local equity prices have collapsed as a result of political and economic turmoil, opportunities surely have arisen and will arise.

Our holdings are finding lots of opportunities — and will....

Russo: Investment opportunities are clearly arising in foreign markets around the world. And they're being exploited by many of our global companies. For instance, Travelers recently purchased a 15% stake in Japanese financial-services giant Nikko Securities. Their goal is to integrate their expertise in the institutional fixed income area with the expertise of Citibank in consumer lending and Nikko Securities in Japanese local market equities and corporate finance....

Philip Morris is actively exploring the purchase of stakes in former tobacco monopolies in Taiwan, Korea and possibly Thailand as a result of decisions taken in those markets to privatize formerly state-held assets. And Indonesia may truly open its market to Philip Morris for the first time now that they'll no longer have to channel all their efforts through entities controlled by the tight grip of the former first family.

Similar acquisition opportunities will likely arise which should allow our multinational companies to profitably expand their presence in emerging markets.

Investing indirectly is our preference for now.

Russo: Having returned from my initial visit to Asia, I believe that my ability to take advantage of opportunities in such emerging markets will be best served at present by investing indirectly via such diversified multinational firms rather than via direct investments in those markets.

The lack of accounting transparency, difficulties relating to foreign-currency hedging, differences in corporate cultures, accounting standards and rules of corporate governance all lead me to conclude that investing via Western operating companies remains the safest way for us to tap into the increasing purchasing power that will prevail in developing markets as they resume their growth and experience their all but inevitable recoveries....

All sorts of unsettling factors face today's traders — and uncertainties that make it impossible to predict even the near-term future. But it's precisely those factors that [create] opportunity for long-term investors willing to hold solid businesses through market turbulence [and act] when emotions trigger overselling and mispricing. I plan to closely monitor our holdings, marshall cash and remain ready to act opportunistically.

—OID

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MARK MOBIUS, TEMPLETON DEVELOPING MARKETS TRUST

"Obviously, if you pick up nearly any newspaper, you'll see we're in an Asian crisis. We've had a tremendous decline in these markets. And that, of course, has impacted emerging markets worldwide. It all started last year when the Thai currency, the baht, was devalued in July, setting off a wave of currency devaluations throughout the region. The value of the Hong Kong dollar has not changed because of the link between it and the U.S. dollar. Other Asian currencies, however, were nearly devastated. Now imagine the effect of these devaluations on the many companies in these countries that had outstanding U.S.-dollar loans. In Indonesia, for example, their U.S.-dollar loan payments suddenly went up about 600%. Few businesses were prepared to handle that kind of change — particularly those that were heavily leveraged. And it was not unusual to find debt-to-equity ratios of one-to-one in these countries [even before the crisis].

"Consequently, we've seen a corresponding decline in Asia's stock markets. In fact, I think it's been an overcorrection. Malaysia's stock market is down 82%, to where it was in 1988. Indonesia is down 89%, to where it was in 1988. Korea is down 73%, to where it was in 1987. The Philippines is down 74%, to where it was in 1992. Thailand is down 76%, to where it was in 1987. Even Hong Kong is down 50%....

"The [Fund's] price per share declined sharply in the past year. [Including the effect of the maximum 5.75% sales charge,] Templeton Developing Markets Trust's one-year total return through August 31, 1998 was –53.25%. While it may not offer much consolation ... our longer-term performance is still better than most of our peers. We are long-term investors, so for us, that's what matters most. And as of August 31, 1998, Lipper Analytical ranked Templeton Developing Markets Trust #1 among 13 emerging markets equity funds for the five-year period....

"This is the time to accumulate stock.... We're not market timers. If you try to time the recovery, you're apt to miss it. By the time you see the light at the end of the tunnel, you're usually too late.... We're not embarking on any special campaign to ... quickly bandage the Fund's portfolio. We're ... doing what we've always done — diligently looking for the best stock values in emerging markets around the world....

"Our recent performance has been distressing for many shareholders. So some ... may be puzzled by my optimism.... But as a value investor, I can't help but see the tremendous opportunities being borne of this crisis. Earlier, I discussed some disastrous market declines.... The flipside of those declines is that we are seeing some incredible stock bargains....

"[S]uccessful long-term investors don't follow the crowd. And right now, ... the 'crowd' is making a mad dash to exit many of the markets where we're shopping for bargains. This is where discipline comes into play. We're determined to stay the Templeton course and encourage shareholders to do the same. [O]ver the long term, the benefits of this approach will become apparent. Furthermore, we believe there are good reasons to have faith in the long-term potential of emerging markets and many Asian markets in particular. [T]he declines in Asia did not suddenly destroy the incredible work ethic in these countries or rob them of the great strides they've made in education and infrastructure development. In fact, their recent economic woes have even failed to quash their optimism. According to a recent worldwide poll ... five of the 10 most optimistic counties in the world are Asian, including Malaysia, South Korea, Thailand, China and Taiwan."

Update on Emerging Markets — September 1998

RICHARD W., DANIEL S. AND RICHARD C. PERKINS, PERKINS CAPITAL MANAGEMENT

"The last time we wrote a 'don't panic' letter to clients was in September 1990. It's as current today as it was then.... Now just as then, there are many things wrong in the world: Terrorists who can and will strike anywhere, anytime; a Russia in financial and political turmoil; Asia (especially Japan) in a downspin; and last, but certainly not least, President Clinton's problems and the resulting concern worldwide about his leadership. As we said in 1990, there are times of uncertainty in any market cycle — times when stocks, both good and bad, go down together.

"The past 2-1/2 years have been difficult for us, for never have we seen a time when big company stocks have gone up while small company stocks have gone down. The Russell 2000 is lower than it was 2-1/2 years ago in the spring of 1996. [W]ere that true of the Dow, it would be below 5000.... There are stocks we wish we'd sold, but there really was no reason, e.g., to sell Ciprico, especially since the company had raised $36 million in a stock offering in mid-1996. Yet today, at $7, Ciprico sells at the value of its cash per share giving zero value to a business which will likely generate $30 million in revenues this year. Or BMC Corp., which at $5, sells at 40% of its estimated liquidation value of $12-1/2 per share. We could go on and on about undervalued small stocks....

"Market bottoms are not made of smiles and pleasant feelings. They come with a great deal of pain, such that you can't stand it any longer, call your broker (or money manager) and tell them to 'get me out now.' Some of that's already happened. There have been significant margin calls.... Corrections and bottoms are Mr. Market's way of resolving the speculative excesses from the prior cycle, thus creating the foundation for the next big advance.... So do not despair. It is *not* the end of the world. That has been reserved for January 1, 2000 and this is still 1998."

Letter to clients of Perkins Capital Management — September 17, 1998

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