Outstanding Investor Digest

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

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FAIRHOLME CAPITAL'S BRUCE BERKOWITZ AND TIGER MANAGEMENT'S JULIAN ROBERTSON "WELLS FARGO, LEUCADIA AND BERKSHIRE REVISITED." AND "INVESTORS THINK IT'S A PERFECT WORLD. WE DON'T."

In this edition's mailbag are a few thumbnail sketches, company updates and broad brush perspectives from two of our favorite contributors — living legend Julian Robertson of Tiger Management and Fairholme Capital's Bruce Berkowitz.

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THIRD AVENUE FUNDS' MARTY WHITMAN CURTIS JENSEN & YANG LIE "THE BROAD INDICES ARE STACKED *AGAINST* YOU. BUT WE STACK THE DECK IN *OUR* FAVOR WITH *THESE*...."

A long-time proponent of buying securities that he terms "safe and cheap" as a means of achieving high returns without incurring high risks, Third Avenue's Marty Whitman has demonstrated the benefits of his approach — first at Equity Strategies Fund and, more recently, at Third Avenue Value Fund. For example, before withholding for potential tax liabilities, Equity Strategies Fund's shareholders earned a compound return of 18.7% per year after all fees and expenses during the nine years ended December 31, 1993.

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BERKSHIRE HATHAWAY'S WARREN BUFFETT & CHARLIE MUNGER "BERKSHIRE SHOULD DO FINE WITHOUT US, BUT WE'RE NOT GONNA LEAVE WILLINGLY."

Introducing Warren Buffett in the pages of *OID* is akin to introducing the Pope at the Vatican — redundant at worst and unnecessary at best. With that reality in mind and with brevity as our goal, we'll just note that he's compiled — first on his own and subsequently in partnership with fellow super-investor and philosopher Charlie Munger — one of the greatest long-term investment track records of all time.

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SOUTHEASTERN ASSET MGM'T'S MASON HAWKINS, STALEY CATES, C.T. FITZPATRICK ET AL. "DOWN ISN'T BAD. IT'S WHAT WE'VE BEEN HOPING FOR. WE THINK THAT THERE ARE GREAT TIMES AHEAD...."

Southeastern Asset Management's Mason Hawkins' stockpicking prowess is not exactly unknown. For example, over the past 10 calendar years, the firm's longest lived fund, Longleaf Partners, generated a compound return of 20.0% per year making the Fund one of the few to outperform the 18% per year return of the S&P 500 over that same period (as it has since its April 8th, 1987 inception).

But of course, that figure understates the margin of

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FAIRHOLME CAPITAL'S
BRUCE BERKOWITZ
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FAIRHOLME CAPITAL MANAGEMENT'S RESEARCH BRIEFS FOR DECEMBER, 1998

The New Household International....

Bruce Berkowitz: Household [HI/NYSE] reported its first full quarter combined with Beneficial. Normal earnings per share, excluding restructuring charges, were 30% higher than last quarter and 19% higher than a year ago.

However, earnings this year will hardly rise due in large part to the initial costs of the merger and lower than expected revenue growth. For the first time in [Chairman/CEO William] Aldinger's tenure, Household had to lower earnings expectations. 1998 earnings of $2.30 are now expected. Fourth quarter earnings will be lower than initially expected. Irrational competition, especially in some areas of MasterCard and Visa where Household has little differentiation but price, is forcing the company to reevaluate its strategy.

The market does not like uncertainty. Household's market value now reflects a skepticism heightened by the November collapse of the securitization market. It is time to review the investment case for Household.

A quick review of Aldinger's achievements....

Berkowitz: Bill Aldinger arrived from Wells Fargo in 1994. I believed he would sell the low return businesses and lower the expenses of the core businesses. He did. Overheads fell dramatically. He also increased pricing. Margins increased and credit quality improved. Earnings rose 20% per year. By 1996, most of his work was complete.

In 1997, Household consolidated Transamerica Financial Services. Overheads fell further. Margins increased. Earnings continued to march at a 20% pace, even though industry credit losses were rising and revenue growth was slowing.

In 1998, Household acquired giant Beneficial. The costs of this acquisition have been incurred this year. The benefits will show next year. Beneficial's overheads were 52% of revenue versus Household's 36%. Efficiently combining the two would drive overheads down to 30% over two years. This process is a replay of the 1994-1996 period, albeit in a lower credit quality environment.

Next, Household may start to consolidate *itself*.

Berkowitz: In 1999, Household expects earnings up over 35% to $3.10. Cash earnings are expected to be $3.40 per share. Expectations are based on the successful consolidation of Beneficial plus a combination of stable credit quality, loan growth, and share buybacks.

By summer, Household will have the regulatory ability and tangible capital to repurchase shares for owners. Estimated excess capital of $1 billion would buy 5% of the company at present prices. The cost would be significantly cheaper than the usual premium paid to acquire competitors or their portfolios. Receivables and profits per share would increase.

If there are no large inefficient competitors left to acquire at a reasonable price, Household would begin to consolidate itself. This is a powerful weapon successfully utilized by great companies.

He's putting his (& associates') money where his mouth is.

Berkowitz: And Aldinger understands the strategy. He appears committed to owners by word and deed. During the last 6 months, he added over $1 million of stock to his personal account at prices from $27 to $51. Last quarter, HI pre-funded employee purchase plans by buying 10 million shares of stock at $40 per share.

But the Market is skeptical. Household's price reflects significantly lower profit growth and little possibility of being acquired. Herein lies the opportunity.

WELLS FARGO + NORWEST MAY EQUAL WAL-MART. INGREDIENTS ARE RIGHT, BUT THE JURY'S STILL OUT.

Investment case for the New Wells Fargo is quite different.

Berkowitz: The Wells we know no longer exists. In November, Wells Fargo [WFC/NYSE] and Norwest became one. Each share of Wells Fargo was swapped for 10 shares of Norwest, which was renamed Wells Fargo.

The investment case is now quite different. In the early 1990's, the company was led by the best banker in the country, who was executing a low-cost strategy dominated by share buybacks. Wells' market price was grossly undervalued due to exaggerated fears regarding real estate. All that was needed was time.

By 1998, a good but not great Chief Executive strayed from a key element of the proven strategy. The 1996 First Interstate acquisition, bought at a good price, was poorly executed. The company's potential had diminished. Wells was now "in play."

Wells Fargo + Norwest = Wal Mart (they hope).

Berkowitz: Today, Norwest owns Wells Fargo. Dick Kovacevich (the new chief) wants the New Wells Fargo to be Wal-Mart. He believes the sales culture of Norwest and Wells' cost culture will merge over a three-year honeymoon.

Success is possible given Norwest's record and Wells' valuable franchise. But most companies with different cultures do not deliver on their vows. Wells exited the home mortgage business. Norwest has the largest mortgage company in America. Wells focused on costs. Norwest (to its credit) put the customer first. Wells aggressively bought back shares. Norwest did not. The New Wells is already lowering promised cost savings, countering with more expected cross sells.

The fundamentals for now....

Berkowitz: Pro-forma, the New Wells reported 3% EPS growth from the previous quarter. Results were up 24% from last year for Wells and up 13% for Norwest. The New Wells expects 1999 to yield reported earnings of $2.23 and cash of $2.60.

Kovacevich has a record of delivering. If he pulls it off, Wells should continue to provide a reasonable return at

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TIGER MANAGEMENT'S
JULIAN H. ROBERTSON, JR.
(cont'd from preceding page)

present prices.

[Editor's note: Of course, Berkowitz' pound-the-table, one-for-the-ages discussion of Wells in 1992 was a classic.]

AT LEUCADIA, IT'S THE SAME OLD, SAME OLD, WHEREAS BERKSHIRE LOOKS QUITE DIFFERENT.

The *Nothing* New Leucadia National....

Berkowitz: Messrs. [Ian] Cumming and [Joseph] Steinberg believe the investment world is manic. Values are much too high. As of 30th September, Leucadia [LUK/NYSE] is sitting with $49 of investments per share and a book value of $30 per share. Significant cash and bonds anchor these values. There is little reason to expect a move in either direction without a major event.

The company is awaiting a favorable IRS tax ruling to decide on a $10-$13 per share "excess" cash distribution to owners. For now, only cash returns can be expected. But remember, Leucadia has had a better record than Berkshire by patiently waiting for opportunities during difficult periods.

The *Almost* New Berkshire Hathaway.

Berkowitz: After its merger with General Reinsurance (GenRe) ... the New Berkshire (NBH) will be Fort Knox. As of writing, on a per share basis, NBH had reported investments of $49,000 and operating pre-tax profits running at $800 per share. Mr. Buffett hopes to continue growing each by at least 15% per annum. If he succeeds, NBH is cheap.

Initially, this will not be easy with 34% of NBH's economic value in cash and Buffett's view that, "Prices are high for businesses and stocks.... We get relatively little in prospective earnings when we commit fresh money." Nonetheless, Buffett appears excited about the future — especially with GEICO and Executive Jet.

GEICO is growing 20% per annum and earning a 5% underwriting profit. With such returns and a market share of only 3% today, the company is lowering premiums, increasing marketing and doubling needed facilities to accelerate growth.

Executive Jet is relatively small, but growing fast. Buffett believes the time-share jet business is in its infancy. The NetJets program is compelling for the rich and busy. With 4 to 6 hours of notice, a jet is waiting for you at one of 2,500 airports in the U.S. Scale makes this possible and creates the moat.

In any case, Washington Post seems to like what it sees....

Berkowitz: Berkshire Hathaway's static numbers have historically understated the long-term potential of the operating companies to dominate with near unlimited parental capital and patience. Owners do not care that fast growth lowers near-term earnings, which potentially lulls the stock price.

Of interest, is the Washington Post's recent purchase of $127 million of Gen Re as a "cheap" way to opportunistically buy Berkshire, which is the Post's largest owner.

TIGER MANAGEMENT LETTER TO LIMITED PARTNERS 12/8/98

For now, we're trimming our sails....

Julian Robertson: November was Tiger's third consecutive month of poor performance on both a relative and absolute basis. Tiger was down 3.0% for the month versus a positive 6.1% for the S&P 500 and a positive 5.9% for the Morgan Stanley Capital International World Index. This brings the year-to-date results to a negative 4.1% versus a positive 21.6% and 18.6% for the two indices, respectively. Unfortunately, I cannot give you too much hope for December because I think it will take the remainder of the month to get our ship in good fighting trim.

A great deal of the November slippage was due to portfolio unwinding, which in the month aggregated almost $4.7 billion in equities alone. This unwinding accounted for most if not all of the negative performance. Rational questions would be, "Why all this portfolio unwinding?" and, "What about portfolio unwinding in the future?"

In Japan, almost anything is possible. So we'll sidestep it.

Robertson: One of the big areas of unwinding has been Japan, which has been a wonderful investment area for Tiger for years. Recently, the situation in Japan has become extremely conjectural with the government guaranteeing everything from real estate to poor quality construction company commercial paper.

Whether or not the Japanese are actually implementing everything they say is highly problematic. However, even if they institute only a reasonable fraction of the program, it would be significant. There is even the potential for the Japanese to print money for the purpose of buying stocks. This sounds crazy, but it is a possibility. With such a possibility looming, it made sense for us to reduce our negative position in Japan.

Investors think it's a perfect world. We don't.

Robertson: Tiger has suffered the last three months primarily because we were set up for everything except a perfect world. Don't get me wrong, the world is certainly not perfect today. However, the perception of the world — at least by investors — is that the extreme easing of credit by our Federal Reserve makes it close to perfect, at least as regards investments.

Now, with Japan easing dramatically and the Europeans jumping on the bandwagon, the whole credit argument is being exacerbated. "Don't fight the Fed" has replaced "We're bullish on America" as the great American investment motto.

Unfortunately, however, the world is still not perfect. Asia is in a depression only slightly less severe than the one America experienced in the 1930's. The GDPs of Korea and Thailand are down 7% and 9%, respectively. Indonesia (GDP down 17%) and Malaysia (down 9%) are on the verge of civil war. Japan's economy continues to sink and the inefficiencies of the state-owned enterprises are taking China close to the brink. We are far from a perfect world. Nevertheless, the perfect world scenario may endure beyond our expectations, and Tiger must be flexible enough to adapt to come what may....

—OID

THIRD AVENUE FUNDS'
MARTY WHITMAN ET AL.
(cont'd from page 1)

[Figures provided by Whitman.] And during the seven calendar years since its November 1, 1990 inception, shareholders of Third Avenue Value Fund have enjoyed a compound return of 22.5% per year.

Due to Third Avenue Value Fund's extremely flexible and highly contrarian style, it doesn't fit neatly into any single fund category. When Whitman has determined that they were safe and cheap in the past, the Fund's invested in everything from high-yield bonds and zero strips to Japanese equities. But since the proof's in the pudding, we should probably also point out that the Fund has handily beaten the average returns of the funds in all three of *Morningstar*'s small-cap fund categories for 1991, 1992 and 1993, for the past five years (ended November 30th) and year-to-date.

He's achieved those returns, incidentally, with volatility well below that of the average fund (much less the average small-cap fund) and above average tax efficiency thanks to its near-microscopic portfolio turnover. And he's done it while carrying around significant levels of cash and/or fixed-income securities for much of that period.

Your editor had chatted periodically with Whitman over the past year or so about the basis of the appeal that a couple of his favorite areas seem to hold for him today. However, it wasn't until November that the light finally went on. (As always, we hope it's a light and not a train.) And when it finally did, we put the pedal-to-the-metal (everything's relative) to bring some of his thoughts about those areas (and his investment rationale for some of his current favorite ideas within those areas) to you.

In the pages that follow, we're pleased to bring you, first, excerpts from a November 5th conference call with clients of Third Avenue and, second, selected excerpts from a series of conversations with Whitman and two of his associates — Curtis Jensen and Yang Lie — beginning in the second week of October and continuing until on or about December 23rd. As we mentioned, we entered some of those conversations primarily skeptical, but exited most of them more than a little intrigued. We hope you will, too.

MOST ANALYSTS *FOCUS* ON THE NEAR-TERM OUTLOOK. WE DEAL WITH IT ANOTHER WAY — WE *IGNORE* IT....

What we look for — first, the *quality* of resources....

Marty Whitman: M.J. Whitman Advisers takes the same approach to valuing common stocks as do people valuing private businesses or people engaged in mergers and acquisitions — be they financial or strategic investors. The approach seems to have three elements:

First, we look at the *quality* of resources in a business, which mostly means a business ought to have an extraordinarily strong financial position [as is the case with] most of our companies, or some franchise — something that gives the company a high quality position with staying power and excess resources that will enable it to withstand and survive unexpected vicissitudes and provide it with the wherewithal to expand.

Second, we look for the *quantity* of resources....

Whitman: The second characteristic of companies in which we invest is that the *quantity* of resources relative to the price we pay is large. By quantity of resources, I don't mean exclusively accounting book value, but rather some objective measure that shows that the company is selling at some substantial discount from private business value or takeover value.

For example, in evaluating real estate securities, the appraised value of the properties would be important. However, it would have little to do with their book value. In appraising companies involved in money management, the emphasis would be on the market value of assets under management — i.e. the price at which they might be sold to another financial institution. And, usually, there's a ready market for those. Finally, in the case of insurers, it would be their adjusted book value.

Third, we look for the ability to create long-term wealth....

Whitman: Those two cues, the quality of resources and the quantity of resources, translate into a third factor — [namely,] an ability to create long-term wealth. The word "long-term" implies a buy-and-hold strategy. And by "creating wealth", I'm referring to any of various methods by which wealth is created and combinations thereof. It can be translated into improved operating earnings. It can be translated into enhanced business value as a result of mergers and acquisitions. It can result in increased value because of the ability to refinance. Or it can be the result of liquidations, going privates or spin-offs.

Interestingly, people who create long-term wealth try to do so on the most tax-effective basis. And aside from the times you're taking advantage of Wall Street's tendencies, operating earnings are the *least* desirable way to create wealth simply because they're taxed at the highest marginal rate and the taxpayer can't control when the tax will be incurred.

Most important element of wealth creation also the hardest.

Whitman: In every company we're involved with, the third factor — the ability to create long-term wealth — is, more than anything, a function of management's ability. Sadly, appraising management is the toughest thing we do. Indeed, practically all of our screwups are the result of misappraising management. The *financial* part of our analysis, by comparison, isn't all that difficult.

Most analysts *focus* on the near-term outlook. We *ignore* it.

Whitman: In contrast to what we do, most other financial analysts concentrate on the primacy of earnings and the near-term outlook for those earnings. Indeed, the near-term earnings outlook and predictions of same are virtually the *only* thing that many of them concentrate on. And regardless of price or the considerations I mentioned, if the near-term outlook is poor, they don't invest.

We're very different in that respect — in terms of being that price conscious. Our pricing in the type of stuff we do really doesn't get created most of the time unless the near-term outlook is very poor.... Markets are too efficient for me to hope that I'd be able to get high quality resources

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(cont'd from preceding page)

[and a] high quantity of resources relative to the price paid — in the hands of management who are likely to use those resources [wisely] — without the trade-off of the near-term outlook not being great. Life just doesn't *work* that easy.

In other words, we don't take much investment risk in terms of an underlying business if we can avoid it. Rather, we prefer to completely ignore market risk — by which I mean a security's prospective near-term performance.

By keeping things simple, we avoid lots of excess baggage.

Whitman: Aside from appraising management, one of the things that makes life simpler for people who invest as we do — investors such as Carl Icahn, Warren Buffett, Richard Rainwater and all the best investors in our view — is that we simply appraise a business, assess its dynamics and *stop.*

In the case of most other analysts, that's not their job. Rather their job is to predict where a security will sell in the near future. And to do that, they have to carry around an awful lot of excess analytic baggage: They have to make forecasts about the economy. They have to formulate an opinion about the market. They may have technical chartist considerations. They worry about dividend policy. They worry about investor psychology. And they worry about whether there's insider selling or insider buying, the supply and demand for specific securities, whether the specialist is any good, etc. In other words, they worry about thousands of factors which, in our view, have absolutely *nothing* to do with the underlying value of the business or its prospects.

It seems to me that what we do is much easier. We don't have to be as smart as those other people — because we do something that's not as difficult.

WE EVEN *PREFER* A NASTY NEAR-TERM OUTLOOK. THAT WAY, WE MAY NOT HAVE TO PAY TO PLAY.

The most overrated factor by far — the general market....

Whitman: Within the financial community, the most overrated factor by far with which buy-and-hold investors are involved is the general market. It is just unimportant for buy-and-hold fundamentalists. Actually, I don't think it's been all that important since 1933.

Over the last 25 or so years — a period during which the Dow Jones Industrial Average went from 700 to 8,800 — virtually every industry with *very* few exceptions ... went through depressions as bad as anything they experienced during the 1930s. The difference is that since the 1930s, there's been no domino effect in the general market.... Virtually every industry — be it automobiles, steel, banks, real estate, savings & loans, row crop, energy, retail,

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everybody — went through very severe depressions without a domino effect.

Indeed, I well remember (and we profited mightily) when Texas shut down during the last half of the 1980s because of the severe depression in energy at a time when that industry accounted for 10% of the U.S. economy. Yet, there again, there was no domino effect.

When the outlook stinks, you may not have to pay to play.

Whitman: But when these industries get depressed, you can buy into the common stocks of companies with impeccable staying power and very strong market positions — and you don't have to pay to play.

Just one war story: In the late 1980s, as a result of buying out banks, I probably controlled more oil rigs than anybody in the *world* because I was the control person in both Nabors Industries and Reading & Bates....

Nabors is a good example of the unimportance of the general outlook. We reorganized Nabors in Chapter 11 in 1988 so that it had an all common stock capitalization. And going forward — until 1992-'93 I guess — we were stuck with this terrible industry depression.

But we were the only company in the industry with the wherewithal to make acquisitions because we didn't have any debt. It had all been washed out in Chapter 11. And Nabors' superb management used that period to acquire other rigs and other companies at really depressed prices. So when prosperity occurred, we had 30% of the land rigs in the lower-48 [states] and Canada, maybe 50% of the higher quality rigs in the U.S., 80% of the rigs in Alaska and a presence throughout the world. And that business, which when we reorganized it was losing $10-15 million per year, had a cash flow of $200-300 million.

That kind of thing can happen.

So we *look* for things with nasty short-term outlooks....

Whitman: And that kind of thing is happening today. Despite the general prosperity, various industry groups are experiencing severe depressions. Therefore, many of the common stocks in those industries are selling at prices that reflect nothing but the terrible outlook for 1998 and 1999. So those are the ones we're focusing on.

One is semiconductor equipment manufacturers. There's no company in that industry on our list ... whose cash alone doesn't exceed its book liabilities.

And Japanese non-life insurers at 30-80% off their NAVs.

Whitman: Another is certain Japanese blue chips — the best companies in that very troubled economy — mostly the non-life insurers. And even when we value them like closed-end investment trusts — [in other words, when we assign no value whatsoever to their businesses] — they sell at 30-80% discounts to their net asset value.

By comparison, the average U.S. closed-end fund sells at a discount of maybe 10%. And the average mutual fund sells at a *premium*....

And real estate finance was hit for a reason — ignorance....

Whitman: Another area where there's been panic has been real estate — especially in non-investment-grade and low-investment-grade mortgages. It's rather obvious what happened. The spread between Treasuries and BBBs grew from 300 basis points to more than 600 basis points despite the fact that the loans were performing loans.

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Why? Mostly because the accounting profession and the academics don't know what they're doing. Now that banks have begun to securitize loans, they're appraised on a mark-to-market basis whether they're performing or not. Thus, when the spreads went up, people who'd borrowed to buy mortgages were in default — or, at least, they were close to default. And the result was a panic in the market.

Markets are getting more efficient? Not this year.

Whitman: That was the first time in my lifetime that there was a panic in the credit markets driven not by poor credit performance, the failure to match maturities or currency risk. It was just driven by marks-to-market. And however important the market may be as an appraisal tool for portfolios of common stock or distressed loans, it's that *unimportant* in the evaluation of performing loans. At least, it *ought* to be that unimportant. Making the mark-to-market important, in that instance, is equivalent to putting the inmates in charge of the insane asylum.

But as a result, a number of financial companies are selling at discounts from their net asset value — in fact, rather substantial discounts. So we're doing a little bit in financial guaranty companies, some insurance companies and some fund management companies.

IN THE SEMICONDUCTOR EQUIPMENT AREA,
WHAT THE STREET'S FOCUSED ON IS NOISE.

Only a few things really matter. Everything else is noise.

[Editor's note: The following segment was excerpted from an earlier conference call:]

Whitman: Before I became a fund manager, I spent a lot of time and built quite a career in litigation support as an expert witness. And in securities litigation, you find, at least with the good people, that no situation is so complex that it can't be reduced to two or three — but, in any case, no more than four — very important variables which hold the key to understanding the case and winning it. Many other things can be *considered*, but they're basically *noise*.

First, there's going to be explosive growth long-term....

Whitman: That type of discipline is also very useful in security analysis and stock picking. I'm convinced that only four variables are really important in semiconductor equipment companies and that everything else is noise. So let me talk to what's important and what's noise:

First, the industry will experience explosive growth long term — meaning say over the next five to seven years. We haven't seen *anything* yet in chip manufacture. So far, it's been mostly a computer business. But as you know, chips are beginning to go into everything. So the market will explode. And not only that, but there are going to be great technological innovations in wafer performance, wafer size and manufacturing techniques. So I don't think there's any question that we can sign off on item #1 — that there's going to be *explosive* growth.

Second, the industry always *has* been and *will* be *cyclical*.

Whitman: Item #2: The semiconductor equipment industry is in the middle of a deep depression today. And I don't know exactly how long that depression will last. However, that industry always has been and always will be very cyclical. So depressions and recoveries will *happen*.

In my view, the semiconductor equipment industry today is very much like the auto suppliers back when the automobile industry was a growth industry — during the '50s and '60s. So there will be highly explosive growth — only that growth will be cyclical.

Third, in this industry we can't eliminate the casualties....

Whitman: The third characteristic is that the pace of technological innovation is such and management ability is so important that not everybody's going to make it. Competition is going to leave a lot of people behind.

And I think we have superb analytic talent here. However, I don't think we or anybody else can specifically identify today which companies will be the winners and which will be the losers. Therefore, you better diversify. Diversification, in this case, is a pretty good surrogate for specific knowledge of who'll be competitive.

Fourth, these stocks are being given away....

Whitman: The fourth characteristic is that many of the stocks are being given away because the near-term outlook is so poor.... We're buying them at book — in some cases, slightly *below* book value. And, in no case are we paying even a 40% premium to book. To me, that means we're getting into these businesses at better prices than a first-stage venture capitalist would have to pay.

And our businesses are already public and already very, very cash rich. Finally, I don't think any of the ones we're buying sell at more than 1 times their peak sales.

So we'll live through the recession. We'll take a shot at seeing earnings, I think it's fair to say, that will be well, well in excess of what they were at their *last* peak.

Wall Street's focused on the noise and 1998 earnings.

Whitman: And those are the essential characteristics, in our view, of the semiconductor equipment stocks that we're involved with. But based on research reports I've read, the Street seems to be focused on two things: First, predicting when the semiconductor depression will end so they can buy these stocks at the bottom and, second, trying to estimate what they'll earn in 1998.

However, given Third Avenue's buy-and-hold approach, those things — while they're most important to the Street — are nothing more than irrelevant noise to us.

[Editor's note: End of excerpt.]

DON'T ASK US ABOUT THE TIMING. WE HAVE NO IDEA.
BUT WHEN IT DOES ARRIVE, IT'LL BE SPECTACULAR.

The outlook? Bad short term. But that's fine with us.

Client: You mentioned meeting with managers of the semiconductor equipment companies on a regular basis. Do you sense a bottoming or turnaround in their business? Second, from these levels, how much can they appreciate? And do you have a price target for FSI Int'l [FSII/NASDAQ]?

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(cont'd from preceding page)

Whitman: We had dinner on October 21st — sharing gloom and doom — with the CEO of FSI. And he was more or less of the view that the bottom was *yesterday* — that his company had hit bottom on October 20th because they just got a few orders. But I can't tell you if he knows any more than we do.

I don't see an end to the semiconductor depression. To us, the [short-term] outlook appears *bad*. Then again, we're humble about our outlooks.... On the other hand, the industry's long-term outlook seems absolutely brilliant. Obviously, the whole world's going digital.

More importantly, the ones we're buying sell between 3 and 7 times peak earnings. And I think the next peak is going to be *better* than the last peak.

And what is our price target for FSI? Probably $30-40 [per share] — or some boxcar number of that magnitude relative to its current price....

One thing's for sure — these companies are solid financially.

Client: You obviously see significant upside. However, in terms of their stability and ability to hang on, presumably you're comfortable...

Whitman: Unquestionably. There's no doubt about it. Lots of these guys — FSI's included — were *quite* smart. So even though they didn't need the money at that time, when the market was terrific they took advantage of the opportunity to raise a lot of money....

Again, we're very comfortable with all of the managers of our semiconductor equipment companies.

But we know that not all of our holdings will be winners.

Whitman: But, obviously, one reason why we want to diversify our semiconductor equipment company exposure is that we view this thing as a venture capital investment — except, once again, we're getting to buy these things a lot cheaper than a first stage venture capitalist ever could thanks to the depressed state of the industry.

But just like venture capitalists, we know we're going to have a high strike-out ratio. Not all [of the companies that we're buying] are going to make it. The industry is too management intensive, too competitive and too dynamic. Therefore, we buy a *spread* of 'em.

But I think it's going to be a spectacular portfolio — with the proviso that I'm sure we're not picking all winners.

A certain number of casualties goes with the territory.

Client: Most of the semiconductor equipment stocks that you own consist of the smaller and mid-cap names. Do you worry about bigger companies leapfrogging them with technology and investments in new technology? Second, you've said before that you expect consolidation in that industry. Do you still believe that?

Whitman: Answering your second question first, I do still believe that there will be consolidation in the semiconductor equipment industry.

As for the first part, I think you're very observant and very right. Again, I'm convinced that not everybody's going to make it. That's one of the problems — one of the risks that goes with the territory — and one of the reasons why many small players will wind up being consolidated.

And that's one of the reasons why I treat our holdings in that area like venture capital — knowing as we go in that not everyone we've invested in is going to be a winner. Fortunately, however, grandfathered in our overall scheme [is that] we own a fair amount of Applied Materials [AMAT/NASDAQ] and KLA-Tencor [KLAC/NASDAQ] — which are, in effect, the 800-pound gorillas in that industry.

All semiconductor equipment cos. aren't created equal....

Client: You said earlier that one of the advantages of a long-term managed portfolio is the ability to concentrate in 10-12 stocks. But you also said you have to be careful with the default risk in some of these things — like the semiconductor equipment companies — and, therefore, that it's a good idea to hold a basket of those companies and thereby hedge your bets a bit....

In my portfolio, I only hold between 10 and 12 stocks — [including] FSI International and Electro Scientific. Should I worry about not having enough diversification?

Whitman: I don't think so. And, first, I don't think we're talking about default risk, but poor performance as a business. And whether FSI and Electro Scientific [ESIO/NASDAQ] prosper or not, they have the financial wherewithal to be survivors. That's very different....

And when I say I expect some clinkers, I didn't mean they'll be wipeouts. That doesn't appear to be in the cards. For example, with FSI, you own three separate and distinct businesses. And in Electro Scientific Industries, you own *five*. So I'm particularly comfortable with both of those. In effect, they've done a lot of diversification in areas where we can't bring a great deal of knowledge. In contrast, I'm somewhat more nervous about Electroglas [EGLS/NASDAQ] — which is in only *one* line of business.

But if you're playing the industry via Electro Scientific and FSI, I think that you're in two very good ones.

RAISING CAPITAL WHEN IT WAS CHEAP WAS SMART.
MORE IMPORTANT IS WHETHER THEY *USE* IT WELL NOW.

Astute managements raised capital when it was cheap.

Client: As you mentioned earlier, some of your semiconductor/capital equipment companies have huge, liquid cash balances ... because they issued stock at relatively high prices. And, therefore, with their market prices having declined so much, their market capitalizations are very small relative to their liquid resources.

Does the fact that their balance sheets look like they do because of [what may amount to an historical fluke] in any way discourage you?

Whitman: It's a matter of the industry's dynamics and an appraisal of the managements. I think astute people built up their cash positions when the opportunity to do it on very advantageous terms arose. And I think those astute managements will use those cash positions very judiciously and that not-so-astute people won't.

Practically speaking, I don't think it's that important how they got these great resources that they have today.

It's not where the capital *came* from that matters most....

Whitman: I think the important issue is whether they'll have the ability to use those resources judiciously.

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And I have a hunch that a number of our managers will. Certainly, if anyone in the industry hopes to become another 800-pound gorilla — such as KLA-Tencor or Applied Materials — they'll do so, at least in part, by using their cash judiciously to expand on a low-cost basis.

And accompanying the industry's consolidation will also be great opportunity. In part, I say that because some very fine companies today are very badly financed and, therefore, candidates for reorganization — whether that reorganization is done out of court or in Chapter 11.

So they certainly have that opportunity ... today. And the managements we've spoken with about the possibility of making acquisitions seem to appreciate that. The management of one of our holdings that we expect to be active in that regard is actually trying to replicate what Nabors Industries did in the late '80s. In fact, we just showed them a potential acquisition today.

RIGHT WHEN WE WERE LEAST EXPECTING IT, WE HEAR AN ENCOURAGING WORD IN JAPAN....

Despite its recent share issue, Chiyoda gives us hope....

Whitman: I am discouraged about Japan's economy. But it's very hard for us — if we're objective and look at the two years we've been there — to complain about the job our managements have done so far. They're not like the managers of our semiconductor equipment companies ... [or our] real estate companies. However, they've generally been trying hard to do the right thing.

For example, we own quite a bit of the common stock of Chiyoda Insurance. It was roughly 37% owned by Toyota Motor. Its book value was up around ¥1,100. But, recently, when Toyota Motor decided to increase its ownership from 37% to 47%, they had Chiyoda issue them new shares at ¥500 per share — or less than half of book.

So we wrote a stinging letter of complaint to Toyota — not necessarily expecting a reply. But we finally got one. And in effect, they said, "If there's a merger or acquisition," (which, by the way, they're considering) "we would try to incorporate all relevant factors in arriving at a fair price that wouldn't be very dilutive."

Needless to say, that came as a complete surprise — albeit a very pleasant one — to us.

We believe Toyota is trying to do the right thing.

Whitman: I'd bet — you might say we *are* betting — that if Toyota Motor were to go further with Chiyoda, the price at which they would acquire common stock would be well in excess of ¥500 per share — which is why we've been buying it at ¥380, which is where it ... traded last week.

[So there's] an example of a company trying to do the right thing.... We had assumed that the company would probably be quite unconcerned about the interests of minority shareholders. But it looks like we were wrong. We've been assured it won't happen again. Time will tell.

Client: But when I read that they could buy shares at ¥500, I couldn't understand why we couldn't, too.

Whitman: Absolutely right.

Client: That's the kind of crap — pardon my French — that doesn't sound "safe" to me....

Whitman: Absolutely. But now we've been assured that in a merger and acquisition context, that won't occur. In terms of importance, the issue was hardly dilutive. It wasn't material. It *would* have been material if the result had been a bad precedent. That's what got us very upset.

Client: I thought that's what it did....

Whitman: Apparently not. But we'll see. Certainly, Toyota was very responsive and very aware of our concern. And you've got a point. However, we're willing to bet that when Toyota acquires an additional interest in Chiyoda, although it may not be at ¥1,100 per share, it'll be at a price that will consider all of the relevant factors.

So far, so good. Generally, I think it's safe.

Whitman: And let me point out something else which I think is very important about our portfolio — going back to the beginning — that I think serves to prove my point:

When we started to invest in these Japanese non-lifes, the Nikkei was around ¥20,000 versus about ¥14,000 today. And yet we have a pretty good profit in our portfolio.

Client: If you're happy, I'm happy — I mean in terms of the safety issue.

Whitman: You raised a realistic concern. In general, I think the managers of our Japanese holdings are doing the right thing. I wouldn't say that for all our holdings. For example, I wouldn't say that about Sumitomo Metal which took over one of its affiliates at its market price. So there aren't any guarantees.

But, generally, I think we'll do OK in mergers and acquisitions in our Japanese holdings when, as and if they occur. Obviously, I'd be a lot happier if Chiyoda were a Delaware Corporation rather than a Japanese corporation. But it's something that we can live with.

In Japan, we're not expecting any sudden miracles.

Client: Are the Japanese as motivated to turn their economy around — or, at least, to move their businesses to be more capitalist — as Americans? And, if not, will your very successful process of picking stocks work there?

Whitman: I'm much more pessimistic about Japan than most people in terms of the Japanese *economy*. I wrote a piece in the October 19th *Barron's* which gives you my view about just how sick Japan is. I think it'll take a long time for the Japanese economy to revive.

We're discouraged about Japan's prospects. But that's OK.

But I think the kind of companies we're in ought to be beneficiaries. One of our big investments, for example, is Toyoda Automatic Loom Works. Toyoda is an affiliate of Toyota Motor and the largest shareholder of Toyota Motor. It mostly consists of a securities portfolio. And we figure that we're buying it at a 35-40% discount to Toyota Motor.

Incidentally, Toyota Motor really isn't a Japanese company. It's an *international* company — probably more North American. So they're insulated.

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So I think our companies are going to do okay. However, if you ask me about the general overall economy — boy, frankly, I'm discouraged.

Based on our experience so far, we can't complain....

Client: I've tried like hell to justify owning our Japanese holdings based on their being, as you like to say, "safe and cheap." But when I think about some of the things you and others have written about how these people think in terms of how they do business, I can't for the life of me figure out how we can justify being in Japan — under *any* circumstances. Can you answer that?

Whitman: I sure can. It's a matter of perspective. First of all, we're in these financially strong companies that ought to prosper if they're managed reasonably well. We entered Japan in January 1997. And about a month ago, Yang [Lie] went out and reviewed what the companies we're in have done since the "Big Bang" — in terms of entering new businesses like fund management, financial guaranty, life insurance, hedging portfolios, direct lending, etc. When we look at the record so far, we can't complain.

And I'm pleasantly surprised by the number of things that you and I would call the right things that the managements of the companies we're in are doing.

Banking system is rotten, but P&C insurance system isn't.

Client: I'm with you on that. It's just the "safe" part that I can't reconcile. When I read about these companies forgiving loans to their debtors out of the clear blue sky... It's the "safe" part that bothers me.

Whitman: I don't think that has to do with the companies that we own. It has to do with companies like Long Term Credit Bank — which we no longer own. The banking system, from what I can tell, is rotten. And that's where I got burned — by failing to recognize that fact.

But the fact that the banking system is rotten doesn't mean the property and casualty insurance system is, too. It isn't. We get very complete, comprehensive disclosure. And I'd be surprised if we have any greater threat of securities fraud or bad accounting in our non-life insurers than we have in their American counterparts. We have our fair share of problems. I just think it's very, very selective.

EQUITY INVESTING DONE RIGHT COULD BE AWESOME.
BUT IMPROVEMENT IN LENDING IS MORE LIKELY.

Portfolio management at P&C insurers is very improvable.

Client: Earlier, I believe you compared Japanese property and casualty insurers to closed-end funds trading at discounts of 30% or more. Are those companies more or less proxies for the Japanese stock market? Or are some of those managers in turn value driven? Also, are they free to buy bargains or are they still so tied into their kieretsus that they have to keep their current portfolio holdings?

Whitman: That's a very good question and a very real problem. But the discounts on our Japanese insurers are more like 30-*80%* — with the average discount over *50%*. And, typically, 90% of their assets are comprised of roughly 50% performing loans and 50% passive investments in common stocks — which *are* basically a proxy for the Japanese stock market.

We believe our Japanese companies *could* do a much better job on their portfolio management. Unfortunately, they seem to be light years away from doing anything about it. But you put your finger on a real problem....

Mitsui *wasn't* being polite. They really were interested.

Whitman: However, remember that as underwriters, the *worst* of these Japanese insurers is much better and much more profitable than the best American companies. Unfortunately, they give those underwriting profits back, in effect, by not having any investment income.

Client: I'm sure that you know the companies in your portfolio well enough to get a feel for the likelihood of them becoming value investors. I understand from you and others that many smaller companies in Japan are roughly as undervalued as the screaming bargains we saw in the U.S. during the mid-'70s. If our Japanese insurers could only be persuaded to invest in some of those companies, it sounds like we'd *really* have something. In effect, we'd have a *double* bonanza.

Whitman: On that score, please allow me to [tell you another] war story. I don't know whether they're attuned to it or not. But Yang [Lie] and I recently had breakfast with the CEO and chief investment officer of Mitsui Marine. And at the end of our breakfast, I told 'em, "Japan isn't going to get out of its problems unless it can attract lenders — which they'll only be able to do if those lenders can get high interest rates and super priority to troubled debtors." I said, "If I were the investment department at Mitsui, I'd staff up a private placement department today that could originate high interest rate secured loans — because there's a great need [for that service]. And, obviously, those loans can provide a company with lots of investment income."

Well, at the meeting, I thought they [weren't interested — that they were only listening to be] ... polite. However, lo and behold, they got in touch with Yang last week and said, "Could we get you to explain to us the private placement origination you have in mind?" So they *weren't* just being polite.

If they could earn even 5%, they'd be doubles and triples.

Whitman: It's certainly something they *ought* to do. Instead of lending money at *1%*, they ought to be the

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PORTFOLIO REPORTS estimates the following were Third Avenue Value Fund's largest equity purchases during the quarter ended 10/31/98:

1. MEDTRONIC INC
2. FINANCIAL SECURITY ASSURANCE HLDGS
3. TOKIO MARINE & FIRE INSURANCE CO ADR
4. ELECTRO SCIENTIFIC INDUSTRIES
5. SILICON VALLEY GROUP INC
6. LAM RESEARCH GROUP
7. HOLOGIC INC
8. LEUCADIA NATIONAL CORP
9. CUMMINS ENGINE
10. AVX CORP

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equivalent of a "Debtor In Possession" lender for *9%*. Again, Mitsui's CEO did pick up on our suggestion that they should be a high interest rate lender.

And if one company did it, others would probably start to do it, too. And if their investment portfolios made 5% instead of 3%, our stocks would double and triple overnight. All they'd have to do would be to keep some semblance of the underwriting margins they have today. They could even *shrink* a little.

I suspect though that if there's anything they're going to do to fix their investment income problem, it's probably going to be on the lending side, not in the equity area.

JAPAN'S REFORMS WILL BENEFIT OUR HOLDINGS, BUT THEY SHOULD PROSPER IN ANY CASE.

We *can't* predict the future. So we don't even *try*.

[Editor's note: The following segment was excerpted from an earlier conference call:]

Client: How long is it likely to take for these ideas, particularly the ones in Japan, to finally mature?

Whitman: ...We *don't* pay attention to timing. I can't predict the future. So I don't even try. I just ask myself, "What are the key factors?"

In my view, predictions are nothing more than noise. I don't have any idea when the depression in the semiconductor equipment industry is going to end or when Japan will manage to muddle through its problems.

A huge revolution is underway. Only it's private.

Whitman: But I'm not worried about it. Despite what you read in the newspapers, a huge revolution's underway. Financial reforms are taking place — and quite rapidly. However, that revolution is coming from the bottom up, not from the top down. So everyone says, "Why isn't the Japanese government *doing* anything?"

The answer is that almost every financial institution in America and Europe with real clout in the private sector has already begun to plow into Japan in a big way — and to rapidly reform its financial institutions.

We think a lot of American and European companies that have begun to plow in have figured out — especially given the prices — that it's far cheaper for them to buy an existing operation in Japan than start *de novo*.

As a result, some of our companies — for example, Nissan Fire & Marine — may well be takeover candidates. I just think it's an *inordinately* promising area. On the other hand, other companies we own — like Tokio Marine — will be just fine competitively. But the reform of Japan's financial institutions is now a daily event. So if I were forced to guess about the timing in Japan, I would guess that it's looking pretty good....

Who needs an economic recovery? Not these P&C insurers.

Whitman: But Japan clearly seems to have fundamental, deep-rooted economic problems. However, I'm not sure what that has to do with whether or not specific financial institutions prosper — and whether or not they start prospering soon.... And, frankly, I don't see any reason why they shouldn't prosper even in a *troubled* economy.

Operationally, I honestly believe these companies are the best, most profitable insurance companies in the world. Whether they'll stay that way, I don't know. However, the poorest Japanese non-life insurer that we're involved with has far better underwriting margins today than the very best American company. Things will get more competitive, of course. But as far as I can tell, it's a dynamic industry — and we're not even paying to play.

Tokio Marine's *already* doing the right stuff....

Client: How [else] do you think these companies could maximize shareholder value? And do you get a sense that their managements are starting to make that a priority?

Whitman: That's a terrific question. In the P&C area, stand-alone insurers like Tokio Marine ought to employ much of their surplus resources outside the P&C industry. And Tokio Marine is doing that.

One of the things that impresses me about them — where I think they're doing the right thing — is that they made an arrangement with United Asset Management to distribute mutual funds in Japan.

And Tokio Marine has 80,000 agents who are used to selling financial products. They already sell the equivalent of a GIC [guaranteed income contract] — and they seem to be putting great effort into marketing GIC-type products. Certainly, their launch into life insurance has been very, very successful. And I expect them to do a big financial guaranty business.

Anyway, as you may have gathered, Tokio Marine's a quality company — and they *are* doing good things already.

Nissan, on the other hand, should surrender and liquidate.

Whitman: On the other hand, Nissan Fire & Marine ... would be very hard put to compete with someone like Tokio — because they just don't have the *cost* structure. So the best thing for them, I think, would be to go into runoff — which they sort of *have* been doing.

And that's one of the nice things about the industry — you can exit without a penalty. They can liquefy their book — they have a book value of maybe $10-12. And the stock is trading around $3. So they could run the whole thing off, pay taxes and distribute $6 per share to the shareholders.

Another alternative for Nissan — sell out to a new entrant.

Whitman: Clearly, they ought to get acquired. And maybe they will be.... Many kinds of ... American and European companies want into the second biggest insurance market in the world. And it's a lot easier to get in there by buying Nissan than by having a start-up operation.

Client: Do you know if they've explored that option?

Whitman: I don't. I've heard rumors to the effect that they explored something with AXA. But I have no way of knowing if that's true or not. Tokio's management is relatively forthcoming, whereas Nissan's management has not been. By the way, Japan lacks modern M&A corporate statutes and a modern tax code. Thus, modern U.S.-type mergers and acquisitions are probably a few years off.

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Client: And Nissan's management is more typical.

Whitman: Yeah. But then that difference is probably reflected in the price....

So far, "safe and cheap" haven't accompanied small.

Client: Will Third Avenue Small-Cap Fund be able to participate in Japanese property and casualty companies in the same percentage as Third Avenue Value?

Curtis Jensen: The companies we're attracted to now on the P&C side are kind of the monsters of the industry.... With only one or two exceptions — Nissan being one — we haven't been able to find Japanese insurers that are safe and cheap [with market caps] of less than $1 billion....

One thing we *don't* worry about is understated *liabilities*....

Client: You often say that what you look for is things that are "safe and cheap". What makes you so confident that these insurers don't have significant pension liabilities or other undisclosed liabilities?

Whitman: Because they have such huge, huge surplus, surplus. There have been accounts in the press to the effect that Tokio Marine has a whole bunch of unfunded liabilities. But we specifically looked at their pension liabilities and concluded that they're no problem — that compared to net worth, they're minimal.

Also, everybody we own is audited by the Japanese equivalent of the Big Six. Also, we've interviewed 'em. And I have a hunch that their disclosure is very, very good. Also, when you include all liabilities, it's our conclusion that these companies are much more strongly capitalized than American insurers.

Furthermore, the companies that we're in are actually much less insurance companies than their American counterparts. What do I mean [by that]? Well, the average Japanese P&C insurer in our portfolio underwrites around 50-60¢ for each $1 of statutory surplus. American insurers by comparison have typically written premiums of more like $2-3 for each $1 of statutory surplus. So, in effect, these Japanese insurers are generally just not all that exposed.

By only buying catastrophe insurance, our hedging's cheap.

Client: What are you doing, if anything, to hedge your currency exposure in Japan?

Whitman: We don't take currency risk. And the way we hedge is by buying put options on the Japanese yen in a notional amount roughly equal to our investments. Incidentally, our hedge is relatively inexpensive — because we buy out-of-the-money options. In effect, we're just trying to guard against major adverse moves in the yen.

For example, when we put our last hedge on, the yen was trading around ¥140 to the $1. So we bought options with a strike price of ¥150. Therefore, we're only paying for protection in the event that the yen goes above ¥150....

In effect, it's a device we use — and an inexpensive one — to hedge us against a catastrophe in the currency.

[Editor's note: End of excerpt.]

WHEN DO WE SELL? WHEN WE MAKE A MISTAKE, SOMETHING GETS WAY OVERVALUED OR WE HAVE TO.

Most of our sales are just the recognition of our mistakes.

Client: You have a buy-and-hold philosophy. But recently there have been some sales and new purchases in the portfolio. Can you explain the philosophy or scheme behind those sales and purchases?

Whitman: The main reason why we sell is if there's been a permanent impairment of capital in a company. If we can't predict future events or our analysis was wrong, we'll kick 'em out right away. And I think you'll find that's the case with most of our sales. We sell our mistakes.

Sitting around is a better way to make money. So we do....

Whitman: Of course, we also sell something if it gets grossly overpriced. But that doesn't happen very often. And we'll continue to hold something if it's modestly overpriced. Our analytic tools work much better on the buy side than they do on the sell side. And all through my long career, I've held securities for three years and sold 'em for a double only to see 'em triple over the subsequent six months. So just sitting around is a better way to make money.

Therefore, by and large, once we're in a security, we'll stay in it so long as there's been no permanent impairment of capital. So most of our exits are in mergers, acquisitions and takeovers rather than sales to the passive market.

Two holdings that we think did get grossly overpriced....

Whitman: That said, on the purchase side, we look at new names all the time. I'd think the majority of our purchases lately though have been adding to *old* names — especially when they got so depressed recently....

We did sell some First American Financial [FAF/NYSE]. We lightened up on it and Stewart Information Services [STC/NYSE]. Those are businesses [in which] we've had huge, huge appreciation. We bought 'em at big discounts. Now they sell at 5-7 times adjusted net asset value and their business is so good that it's hard for us to figure out how it gets better. So we lightened up on our title insurers, although not without some trepidation.

You'll probably look at 'em next year and say, "Whitman, you ass — why in the world did you sell those?" We just think they got close to being grossly overpriced, although we still own the bulk of our stake in those two.

We believe in concentration....

Whitman: One of the things I like very much about advisory accounts given our approach and background is this concept of dedicated, concentrated portfolios to take advantage of these rolling depressions. For investors interested in maximizing long-term return, for example, we'd have no problem building a portfolio consisting of semiconductor equipment manufacturers and Japanese non-life insurers. Today, those names would include ADE [ADEX/NASDAQ], Electroglas, Electro Scientific Industries, Speedfam [SFAM/NASDAQ] and Silicon Valley Group [SVGI/NASDAQ].

And for clients who can buy Japanese securities, they would include the ADRs of Tokio Marine [TKIOY/NASDAQ], the EDRs of Mitsui Marine and Chiyoda Fire & Marine. So

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we can make up a [concentrated] portfolio.

One of our favorite fantasies — great Japanese managers....

Whitman: But I would like to make one comment about how tough life in Japan can be.... Given our huge investment in semiconductor equipment manufacturers, we've had any number of their managements troop through our office — and we've visited others. But in that industry, it's my impression that ... they're all terrific, hard working, very dedicated and quite smart.

If the managements of our Japanese companies were that good, they'd make us *ungodly* rich — in part because they'd realize they're the *only* capital-rich institutions in an extremely capital short economy. And it's not that our Japanese managers aren't doing most of the right things, but they're just not the same. For example, they don't have the same sense of urgency. Given their pricing, however, our Japanese holdings are quite attractive.

WE COULD CONCENTRATE IN REAL ESTATE, TOO. AND, THERE, OUR MANAGERS ARE FIRST RATE.

Real estate co. mgm'ts are dedicated & high quality, too.

Whitman: We could also do real estate as part of a dedicated portfolio.... We think the people we're dealing with in our real estate holdings tend to be very dedicated, high quality managers, too.

Anyway, that's what we do. And as of today, I believe that there are tremendous opportunities out there for long-term wealth creation....

If I were still doing takeovers, here's one I'd focus on....

Client: What about Alexander & Baldwin?

Whitman: It's been a long wait, huh? Hawaii is much more oriented to Japan than it is to California. And if I know what I'm talking about in Japan, which I may not, it could be a long wait [yet].

But one reason why we're in Alexander & Baldwin [ALEX/NASDAQ] is that I think it's a great takeover candidate. It has separable businesses. Look at its proxy statements and see who owns what. And even though we could be in for a long wait before that business demonstrates wealth creation, there are obviously tremendous values. If I were still in the takeover business — as I was in the old days — boy, that's one I'd focus on.

Do we still like Forest City? Well, we're *buying* it....

Client: You used to buy Forest City [FCEA/NASDAQ] quite a bit — and you were always high on its management. Do you still like Forest City?

Whitman: Well, we're buying Forest City right now. It's in our price range today....

Tejon's five-year plan should realize substantial value.

[Editor's note: The following segment was excerpted from an earlier conference call:]

Client: Marty, could you comment on Tejon Ranch [TRC/AMEX] including the upper valuations you see on it and, perhaps, a timeline?

Whitman: What *I'm* happy with, since Bob Stine came on board in May 1996, is Tejon Ranch's management. I think the company's very well managed under Bob.

It has the largest contiguous land holding in California — it's a *monster* — and a five-year plan which, if it works, should result in the company realizing substantial value.

The rate of return under Bob Stine ought to be pretty good.

Whitman: Tejon just broke ground on a 450-station truck stop with a restaurant, motel and everything. I never knew about this, but it's really a gigantic business. And after that, we will develop an adjacent 200 acres for industrial development.

[In addition], as part of the five-year plan, we've been looking at a whole bunch of other deals including destination resorts, ranchette development and, maybe, some commercial development. We're only 60 miles from Los Angeles and a lot less from the San Fernando Valley.

I feel very good about it. I don't have a time line or an ultimate workout value. But I suspect the rate of return under Bob Stine's leadership ought to be pretty good.

CTO's returns should be pretty good from today's price.

Client: You have a position in Consolidated-Tomoka Land Company. Could you talk a little bit about that and what type of potential you see in that holding?

Whitman: Well, [we see] less potential than [we did] when we first bought it. Its key asset is some 29,000 acres in Daytona and environs that they're trying hard to develop. When we went in, Florida real estate people told me — and they were probably boxcar numbers — that it was [worth] something over $100 a share.

But *forget* about it. It's a nice investment. I don't know what the workout will be. It ought to [provide some] pretty good appreciation over the current ... [stock price]. But it doesn't have the same potential upside as some of our other real estate holdings — such as Alico (which is in Third Avenue Small-Cap Fund), St. Joe Corp (which is in Third Avenue Value Fund) or Avatar Holdings.

But it'll probably be all right. It's being developed. And it will be. It has an awful lot of acreage on both sides of U.S. 1 in the Daytona area.... They developed a golf course with the LPGA [Ladies Pro Golfer Association]. They've done some hotels. And unlike some of our other real estate holdings, its management has some sense of urgency.

[Editor's note: End of excerpt.]

THE STUFF WE'RE DOING IS *FANTASTIC*! I KEEP SAYING THAT IT'S 1974 REVISITED.

New processor could power Tecumseh to very nice returns.

Client: What do you think of Tecumseh Products?

Whitman: Well, Tecumseh [TECUA/NASDAQ] has a great balance sheet. If they survive their problems with the scroll compressor (which they seem to be well on the way to doing) Tecumseh should be a very attractive holding.

Let me ask Yang Lie to elaborate on it. Would you like to add anything about the scroll compressor aside from the fact that Tecumseh seems to be getting competitive?

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Yang Lie: Sure. They shipped a scroll compressor earlier that wasn't robust enough. So they had to pull it ... [and] redesign it. They've taken steps since to use some of the patents to make a more robust product.

Tecumseh's provided its new scroll compressor to some of its customers on a trial basis to get feedback on it. But it'll probably be another three to nine months from now before they complete their trials.

Once they do, they'll be able to ship the product. But until then — until they're comfortable the latest version is sufficiently robust, dependable and so forth — they won't. They don't want to make the same mistake again.

The only issue is whether there'll be major appreciation.

Client: Earlier, I believe you said, "*If* they survive." Do I sense a little doubt there?

Lie: I believe Tecumseh Products is well on the way to making the product viable.

Whitman: I probably misspoke. As I said earlier, Tecumseh does enjoy enormous financial strength. Furthermore, it has enormous earning power *outside* of room air-conditioners — which is where its scroll is used. So it's not really a question of survival.

But in order for Tecumseh to become an important appreciation vehicle and fully utilize its financial resources, obviously, the scroll compressor is very important.

Oil service folks are optimistic. Of course, they *always* are.

Client: What do you think of Nabors Industries and its possible takeover of Pool Energy? And what is your outlook for the price of oil over the next 12 months or so?

Whitman: I can't comment on Pool Energy [PESC/NASDAQ]. We're in this hostile environment with them now. So I don't think it behooves me as a director and a large stockholder in Nabors Industries to comment. Whatever the management at Nabors says, I adopt.

And I'm really not a student of oil prices. I would say that you can't speak to anybody in Houston who's not optimistic. Then, again, they've *always* been optimistic. So I just don't know.

I suspect ValueVision will either liquidate or get acquired.

Client: I think we also have a little stock called ValueVision International [VVTV/NASDAQ] in our portfolio.

(continued in next column)

Is anything going on with it?

Whitman: I hope they're liquidating! They've got a big cash position. They didn't do that merger. And I've got a hunch that it's more a risk-arbitrage security and that there'll be a reasonable workout in a reasonably determined period of time. I suspect they'll either liquidate or get acquired....

Bargains we're finding today are *terrific* — like '74 revisited.

Client: I understand that many small-cap stocks have been decimated. When you survey the landscape, where would you rate the value of small-cap stocks today relative to where it's been over the past 15-20 years?

Whitman: The stuff we're doing is *fantastic*! I keep saying it's 1974 revisited. And whether or not the market is decimated or deserves to be decimated will be proved or disproved by the future performance of the businesses.

Client: However, from a relative sense, you think that it's a great time to buy.

Whitman: I do. In fact, I never dreamed I'd be able to get into these semiconductor equipment companies at prices far more attractive than I'd get if I were a first-stage venture capitalist....

WHAT DRIVES US? INVESTMENT CONSIDERATIONS AND SELF INTEREST (I'M A BIG SHAREHOLDER, TOO.)

Our cash is way down....

Client: I understand that your high cash position was one of the reasons why you closed the Fund for awhile. Given that you've reopened it, do I gather correctly that you've been able to get most of it invested?

Whitman: That's right. Thanks in part to buying some of the securities that we've talked about today, we reduced our cash position from up around 40% at midyear to down around 10% today.

Too much of a good thing that *isn't* so wonderful....

Client: What type of analysis of clients' portfolios do you perform on an ongoing basis to assure that each one is full of the best opportunities at a given point in time?

Whitman: You raise a good point. We're not looking for the *best* opportunities. We're looking for opportunities that are good *enough* given the client's objectives. I think anyone who tries to do the *best* will overtrade the portfolio. We're just not that good.

We want to monitor each portfolio very carefully to make sure that each portfolio is always good enough. However, I think it's a mistake to try and do the best and do comparative analysis. That'll turn you into a trader. It's antithetical to a buy-and-hold approach to investing.

Investment benefits of new funds far outweigh any conflicts.

Client: Do you pay attention to tax issues — because there have been some losses recently — in your separately managed accounts?

Whitman: Yes, tax considerations are very important. And we do manage on an after-tax basis.

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THIRD AVENUE FUNDS'
MARTY WHITMAN ET AL.
(cont'd from preceding page)

Client: You've opened Third Avenue High Yield Fund and Third Avenue Real Estate Fund. However, given that the same guy who manages Third Avenue Value Fund's real estate component also manages the Real Estate Fund, will Third Avenue Value stay the same or change?

Whitman: In recent weeks, we've purchased some new names in Third Avenue Value in the high-yield and real estate areas. The high-yield ideas were originated by Margie Patel who runs our High Yield Fund. And the real estate ideas were originated by Mike Winer who runs the Real Estate Fund. Not only are they free in those small funds to do things, but I've found them to be a terrific asset in terms of creating investment opportunities for ... Third Avenue Value Fund.

The benefits far outweigh any potential conflict. I just don't see any conflicts. Margie and Mike have generated important new ideas for Third Avenue Value Fund....

When it comes to distress investing, we're not big *enough*.

Client: The Michael Prices and Tweedy, Brownes of the world accumulated assets to the point where they could no longer buy smaller companies. And now you've been doing a great job of accumulating assets yourself. However, by doing such a great job of bringing in assets, are you headed down the same road — closing yourself down or limiting yourself the same way eventually?

Also, how big can you get? Do you expect to put a cap on your size?

Whitman: In Third Avenue Small Cap Fund, we do have a problem. In FSI, we violated the poison pill. And in Silicon Valley Group, we either violated the poison pill or we're just about to violate it. So that's one side of the coin.

On the other hand, we invest in more than equities.... I mentioned Nabors earlier. Given the right circumstances, we'd do a good job in distressed merchandise when it's safe and cheap. And one way to be safe when you're buying distressed merchandise is to own enough of a class that *you* become the 800-pound gorilla. There, we don't even have *enough* size to do some of our deals.

We're driven by investment results — and self interest....

Whitman: I don't know what constraints we'd have. We'd clearly have some in public small caps. But let me assure you that we're driven by investment considerations, not marketing considerations or anything else. I just own too much stock [chuckles] in Third Avenue. And, therefore, it's in my self interest.... So any time we might get so big that it would diminish our opportunities, the Funds would close or the Advisers wouldn't accept money.

Client: And you don't know where that point is?

Whitman: Not yet. We may screw up investments. However, what truly drives us is investment considerations — getting good enough value for each account and fund.

IF YOU CAN'T PREDICT THE FUTURE, STACK THE DECK. BUT THE BROAD INDICES ARE STACKED AGAINST YOU.

OID: In your conference call, I believe you said that the bargains you've been finding recently remind you of those that you were finding in 1974.

Marty Whitman: That's right.

OID: With most stock prices up since then, I imagine that comparison would no longer apply.

Whitman: Actually, I think it *does*.

OID: How can that be?

Whitman: Well, we don't *buy* indices. All I know is that we're finding terrific bargains in selected sectors. We've been buying some mortgage-backed securities and junk bonds, for example, at absolutely fantastic prices. For example, we were buying Imperial Credit Mortgage down around $7 per share when its hard book value on a mark-to-market basis was more than $14 and it had almost no borrowings outstanding.

OID: And where's that one trading today?

Whitman: Today, it's trading slightly north of $9.50 — or less than 70% or so of hard book. So I think it clearly remains a 1974-style bargain.

And we were buying junk bonds — believe it or not, *convertibles* — yielding 30% to maturity. Granted, that opportunity's receded a bit. Today, there's only one that we're buying. And its yield-to-maturity is down to 25%.

A number of real estate securities also continue to trade at depressed prices — at discounts of 30-50% from their appraised value — including Forest City Enterprises, Koger Equity, Alexander and Baldwin, Commercial Equity, Catellus and Alico.

OID: We don't mean to look a gift horse in the mouth, but are discounts of 30-50% 1974-style bargains?

Whitman: I think they're compelling. However, if they aren't at 1974 prices, they're certainly at 1982 prices. But if it's 1974-level prices that you're after, we should tell you about some semiconductor equipment companies.

OID: How can that be? I read somewhere that the average stock in the group that includes that sector had risen 67% over a recent 8-week period.

Whitman: It's been unbelievable, all right. I can't give you the statistics for the sector as a whole. However, it's true that the semiconductor equipment segment of *our* portfolio has risen 54% since October 15th.

OID: On the other hand, an associate with better genes tells me that the sector is actually down for the year...

Whitman: I'll have to rely on your associate there. But our semiconductor equipment stocks as a group aren't up very much from our cost. We've invested approximately $288 million in the group and their market value at their current prices is around $300 million. So as a group, they're not up materially from what we've paid.

But let me answer you another way: Value investors deal in probabilities, not predictions — because the future

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THIRD AVENUE FUNDS'
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(cont'd from preceding page)

is generally unpredictable. And however much or little stock prices have gone up or down recently, it's nothing more than random walk. If you pay attention to the stock market, you'll go crazy — because it truly defies reason.

OID: That may partly explain my state of mind.

Whitman: The primary way that an investor can compensate for uncertainty is with pricing. Low prices put the odds on *your* side. High prices put them *against* you. That's nothing more than plain Graham and Dodd.

One measure of valuation, of course, is the multiple of price-to-book — simply stock price divided by book value. Unfortunately, book value in and of itself doesn't mean a whole lot for most companies because you have to adjust that book value up or down on a case-by-case basis to assess the resources you get relative to the price you pay.

But for an *index*, I think the price-to-book multiple is a pretty good measure as-is. Therefore, let me give you the price-to-book multiple of the Dow Jones Industrial Average at year end 1974 and a few other points in time:

Date	Multiple of Price to Book
12/31/74	0.8
12/31/82	1.2
12/31/87	1.9
12/31/90	2.1
12/29/95	3.9
12/11/98	5.7

OID: Are you trying to scare us or what?

Whitman: That isn't my intention. However, clearly, if you buy the Dow Jones Industrial Average, or almost any other broad index today, you're accepting very lousy odds. They're stacked pretty heavily against you — because you pay an awful lot relative to the resources that you get.

AT A DISCOUNT TO UNDERSTATED HARD BOOK, WE THINK THESE THINGS ARE *TERRIFIC* BARGAINS.

OID: And presumably, these statistics relate somehow to your semiconductor equipment companies...

Whitman: They do. The price-to-book multiples of our semiconductor equipment companies contrast starkly with that of the Dow Jones Industrial Average and most other broad indices. For example, as of December 17th, Silicon Valley Group, C.P. Clare, Speedfam International and FSI International all sold at discounts to book value of 40%, 29%, 19% and 20%, respectively [— in other words, at price-to-book multiples of 60%, 71%, 81% and 80%].

OID: Those sound mighty cheap, all right.

Whitman: They're *very* cheap — because not only are they trading at very low multiples of book, but they're also trading at very low multiples of *hard* book. There are virtually no intangibles whatsoever on the balance sheets of any of these companies.

But rather than tell you about these companies myself, let me bring in a couple of my associates.

OID: Three against one, eh?! No problem — at least not as long as we get to do the final edit...

Whitman: Curtis Jensen is one of the co-managers of Third Avenue Small-Cap Fund. (I'm the other co-manager.) Prior to joining Third Avenue, he was a commercial banker and an outstanding student in the course I teach at the Yale School of Management.

And Yang Lie is Third Avenue's resident engineer and a very talented analyst. Prior to going back to school to earn her MBA, she was a project engineer at Motorola. And, frankly, I think both of them are better equipped to understand this business than either you or me.

OID: Why would semiconductor equipment stocks be compelling bargains at 65-85% of book value?

Whitman: Several reasons: First, as I said earlier, at year end 1974, the Dow Jones Industrial Average sold at 80% of book. Therefore, relative to book, these companies are literally selling at 1974-level valuations.

OID: You could say that about steel companies, too...

Whitman: And second, these aren't steel companies. Semiconductor equipment companies produce the equipment that semiconductor companies use in their "fabs" (short for "fabrication" plants) to produce their semiconductors (the industry jargon for which is "chips").

And I think that you begin to get a sense that these semiconductor equipment companies aren't such terrible businesses right away if you look back and see that compared to the last time these companies were reporting peak earnings — which was back around 1996 and 1997 — I think most of these companies saw their stock prices get up to *4-8* times book.

OID: Wow. Talk about a stark contrast in valuation...

Whitman: And it's worth noting that these firms tend to spend heavily on R&D and that all of their expenditures — 100% — are *expensed*. Not one penny of their R&D expenditures is capitalized — *none*. So, once again, there are virtually no intangibles on the books in this industry.

OID: That sounds like an extremely important point.

Whitman: You better *believe* it.

Yang Lie: Especially given the importance these companies tend to assign to keeping up technologically. Most of them have tended to spend 10-12% of their sales on R&D.

Curtis Jensen: So their earnings and book values are probably significantly understated. At the very least, they're *conservatively* stated.

OID: They sound very cheap.

Whitman: We think they remain *fantastic* bargains. And even though that segment of our portfolio is up a lot from its lows, nearly *all* of those companies remain on our buy list. Granted, these stocks are listed on the NASDAQ. Therefore, we can only buy 'em with limit orders — and our bids are below the market. But they are on our buy list.

Plus, the ones that I mentioned earlier aren't up nearly as much as that segment of our portfolio overall.

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THIRD AVENUE FUNDS'
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USUALLY, ONLY THREE OR FOUR FACTORS COUNT.
HERE'S WHAT COUNTS IN THIS BUSINESS....

OID: On the other hand, I see no moat. The area seems to consist mostly of cyclical commodity businesses.

Whitman: Yep.

OID: Plus, their customers are other businesses — many of whom are far larger and nearly all of whom, by necessity, are extremely price sensitive. It sounds like Berkshire Hathaway's old suit liner business...

Whitman: Go on.

OID: And don't these companies always run the risk of one or more customers achieving sufficient clout to make their own equipment, transfer the leading share to a competitor or, at the very least, squeeze prices and profits down to razor-thin levels?

Whitman: Don't stop. I can tell you're on a roll.

OID: And Bob Rodriguez, the chief investment officer of First Pacific Advisors and portfolio manager of FPA Capital, suggested to us earlier this year that a recession is overdue and that it probably wouldn't be kind to semiconductor equipment companies.

Whitman: Yep. We read that.

OID: For all of those reasons, aren't these companies what Bill Ruane of Sequoia Fund might refer to as "trading sardines" as opposed to "eating sardines"?

Whitman: I don't think so. I think the industry's going to be *so* good and that the good companies are going to do so well — *spectacularly* well, in fact — that they *are* "buy-and-hold". So I think everything you've said is right, but I put it all down as irrelevant.

OID: I beg your pardon.

Whitman: Based on my own personal experience — both as an investor in recent years and an expert witness in years past — rarely do more than three or four variables really count. Everything else is noise.

OID: That's easy for you to say. If you had 64 pages...

Whitman: We think only three or four things count in this industry, too. What are those three or four things here? The first is that we think there's going to be explosive growth over the next decade and beyond. Why? First of all, semiconductors are no longer only used in computers. They're becoming ubiquitous — getting incorporated in everything from telephones to televisions to toys to cars and even credit cards.

OID: Even greeting cards, for God's sake.

And Rodriguez told us that high definition TVs utilize something like 500 microprocessors each — versus less than 10 in present day TVs.

Whitman: Yep. The whole world is going "digital". There's no question about it. And that digital revolution in telecommunications, media and so forth is another reason why we think that it's very likely that there's going to be explosive growth in the demand for semiconductors and, therefore, semiconductor equipment.

Also, basic advances in semiconductor technology — for example, the use of smaller and smaller circuits to achieve increased circuit density — will in and of itself result in semiconductor manufacturers having no choice but to replace and/or re-equip the equipment in their facilities simply in order to stay competitive. They have to ante up for the latest tools as a cost of doing business.

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

Whitman: The second important factor, we believe, is that the industry has always been highly cyclical and characterized by a recurring series of booms and busts. And we don't expect that to change. We believe it's a primary and permanent characteristic of the industry which anyone investing in the area should anticipate and incorporate in their security selection.

Third, the industry is very venture-capital-like — in other words, excruciatingly competitive, characterized by rapid change and a high incidence of both strike outs and home runs. Thus, it's highly management-skill-intensive.

PORTFOLIO REPORTS estimates the following were Third Avenue Small-Cap Value Fund's largest equity purchases during the quarter ended 10/31/98:

1. EVANS & SUTHERLAND COMPUTER
2. FINANCIAL SECURITY ASSURANCE HLDGS
3. FBL FINANCIAL GROUP CL A
4. DELTIC TIMBER CORP
5. CAPITAL RE CORP
6. ELECTROGLAS INC
7. KOGER EQUITY INC
8. SPEEDFAM INTL INC
9. HOLOGIC INC
10. CP CLARE CORP

And we expect that characteristic to persist, as well.

Therefore, even though we believe that the *industry* is going to experience explosive growth, we don't believe that every *company* will. And therefore, we expect merger and acquisition activity on a relatively large scale to occur within the industry.

So if we were smart enough, we'd just buy the ones that are going to be the winners that are cheapest today. But, sadly, we're not that good. Even worse, we don't know which ones are going to be the *losers*. And in fact, we don't believe anyone does. We believe the industry is that tough and unpredictable.

OID: Like I said...

Whitman: So we would rather not have to diversify — since diversification is a surrogate for knowledge, control and/or price consciousness. And if we could predict the future of these companies, we'd be less diversified. However, we can't. So we *have* to diversify.

Also, given those uncertainties, we only want to own companies that we think possess incredible staying power. And those are the ones we're buying. For example, I'm not aware of any semiconductor equipment company we own that doesn't have cash exceeding its total liabilities.

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OID: Certainly, investors can resort to diversification and/or staying power to offset a lack of knowledge. But couldn't you also just pass on the area?

Whitman: We could. But as I said earlier, the valuations in this industry are very attractive. And given the explosive growth in demand that lies ahead, most of these companies are venture-capital-like investments. Only they have two big *advantages* over venture capital:

First, their *prices* are far *better*. I've already given you an indication of their valuations relative to book value. Well, they're also very cheap relative to past peak earnings. For example, three of the four companies that I mentioned earlier are trading for between 5-1/2 and 8-1/2 times their past peak earnings. And one — Lam Research — is trading around *4-1/2* times its past peak earnings.

And we're very confident that the *next* earnings peak for most of these semiconductor equipment companies is going to be higher than their *last* peak — a *lot* higher.

OID: Would you like to hold on while I call my broker or would you prefer that I call you back?

Whitman: And besides their *returns* being higher, more often than not, they're also better *companies* — much more solid than most start-ups.

OID: So despite all of the negatives, the stock market is offering you a risk/reward ratio that you can't resist.

Whitman: That's right. And that's what counts. The immediate earnings outlook and predictions about how long the current industry depression will last is just noise and irrelevant to what we do as buy-and-hold investors.

OID: So much for my next two questions...

ALL SEMICONDUCTOR COS. AREN'T CREATED EQUAL.
FAB BUSINESS IS FABULOUS, CHIP MAKING AIN'T....

OID: But why semiconductor equipment companies rather than semiconductor manufacturers or some other equally unfathomable high-tech company?

Whitman: To me, the semiconductor equipment industry is more understandable, for example, than semiconductor manufacturers or computer manufacturers. And I'm more comfortable with these companies than I am with all of the poor schmoes who have to go head-to-head against Intel. We also own some software companies that we think are properly situated. And we've put together a little portfolio of medical device manufacturers on much the same theory. We just don't have the same discomfort owning those that we might owning Lattice Semiconductor, National Semiconductor or Micron Technology.

Lie: I agree. Semiconductor *equipment* companies tend to be concentrated in niches — most often based on proprietary technologies. Semiconductor *manufacturers*, on the other hand, tend to be exposed to competition from the big players. And, of course, it's hard for smaller players to compete against gorillas like Intel.

OID: It certainly doesn't sound like my idea of fun.

Jensen: Nor mine. I think the capital intensity of the semiconductor manufacturing business alone was enough to steer me clear of it. I don't like the idea of being in a business where you have to spend lots and lots of money fairly regularly.

OID: The notion of selling tools sure sounds better (other things being equal) than having to buy 'em. But why wouldn't semiconductor equipment companies have to spend lots and lots of money regularly, too?

Whitman: They *do* — for R&D.

OID: Why not for capital spending, too?

Jensen: They don't *need* a lot of bricks and mortar. What they need are little clean rooms where they create and assemble expensive tools. And they *buy* their *components*. So the business just doesn't require a whole lot of bricks and mortar or a whole lot of outlays on expensive tooling.

Lie: By contrast, a fab [fabrication plant for the production of semiconductors] typically costs $1-2 billion. By no means are they cheap. Thus, chip makers clearly face very significant capital expenditure requirements, whereas semiconductor equipment makers don't.

Jensen: And not only are capital expenditure requirements much lower for semiconductor equipment companies than they are for the *chip* makers, they're probably lower than those of *most* businesses.

Lie: Also, there are approximately 20 different steps in the chip manufacturing process. And some equipment can be used in more than one step. The 800-pound gorilla in semiconductor equipment is Applied Materials. And it isn't specialized. It has exposure across most of the process areas on the front end.

(Of course, front end processes refer to those in which the chip is made, whereas back end processes refer to those in which they're tested and packaged.)

And most of those 20 steps are relatively discrete with different factors being most important at each. Thus, it's much easier for semiconductor equipment suppliers to occupy and defend a niche.

OID: Interesting.

Jensen: That's right. It's much harder to assess whether companies will keep buying their chips from National Semiconductor. However, one thing that we think we do know is that National Semiconductor is going to have to keep buying tools to run its factories. We believe that we can pretty well winnow down the list of suppliers in each equipment niche to the two or three who have a good shot at being successful. And those are the ones we've bought.

OID: Qualitative and quantitative factors considered.

Jensen: That's right.

GOOD TIMES IN THIS BUSINESS ARE VERY GOOD —
ESPECIALLY WITH SMART MANAGEMENT IN CHARGE.

Whitman: One of the hardest things that we have to do is evaluate management. And since we began buying

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our semiconductor equipment companies, we've met — primarily one-on-one — with the managements of most of the companies we've bought. Nearly *all* of the ones that we've met are terrific — extremely dedicated and very good. We're very happy with 'em.

In contrast, we have huge investments in Japan — mostly in non-life insurers. And I shouldn't say this...

OID: It won't go beyond our pages.

Whitman: In one Japanese company after another, I feel as though I'm dealing with a bunch of deadheads. It's quite a contrast.

But one after another, managers in the semiconductor equipment industry seem dedicated and smart — just the way we like 'em.

OID: Of course, that may be because those who aren't very nimble get winnowed out quickly in this business.

Whitman: That's a good point.

OID: Explosive growth in demand sounds like a given. But there's been enormous growth in air travel, too. And the returns in that industry have been negative....

Whitman: Prior to the current industry depression, the semiconductor equipment companies we're buying demonstrated substantial earning power relative to their capital employed and their current stock prices. In the good times, ROEs of 20-30% have probably been the norm.

OID: And during the bad times — like today, ROEs have no doubt been negative. But what kind of return do you think they're likely to earn over a full cycle?

Whitman: Above average. But I can't refine it much.

Jensen: Whatever the ROEs have been, it's somewhat misleading because so many of these companies have maintained relatively cash-rich balance sheets.

Whitman: Again, these are very smart managers. Therefore, when things are going well, the stocks of these companies tend to get super P/E ratios in the stock market. And most of the companies that we own got their cash by taking advantage of super stock prices to issue stock. They've been terrific at that. When their stock's been up around 40 times earnings, they've often issued shares.

Jensen: Exactly. For example, at the end of 1997, Speedfam did a secondary issue and raised money at $52 per share — or more than 3-1/2 times today's price.

Whitman: And Lam Research did the same thing. They issued a subordinate convertible at $87 per share — or nearly 5 times its current price.

OID: Wow.

Jensen: We also own the fixed-income securities of some super credits in the semiconductor equipment area. For example, we bought Cymen's 3-1/2s of 2004 at a yield-to-maturity of about 17%. And their yield-to-maturity today is probably still 14-15% — which obviously isn't bad.

Whitman: And anyway, those share issuances are something else that suggests to us that we're talking about very astute managements.

Lie: Again, we picked well financed companies, too, because the industry is cyclical; so if a company doesn't have good finances, it's likely to become a casualty during the down part of the cycle during the tough times — either by going under or falling behind and becoming a non-player.

WHY IS C.P. CLARE SO CHEAP? WHO KNOWS?!
BUT AT TODAY'S PRICE, IT'S A *HECK* OF A BUY.

OID: Might you tell us a little bit about C.P. Clare and why its stock has taken such a beating — especially in light of its industry group having done so well?

Whitman: I don't know. But I *never* have any idea why the market does something. And if I ever think the market knows more about any of our companies than I do, I shouldn't *own* it — and I *wouldn't*. What's the market got to do with it? Feel free to quote me on that.

OID: The last time we asked you something like that, you said it was like asking you to understand abnormal psychology.

Whitman: Exactly. Who *knows* about the market?

OID: If it's abnormal psychology, I feel very qualified...

Jensen: C.P. Clare has gotten hammered particularly bad recently. But we don't know why. But if you're asking if there's anything at a company level that makes it less attractive than any other company in this area, I don't know of anything. I just think it's a heck of a buy.

OID: Then let's go straight to the ultra-sophisticated fundamental analysis: How does C.P. Clare stack up in terms of business lines and all that techno-stuff?

Jensen: First of all, we tend to lump C.P. Clare in with the semiconductor *equipment* companies. But it really isn't an equipment vendor. It's a manufacturer with two segments: The first is analog and mixed signal semiconductors. And the second is discrete components like relays and switches and magnetic components for modems, transformers, etc. And those two segments each account for roughly half of their revenues.

We lump it in with the equipment companies because its fortunes are also tied to the semiconductor cycle.

Whitman: Yeah. We lump Electro Scientific and AVX in with them, too. AVX isn't an equipment company either. It's an electronics company — it makes capacitors — which are basically used in almost every type of electrical device.

Lie: The fortunes of one may lag or lead the other at different points in time, but they're clearly related.

Jensen: We expect C.P. Clare to exit the second segment — the relay and switch side of the business — and reinvest that capital on the semiconductor side. They think their competency is based on the semiconductor side — where they think there are better growth opportunities.

OID: And I gather you view that as a plus?

Jensen: We do — for several reasons: First, I think it is their distinctive competence. Second, it's a higher growth segment by nature of the end markets they serve:

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(cont'd from preceding page)

i.e., communications (modems and cellular handsets). And, third, I think that they should be able to achieve reasonable margins in that segment. The product cycles and design cycles tend to be a little longer in that segment and not quite as ferocious.

OID: I guess everything's relative.

Whitman: As I recall, C.P. Clare says that they're the big factor on the analog side. They're the king of analog — whatever the heck that is. Isn't that right, Curtis?

Jensen: Yeah. In the markets they serve, they claim to be #1 or #2, although I can't give you an exact figure because it depends on how you measure share — whether you're talking units or dollar volume, how you split up the product category, etc. But they claim to be leaders.

OID: How would you assess the quality of its business and the quality of its management relative to the quality of the other businesses you've told us about and the other players in that industry?

Jensen: Well, C.P. Clare's been in business for about 60 years. So it's not an upstart business by any means. It's run by a guy named Art Buckland who has a lot of his personal wealth in the stock. He became the president of the company in 1993 and is currently president and CEO. And he runs a conservative show.

Whitman: Based on everything I've read and heard, they're well respected — both in terms of their technology and customer satisfaction.

Part of my thesis for C.P. Clare is that its customers on the semiconductor side are companies like Motorola, 3Com, Ericsson and Nokia. Thus, by buying C.P. Clare, you're participating in the growth of those — only without *paying* for it.

OID: That sounds like a winning combination. But could you tell us the range of prices you haven't paid?

Jensen: I believe that we've paid as little as $7 and as much as $12 for C.P. Clare.

Whitman: And our average cost is up around $9 versus a current market price of about $6.00.

OID: With apologies for asking you to understand abnormal psychology, stocks go down for a reason. What do you think the reason could be here — aside from the current state of the industry?

Whitman: It's probably what the reason *usually* is: Merrill Lynch, DLJ or some other major broker said the company's earnings outlook for the next six months is poor — and they're probably right. But to us, that's *irrelevant*.

Jensen: Again, we don't know of any reason. It doesn't look like any of their large shareholders are selling. C.P. Clare was break-even in the latest quarter on an operating basis, although its reported numbers were much worse as a result of having just completed an acquisition and letting some people go.

OID: Including its chief operating officer, I gather.

Jensen: That's right, although I believe that was just part of their slimming down process. Art Buckland is basically going to do that guy's job for now. They're just tightening their belts and saving some money.

[Editor's note: On December 21st, the company also announced the resignation of its CFO (and his immediate replacement by the Vice President and Senior Analyst to the CFO at Fidelity Investments).]

Jensen: Also, they're in the process of expanding their manufacturing capacity. And I mention that because when someone does something like that and the cycle starts to turn against 'em, as it has with C.P. Clare, one result is low capacity utilization. And that really hurts a company's earnings in the short run.

OID: But you think it's a good thing over the long run.

Jensen: I do. In the past, C.P. Clare has been capacity constrained. And that facility should eventually enable them to lower their costs, improve their margins, etc. So they've invested money in their business over the last couple of years. And when the cycle finally turns and demand comes back, I have to believe its earnings will come back, too — as Marty says — stronger than ever. In any case, *we* think it's going to be nice.

But for now, business conditions are soft. And its results are temporarily depressed. However, I don't think it deserves to be trading at around 70% of book value....

SILICON VALLEY GROUP ISN'T #1 IN MARKET SHARE, BUT IT *IS* DOMINANT IN TERMS OF TECHNOLOGY....

OID: And Silicon Valley Group also looks very cheap. What's the story there?

Lie: Silicon Valley Group is in a somewhat more competitive industry. Their technology's very leading edge. They're focused on deep ultraviolet [UV] technology.

OID: Super. Remind me to ask you what that is another time...

Lie: Their big competitors in it are ASM Lithography out of the Netherlands and Canon and Nikon in Japan. So they have really big competitors.

They're trying to get their customers to move from their prior generation I-line to their deep UV. And it's happening. They are moving. But given the state of the semiconductor industry, it's been happening more slowly than it would have otherwise.

OID: So the extra deep discount is based on investors being in a deep ultraviolet funk because of that delay?

Lie: That's right. They have really good technology. Even Silicon Valley's competition will tell you that. Their customers include Intel, IBM and Motorola. And, certainly, Intel — given its status as the 800-pound gorilla of the semiconductor manufacturing business — should give you an idea of just how good Silicon Valley's technology is.

Whitman: And an indication of how highly *we* regard it is that we own 16-17% of Silicon Valley's common stock.

OID: Sounds like true love to me.

But how would you rank its management?

Jensen: Its chairman, Papken Der Torossian, has

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been around forever.

OID: He's old and decrepit?
Jensen: That's not exactly what I meant. I mean that he's been through multiple cycles.

Whitman: He was in here the other day. And their CFO, Russ Weinstock, was in here, too. They seem like good guys. Anyway, *I* like 'em.

OID: If we need to complete a foursome for Monopoly, I'll keep that in mind. But how would you rank them management-wise?
Lie: Because both have been through cycles together before, I think that experience helps 'em manage the swings.

Jensen: Most of the managers running these companies have been around for a long time. So they've been through multiple cycles. And that's a source of comfort to us.

OID: There are a lot more young fools than old fools...
Lie: Relative to the company's size (and we're talking about annual revenues of around $600 million) we think Silicon Valley Group's management is pretty good.

Whitman: Both of them are *plenty* good enough in our view. We can't cut it that fine.

OID: Nobody's perfect.
Whitman: It's not so much management-related. But more can go wrong at Silicon Valley Group than could go wrong at Applied Materials which we own, too. However, we're not buying Applied Materials today.

OID: Because of its price.
Whitman: Exactly.

OID: Is Silicon Valley Group dominant within one or more of their core niches?
Jensen: Silicon Valley Group isn't dominant in terms of market share, but it is dominant in terms of technology in the photolithography area. It sells its tools under the Micrascan brand name.

OID: But if it's dominant in terms of technology, why isn't it dominant in terms of market share?
Lie: What happened is that Silicon Valley Group had some problems during the peak times that kept them from being able to fulfill the demand of everyone who wanted to buy their machine. Therefore, although they were able to land some key accounts, they don't have market share leadership in that area yet.

Jensen: By the way, photolithography only accounts for about 50% of their sales and orders today. But it should account for a considerably higher percentage within the next year or two. They're not really anything special outside of that area. So Silicon Valley Group's future is in photolithography.

OID: Who's the market share leader today?
Jensen: It depends on how you segment the market. But the overall leader is probably ASM Lithography — which is a Dutch company.

OID: And how likely is it that Silicon Valley Group eventually captures share leadership in that area?
Jensen: That's very hard to say. That business is at an interesting crossroads because competing consortiums are discussing the standards for the next generation tool. And Silicon Valley Group and Intel are in one camp. However, IBM is one of the members of the other group. And it's not clear which standard is going to prevail.

I don't think its Silicon Valley Group's intent to go out and kill Nikon and Canon. I believe that they just hope their standard prevails and that they're able to build a good product and get their fair share of sales.

OID: Their fair share being...
Jensen: Today, that segment probably has revenues of between $250 and $300 million. And they'd like to scale it up to have revenues of $1 billion in the next few years. They think it could be a $1 billion business in a few years.

OID: What do you think?
Jensen: I think those goals may be a little optimistic. But I don't think they're off the wall. I think those figures provide an indication of the potential that's there. In effect, it's not a zero sum game because that pie is likely to grow at a very healthy clip over the next several years.

[Editor's note: If SVGI were able to achieve incremental revenue of $500 million, that would be equivalent to approximately $15 per share for each of its 33-odd million shares outstanding. On its face, at least, that doesn't sound too shabby for an $11 stock — especially one with $4.50± per share of net cash which has sold for more than $49 per share.]

Jensen: One reason why its earnings have looked so bad, by the way, is that they've been adding lots of capacity in anticipation of future demand. And until it materializes, that additional capacity will be a drag on their results.

OID: But you expect it to be a plus over the long-term...
Jensen: That's right. By the way, we've also tried to diversify by process segment to avoid getting overloaded in any single process. We don't want to be too concentrated in resist processing, lithography, probing or anything else.

OID: Primarily to avoid being overly concentrated in a process that becomes technologically obsolete.
Jensen: Exactly.

OID: You mentioned that Silicon Valley Group was the technology leader, but not the market share leader. Are any of the other companies you mentioned leaders in technology but not market share or vice versa?
Jensen: I believe FSI International has the leading technology in a couple of its segments, whereas it's probably only #3 or #4 in terms of market share. That's the situation in both their surface conditioning and their microlithography segments.

OID: Do you think their share is likely to change?
Jensen: I think they're very determined to be #1 or

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#2 in their respective markets or not be there. And I think within a reasonable time frame — maybe 12-18 months — that they will make a move in some of their businesses.

OID: Any others?

Jensen: Technology is also ahead of market share at GaSonics International.

[Editor's note: FYI, on December 16th, GaSonics announced that its board had authorized the purchase of up to 500,000 of its 14.2-odd million outstanding shares.]

BULLET-PROOF MOATS? DON'T HOLD YOUR BREATH.
BUT GIVEN THE VALUATIONS AND FUTURE GROWTH....

OID: You don't worry about Applied Materials or any other big players steamrolling these guys?

Whitman: We *do*. Over the long term, *all* of these companies are vulnerable. All of them are in danger of being unseated. That's why we're diversified.

OID: So there's not much of moat.

Whitman: If they have a moat, it's limited — based in part on engineering, in part on how well they maintain their customer relationships, in part on whether or not they produce a high quality product with a low level of defects and in part on whether they deliver it on time.

OID: There's no need to get personal.

Whitman: Also, the industry is very fast moving.

Lie: Agreed.

Whitman: *Everyone* has vulnerabilities on that score. No one is immune from that risk in this business. That's just one of the characteristics of the industry.

OID: And don't these companies face a stiff headwind — and foreign competitors who enjoy cost advantages — given current exchange rates?

Lie: They do. That's definitely an issue.

OID: Also, couldn't an expensive U.S. dollar hamstring their ability to compete for who-knows-how-long?

Jensen: Sure. If the U.S. dollar stayed too expensive for an extended period, they could be in for a world of hurt. Their primary competitors outside the U.S., incidentally, are pretty much exclusively Japanese players.

Lie: But those Japanese players are very aggressive.

Whitman: We're sorry we don't own Tokyo Electron. We would if it sold at the kind of price as those we've discussed. It's not on our radar screen. But the last time that we looked, it was selling at around 24 times earnings, 3 times book and 1.5 times revenue.

OID: How big are the Japanese players in this area relative to the American participants?

Jensen: *Big*. The two largest Japanese players in this business are Tokyo Electron and Tokyo Seimitsu — also known as TSK.

Lie: They're similar in size to Applied Materials...

Jensen: Which is the largest in the world.

Whitman: Those two Japanese firms are big mothers. For example, Tokyo Electron has sales of ¥455.6 trillion — which, at prevailing exchange rates, is over $3.92 billion.

Jensen: But the revenue figures for Tokyo Electron and Tokyo Seimitsu are somewhat misleading because they have other businesses besides semiconductor equipment.

OID: On the subject of competition, "Value Line" says Applied Materials has tended to gain market share during tough times such as today's because of their high R&D outlays and conservative footing.

Lie: That's their strategy. And they've been gaining market share during this downturn in several segments including chemical mechanical planarization.

Whitman: But if someone wants a market that one of these companies has, they can do it in two different ways: (1) They can either enter the market by making something de novo; or (2) by acquiring an existing player — generally at a premium to the market.

And given the pricing, I think the dynamics are going to play out in M&A [mergers and acquisitions] rather than new entrants. If I wanted to compete with C.P. Clare in the analog business, I know that I'd go out and *acquire* them. Given current pricing, that would make a *lot* more sense.

Jensen: Plus, one of the ways that these companies can improve their economies of scale is by merging — as Speedfam and IPEC [Integrated Process Equipment] just did. So competition from AMAT and other bigger players could drive the trend of consolidation.

Whitman: And again if we're right about the growth, these companies could lose share and still do fine.

VERY LITTLE IS WRITTEN IN STONE, EVEN GROWTH.
AND MASTERS OF THEIR OWN FATE THEY'RE NOT....

OID: What then could turn these things into mistakes — besides killer competitors, a prolonged downturn or a U.S. dollar that remains overpriced for awhile?

Whitman: What else could turn 'em into mistakes? As you say, the severe industry depression could wind up lasting much longer than we think likely at this point. Also, the strikeout ratio among our companies could always be higher than we expect.

I think the biggest thing that could go wrong would be that contrary to what we expect, the industry *doesn't* grow. So instead of resembling the auto parts industry, it winds up resembling the textile industry. If it turns out to be a shrinking industry, if the Japanese or the Koreans or someone else runs American companies out of the industry, then we'll be in trouble. There's no question about it.

OID: In other words, although these companies are selling at very low multiples of trailing peak earnings, they might never see those peak earnings again.

Whitman: You've got it. But other than the things we've touched on, I'm not sure what else could go wrong. One thing that's *not* very likely to go wrong, in *my* opinion at least, is for these companies to burn through their cash

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and become insolvent — at least under current conditions. And that's unlikely for *two* reasons: First, most of the ones that we own have net cash. Second, the ones we own aren't likely to have a very high burn rate on their cash. So I think that's *very* unlikely.

OID: And yet it looks like either their cash balances and book values are declining or growing, if you will, in the wrong direction...

Whitman: I don't think so. Most of the companies we own are managing to be cash flow neutral. But even if industry conditions *do* worsen and these companies start to burn cash at a very high rate, our hurt may be minimal. When you're in well capitalized companies, if they *do* start to dissipate, you usually get a chance to get out. On the other hand, when you're in *poorly* capitalized companies, you better watch the quarterly reports very closely.

OID: I strongly resemble that remark.

Whitman: It's always possible that our companies cut back too much. We keep telling 'em we don't want 'em to do that and they keep stroking us. Most of 'em tell us they're maintaining R&D. But I don't necessarily believe it — because they are in a very severe depression and they're probably getting another message from the other analysts. So a lot of 'em play the quarterly earnings game.

Jensen: Although R&D cuts tend to be a last resort.

Whitman: On the other hand, a bigger risk even than cutting back too much on R&D may be cutting back too much on customer service...

OID: Customer service?!

Whitman: Customer service. If you're not a supplicant to Intel, they'll boot you from here to...

OID: Please! We want to maintain our PG-17 rating. But it sounds like most of these companies only have their business through the good graces of the semiconductor companies — and that their revenues are subject to termination almost at whim.

Jensen: It is something of a contracting industry — where these companies are supplicants. For example, one of the next big technological advances in the industry is the upcoming transition from the current 200-millimeter, 8-inch wafers to 300 millimeter, 12-inch wafers. And that move will require very expensive retooling.

OID: Sounds good for the equipment makers.

Jensen: It is — over the long term. However, roughly twelve months ago, the major chip makers like Intel told the equipment vendors to have next-generation, production-ready tools ready for testing within six months. So these companies raced to develop next generation tools.

But then, all of a sudden, Intel and IBM said, "Oh, we're not quite ready for those tools yet. In fact, we probably won't need 'em until after the turn of the century. So maybe you don't need to rush after all."

However, meanwhile, these tool companies had been spending money like crazy — incurring additional expenses and putting off other projects in the process.

OID: In effect, when the major chip makers say jump, the equipment makers say, "How high?".

Jensen: Exactly. The major chip makers call the tune — dictating allowable turnaround time and everything else. And, in fact, by reducing the allowable turnaround time, they've put even more pressure on the equipment vendors.

Plus, there's a critical mass issue. Tool makers have to be able to service their customers around the world, seven days a week, 24 hours a day 365 days a year.

OID: You sound like you're making the case for Applied Materials again.

Jensen: We think most of our companies have that capability, too. However, it is something to be aware of. There are hundreds of tool vendors — many of whom make essentially the same tool. And there isn't going to be a need for the third, fourth or fifth player at some point.

The ultimate irony may be that the chip makers have gained all kinds of efficiencies because of enhanced output resulting from improvements in semiconductor equipment. One of the things that's been hurting the tool makers is "die shrink" — where they shrink the geometries of a given wafer and chip. As a result, they get more chips per wafer which increases the volume of chips they can crank out using the same number of existing tools.

OID: And therefore, there isn't an absolute correlation between the unit volume of semiconductors and the ultimate demand for semiconductor equipment.

Jensen: Exactly — although, again, we expect growth to be explosive long term nonetheless both as a result of higher volumes and continuing technological advances.

THESE COMPANIES USED TO SELL AT 2-3X *REVENUE*.
HERE'S A DOMINANT PLAYER AT 4-1/2X PEAK *EARNINGS*.

OID: What would it take price-wise to make you sell — 2 times post-recovery revenue?

Whitman: I doubt it. What *would* make us sell (and *fast*) is if we detected a permanent impairment of capital. And that's going to happen to quite a *few* of 'em.

OID: Is there a price at which you would consider these things fairly priced — relative to their revenues or anything else — in, say, the good part of their cycle?

Whitman: I don't know. It would depend in part on the merger and acquisition environment. All I know is that as long as they keep their strong cash position, most of those companies' stocks are trading nowhere *near* a price at which we'd even *think* about selling 'em today relative to their book value, net asset value *or* prior peak earnings.

OID: So their sales and earnings are depressed along with their stock prices. What kind of valuations did these companies tend to sell at in the good times?

Jensen: Probably 2 to 3 times revenues during the good, old, frothy days.

OID: Versus 4 times peak earnings, I believe you said, in the case of Lam Research.

Whitman: That's right. As I recall, Lam Research's

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peak earnings on an undiluted basis were $4.92 per share. They did make an acquisition since then for stock. However, based on the raw numbers, that's what they were.

OID: What else can you tell us about it?

Whitman: I think the issue for us is more qualitative.

Lie: Lam Research has a dominant position in the etch market — which is the process of removing material not required for a chip's design pattern. Also, as Marty alluded to earlier, Lam acquired OnTrak Systems. And along with that acquisition also came a solid position in the chemical planarization market.

OID: Come again?

Lie: Chemical mechanical planarization (CMP) refers to the process in which wafers are polished so that they're flat enough to lay another pattern layer onto the wafer.

Jensen: It's a very expensive grinder essentially.

Lie: It's a big growth area. And Lam's market share in that area is growing. Plus, along with OnTrak Systems came Jim Bagley who had been vice chairman and COO of Applied Materials before joining OnTrak. So Lam Research also got someone with a vast amount of knowledge to run Lam. Thus, it has very good management, too.

OID: Why does a company with all those virtues sell for only about 4-1/2 times trailing peak earnings? Something doesn't compute. What's the catch?

Whitman: No catch.

OID: Are there any others you'd like to mention? Or if you like your entire portfolio, we'll just put your telephone number at the end of the feature...

Whitman: We really *do* like our entire portfolio. But besides those we've already mentioned, the ones we've been buying and have open orders for at today's prices include ADE Corp., AVX, Electroglas and GaSonics International. There are others we like qualitatively that don't make the cut quantitatively — i.e., in terms of price. But the ones I just mentioned make it qualitatively *and* price-wise.

And I suspect there are more than a few good names that we've left out. We can't buy everything, after all.

OID: Again, most of the stocks in this industry group have gone up a ton. Are these still cheap for a reason?

Jensen: The group has come back a fair amount. However, they were extremely oversold. The industry actually seems to be recovering a bit. At least there's a more positive tone.

And Joe Reinhardt of ESIO spoke at our conference. He didn't talk about their quarter. But he said things in the industry seem to be bottoming. He said, for example, that he recently sat down with a salesperson whose goal was $20 million of bookings who came in with *$200* million of prospective bookings. So his sales force isn't euphoric, or anywhere near euphoric, but they're feeling better.

We've heard the same kind of thing from other folks in the area. And the stock prices seem to be looking ahead.

OID: But there's nothing wrong with any of these companies that you're aware of that might justify their prices being as depressed as they are?

Jensen: Aside from those that we've discussed, nothing that we can find.

Lie: I don't think they're cheap for a reason. I just think companies like Applied Materials and KLA-Tencor moved first and that the smaller companies will follow, but only after a lag. That's all.

Whitman: And if so, their biggest negative is basically their lack of current earnings.

OID: In that case, sign us up. We reconciled ourselves with that negative years ago.

OUR JAPANESE INSURERS HAVEN'T BEEN DISASTERS, BUT WE ARE LESS OPTIMISTIC THAN WE WERE....

OID: Do you have any other bargains for us today?

Whitman: Well, of course, we believe that our Japanese non-life insurers remain fabulous bargains.

OID: I wanted to ask you about those. But I thought

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SELECTED FUNDAMENTAL/VALUATION DATA
ON SOME OF THE SECURITIES MENTIONED

Company	Stock Price 12/24/98 ($/Share)	Book Value ($/Share)	Price to Book	Net Cash ($/Share)	Cash as % of Stock Pr	Peak Earn ($/Share)	Price to Peak EPS	Peak Sales ($/Share)	Price to Peak Sales	Data as of
C.P Clare Corp. [CPCL]	5.63	8.64	0.65	0.50	0.089	0.89	6.4	16.64	0.338	9/27/98
Electroglas, Inc. [EGLS]	12.00	9.50	1.26	6.64	0.554	1.88	6.4	8.58	1.399	9/30/98
FSI Int'l. [FSII]	10.25	8.55	1.20	2.73	0.266	1.24	8.3	13.19	0.777	11/28/98
GaSonics Int'l. [GSNX]	8.06	5.32	1.52	2.12	0.262	1.14	7.1	8.96	0.900	9/30/98
Lam Research [LRCX]	17.63	12.78	1.38	(0.22)	(0.013)	3.76	4.7	34.39	0.512	9/30/98
Silicon Valley Grp. [SVGI]	10.81	18.06	0.60	4.70	0.435	1.94	5.6	19.65	0.550	6/30/98
Speedfam Int'l. [SFAM]	16.38	17.89	0.92	8.11	0.495	1.25	13.1	11.49	1.425	8/31/98

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you might prefer not to think about 'em.

Whitman: Actually, our Japanese holdings haven't done as poorly as you might think. As of December 17th, our cost basis in those holdings was $161 million — versus a current market value of $164 million.

OID: They're actually up a bit?! Our subscribers aren't going to believe that any more than we do.

Lie: Yeah. Even *I'm* surprised.

OID: I thought stocks in Japan had experienced death and desolation since you began buying 'em.

Whitman: Yeah. When we first began buying our Japanese non-life insurers, the Nikkei was at ¥20,000 versus less than ¥15,000 today.

But I think if you were to look at the gamut of financially strong businesses in Japan, you'd find the same good relative performance. Why? Because the Nikkei includes bank stocks that are off 60-70% in that period and domestic companies that weren't very well financed.

Lie: And real estate.

Whitman: Yeah — and construction and shipping. Meanwhile, the Japanese non-life insurers that we bought are *extremely* strong companies. Plus, we bought 'em at huge discounts from NAV [net asset value]. And like I say, that kind of thing helps in a bear market.

OID: Because you bought the ones with the strongest balance sheets, etc.

Whitman: When you buy the stocks of companies that are very well financed at deep discounts, more often than not, good things happen.

Mind you, it doesn't hurt to have good old dumb luck. Our biggest position in Japan by far has been Tokio Marine. And our cost basis there is about $46 million versus a current market value of $59 million. And Yasuda's up, too — from our cost of about $12 million to about $15 million.

However, some of our Japanese non-life insurers have done worse than others.

OID: Those are the ones we're most interested in. But before I ask you about them, might I trouble you first to review your rationale? I assume it's similar to that of the folks at Cundill Funds and Longleaf Partners.

Whitman: Yeah. I suspect we're more pessimistic about the business environment and economy in Japan than they are. For example, I think Peter's more optimistic about the prospects of a business recovery in Japan than we are. And I think the guys at Cundill and Longleaf are more favorably disposed to some of the managements than we are, too.

OID: Although I get the impression that may not be saying very much — at least in the case of Cundill...

Whitman: We don't see any imminent recovery. We're just buying these things cheap. However, those guys are closer to it than we are. For example, we only deal with companies who publish their reports in English, whereas Peter gets English translations of the reports that only publish in Japanese. So we have a more limited universe. And you won't find investors who are any better than Cundill and Longleaf. They're both terrific.

But if I'd had the same opinion of managements in Japan when we started investing over there as I do today, I don't know if we'd have gone in as heavily as we did — *despite* the fact that they were so cheap.

OID: Very similar to what I say about publishing...

Whitman: I don't think I could have passed up stocks this cheap anyway. And we were never enchanted with Japan's managements. I just thought the same thing would happen there that happened in the U.S. in the '70s and '80s when capital markets got so efficient and management shaped up and worked for the shareholders or shipped out.

Maybe we're just too far in the middle of it. But Yang and I were in Tokyo recently. And it's not a pretty picture management-wise. Most of the managements we see in Japan are plain vanilla and don't make use of their immense resources — at least they don't make use of them as much as we'd like.

On the other hand, some managements, like the one at Tokio Marine, are doing a lot of *very* good things.

OID: Unfortunately, they're the exception.

Whitman: Exactly. So will Japan's capital markets get efficient enough to force those other managements into joint ventures, mergers and acquisitions and all of the stuff that happened in the U.S.? I feel less certain about that today than I did 18 months ago.

I don't want to hold us out as experts in that area. One reason why Buffett is such a great investor is that he's a fantastic judge of people. We're not. For us, the best single indicator of management is the documents.

OID: To look at the paper trail.

Whitman: Yeah. I think they provide a lot of clues. So we read those documents carefully. And when we do, we conclude that although these capital rich companies have huge opportunities, we're very doubtful that their managements will take advantage of 'em.

YOU SAY STOCKHOLDERS ARE STAKEHOLDERS?
NOT IN THE EYES OF JAPANESE MANAGEMENTS.

Whitman: One reason for our lessened expectations has been a series of disappointing incidents relating to how managements have treated shareholders. For example, we acquired a pretty good-sized position in Chiyoda Fire & Marine — approximately 5.6 million shares. And we're up only very slightly in that position — to about $19.4 million versus our cost of approximately $19.2 million.

But the principal reason why we bought Chiyoda rather than another insurer was because 37% of its outstanding common stock was owned by Toyota Motor — which is a truly great international company.

OID: Save your commercials for Third Avenue — unless you'd like a rate chart, of course...

Whitman: And Toyota's also very important in Chiyoda's management. Three of Toyota's top executives also serve as top executives at Chiyoda. So we didn't have

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to be rocket scientists — or even interview management — to conclude that Toyota might want to expand its interest in Chiyoda. That was clear from the documents.

And sure enough Toyota announced in September that it was expanding its interest in Chiyoda from 37% of its outstanding common to 47%. Well, as you may suspect, that was fine with us. But it accomplished that increase in part by having Chiyoda issue it new shares at ¥500 each — which was the market price of its common at that time. And that sorely disappointed us.

OID: Why did you find that so disappointing?

Whitman: Because according to our calculations, its net asset value at the time was around *¥1,100* per share. Toyota would never have gotten away with having Chiyoda issue it shares at a 50%+ discount to net asset value if it had been a Delaware corporation, for example.

And that's only our *latest* war story. We experienced a similar incident at Nissan Fire & Marine in February of last year...

OID: And David Briggs of Cundill Funds told us that Mitsui Marine & Fire did something similar earlier this year.

Whitman: That's right. Mitsui's management demonstrated a similar disregard for its stockholders when they sold a new issue this past March. And Longleaf suffered through that incident with Cundill and us, too. So Cundill, Longleaf and ourselves have now suffered through *three* disappointing incidents.

But the last of the three — and the most troubling — was the one at Chiyoda. I found it particularly unsettling. Why? Well, I'd met Toyota's management. I knew that Toyota was a truly international company and that its management hadn't set out to hurt Chiyoda's shareholders — that no "dirty mind" was involved. I knew that they consider it *important* to treat minority shareholders fairly. They just didn't *know* any better.

ARE WE BEING OVERLY PESSIMISTIC? PROBABLY. EVEN SO, THERE'S STILL NOT MUCH DOWNSIDE.

Whitman: We'll probably be OK in any case. The first question that real value investors ask themselves is, "What's likely to go wrong — and what's my downside?"

And from today's prices, with this kind of financial strength in such a stable, industrial company, there's not much that can go wrong, in my view, long term. Granted, if reforms progress very slowly, then we might not earn a satisfactory return. That's quite possible. But I don't think there's much downside.

OID: Heads you win, tails you don't lose.

Whitman: Exactly. So we'll just hang out with our Japanese investments. I don't expect 'em to turn out bad. And I don't want to speak for Yang. However, I guess that we're a little more discouraged about our odds of earning a super return in those than we were six months ago.

Lie: Yeah. I think that's definitely a fair statement. It's discouraging. But, then again, these things are selling at such huge discounts to net asset value that at least we're probably not going to get hurt.

Whitman: Exactly. And let me fast forward to the end of the Chiyoda story — just to show the way we are: Toyota paid ¥500 per share. So Chiyoda's stock cratered. And we've been buying it recently at less than ¥400.

OID: Down around 45% of net asset value!? Not bad.

Whitman: Not at all. And my point is that although their actions were disappointing, when its stock price fell, we put our money where our mouth was and took advantage of the opportunity to buy *more*.

OID: Even though it was your low point psychologically — until your subsequent correspondence with Toyota cheered you up a bit...

Whitman: Exactly.

[Editor's note: See Whitman's comments about his correspondence with Toyota Motor on page 8.]

Whitman: I'm not being completely fair because the resulting dilution didn't amount to much. And at the price we paid, it didn't make much difference.

OID: Yeah. It sounds like they paid more than you.

Whitman: They did. But it was a bad precedent for Toyota in terms of its future consolidations. Plus, it was another example of Japanese managements not giving the stockholder constituency much consideration.

Another reason why I say I'm not being completely fair is that the money Toyota's investing in Chiyoda will be utilized for productive purposes. So it's not a zero sum game. I don't want to suggest that there aren't benefits for Chiyoda — because there are. For example, the more Chiyoda ties up with Toyota and the more activities the two companies undertake together, the better for Chiyoda.

However, it's like I told Toyota: "That money would be just as productive for Chiyoda if you paid *¥700* per share as if you paid *¥500*." [Chuckles.]

And Chiyoda's actually my favorite Japanese insurer.

OID: Huge discount aside, why?

Whitman: Because I see a catalyst. I suppose that I'm getting to be a real stock market speculator. But in a September press release, Toyota's president said that he wants to increase Toyota's presence in financial services — and that he'd like it to be more like General Motors' GMAC [General Motors Acceptance Corp.] Of course, GM is very big in insurance. (It owns 100% of Motors Insurance.) So it sounds like Toyota is going to be increasing its stake in Chiyoda.

Therefore, it's now a quasi-risk arbitrage and no longer a simple buy-and-hold investment. I guess that's why I'm stepping up to the plate to buy Chiyoda today.

But what can I say? I guess I've actually turned into a short-term speculator just like everyone else.

OID: Of course, we frown on short-term speculation. By the way, are there any options traded on Chiyoda?

Whitman: As you say, my correspondence with Toyota made me feel better. But it may be more accurate to say it made me feel less *bad* — because, as I said earlier,

(continued on next page)

THIRD AVENUE FUNDS'
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(cont'd from preceding page)

I'd still feel better if Chiyoda were a Delaware corporation. Those issues are still very much up in the air in Japan — and only time will tell how they ultimately play out.

OID: But aren't big financial services firms coming in and shaking things up — including Travelers and GE?

Whitman: Yep. GE has entered into a joint venture with Toho Mutual — which is a big life insurer — and taken stakes in several credit companies. And Travelers has bought a huge stake in Nikko. So a tremendous revolution is underway in the financial services area. But it's being driven by the private sector. Virtually every major European and American financial institution is in the Japanese market either de novo or via joint ventures (mostly the latter) selling mutual funds, doing investment banking, underwriting new forms of insurance such as financial insurance, new types of life policies, you name it. *Everybody*'s there. And, for the most part, they're working with the companies that we've invested in.

OID: That doesn't sound so bad.

Whitman: It isn't. On the other hand, I don't think anybody's done anything really good takeover-wise in the non-life area. At least *I'm* not aware of any takeovers in that area so far — only joint ventures.

Are we being overly pessimistic? Could be. A lot of good things are happening thanks to the private sector. And if there's one mistake I've made over and over again over my long career, it's been to consistently underestimate how buoyant economies and markets have been. Both have tended to be far more buoyant than I ever expected.

OID: You and Buffett. And if not for that, I'll bet that both of you guys would be rich today.

Whitman: Actually, I've noticed that *most* value guys tend to have overly bearish outlooks — both regarding the economy and the stock market. It's certainly true of me. And it's how Graham and Dodd were to a fault. Certainly, since the end of World War II, the U.S. economy's been far more buoyant than Graham and Dodd and most of their disciples — and I number myself among those disciples — would have ever expected.

So I wouldn't be a bit surprised if it were to turn out that we were overly pessimistic today.

OID: It's a good thing that you show some promise in money management. With that kind of conservatism, the high stakes world of investment publishing is out.

Whitman: As I said in our conference call, I think these insurers should be able to do fine in a bad economy. And I know a helluva lot more about companies than I do economies. And I know that these non-life insurers are uniquely well situated to be the beneficiaries of the trouble that Japan's going through — because they're basically the only capital-rich financial institutions in what is otherwise a woefully capital-short economy.

The only issue in my mind is basically how much their managements will be able to take advantage of the opportunity. Again, they're mostly doing the right things, but they're not doing the kind of big dramatic things that they could be doing. But it's gonna be great if I'm wrong about these guys.

NISSAN & MITSUI HAVE SEVERAL THINGS IN COMMON: UNHAPPY PRECEDENTS, DISGUST & DEEP DISCOUNTS.

OID: Speaking of being wrong, might we ask you which of these are your biggest losers?

Whitman: Among our Japanese stocks, I think our two biggest losers so far have been Nissan Fire & Marine and Mitsui Marine & Fire. Our cost basis in Nissan is about $21 million versus a current market value of about $15 million. And our basis in Mitsui is roughly $44 million versus a current market value of around $38 million.

On a per share basis, our average cost in Nissan is about $3.86 versus a current market of around $2.75. And our average cost per share in Mitsui is around $6.00 versus a current market of about $5.25.

OID: Are either or both bargains today?

Whitman: I think *both* are. And one of the reasons why is that both sold common stock publicly at a discount not only to their net asset value, but also at a discount to their market price at the time.

OID: Sounds like grounds for serious disgust to me. Do they have discounts to net asset value to match?

Whitman: Nissan sells at an *unbelievable* discount. Basically, it's far and away the cheapest Japanese insurer relative to its net asset value. When we were buying it at $3.50 or $3.75 per share, for example, we estimate that its net asset value without a reserve for capital gains taxes was up around $12.

OID: Wow. And today?

Whitman: Nissan's book value today is around $10. And it's stock price is around $2.75.

OID: In other words, Nissan is currently selling at a discount to net asset value of more than 70%?!

Whitman: Yep. And that's one of the reasons why the Chiyoda experience was so upsetting. For example, suppose someone was interested in acquiring Nissan. What would their obligation be to pay a fair price?

An acquirer *might* pay a fair price (because Nissan's management might negotiate on our behalf — given that it might be an arm's length transaction with an outsider). But it's a risk — and, potentially, a very real problem.

Nissan is the only lesser quality Japanese insurer that we've bought. And one of the reasons why we went into it, even though it's much lower quality than Tokio Marine or any of our other insurers, is its high expense ratio.

OID: You bought it because of its high expense ratio?

Whitman: In part, that's right. We figured that the combination of its high expense ratio and its deep discount to net asset value made it a natural takeover candidate.

On the other hand, besides *paying* less, you're also *getting* less — not only in terms of its higher expense ratio, but also a less shareholder-oriented management.

OID: And Mitsui?

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Whitman: Basically, you're *paying* more for Mitsui — about 50% of net asset value. But you're *getting* more, too. It has a *very* high quality business, a lower expense ratio and a management which, in our view, is like Toyota's — that's trying hard to do right by its shareholders. We think very highly of its CEO and CIO [chief investment officer].

OID: And I see that they do publish an American-style annual report in English.

Whitman: Yeah. I think they're trying very hard to have American-style relationships with their shareholders.

OID: How does Mitsui's current 50% discount to NAV compare to what it was when you bought your shares?

Lie: It's probably about the same.

OID: Because Mitsui's book value has declined by roughly the same amount as its stock price...

Whitman: That's right — along with Japan's market. I can't tell you exactly how much Mitsui's book value has declined because its biggest holding is Toyota — whose stock price really hasn't tended to move very much in line with the Japanese stock market.

Lie: Yep. Mitsui owns about 6% of Toyota common.

Whitman: But I really don't try to cut it that fine.

OID: Don't worry. We'll add the false precision later.

Whitman: In any event, we think Nissan and Mitsui are *both* very attractive bargains today.

THE BEST AUTO COMPANY IN THE WORLD
AT A 35-40% DISCOUNT TO ITS CURRENT MARKET.

OID: You mentioned earlier that Tokio Marine and Yasuda are both up from your cost. Could you give us a thumbnail summary on them?

Whitman: Sure. On a per-share basis, the ADRs of Tokio Marine are up from our cost of $45.26 to just under $58 today. (By the way, the ratio is five ordinary shares per ADR.) But that $58 still represents a discount of between 35% and 40% from net asset value.

And Yasuda's up, too — to $4.90 or thereabouts from our cost of around $4.16. However, I'm sure it still trades at a discount of at least 50% to its net asset value.

OID: What can you tell us about them quality-wise? And are either or both of them still bargains today?

Whitman: Well, Tokio Marine, Mitsui, Yasuda and Sumitomo are the four biggest non-life insurers in Japan. And if you were to put me up against a wall, I'd tell you that I think Tokio Marine is the highest quality-wise — Tokio being #1 and the others more or less bunched.

Yasuda, Sumitomo and Mitsui may be a step behind Tokio Marine. But I think all three are *very* high quality. So Yasuda is a top dog, too. And as I said, I'm sure it's still selling at a discount to net asset value of at least 50%.

OID: And yet you're not adding to your position in Yasuda — or, for that matter, Tokio Marine?

Whitman: Not really. We have open orders in for Tokio Marine's ADRs, but they're way out of the money.

OID: May we ask why you're not buying them.

Whitman: Because we're buying Chiyoda. Isn't that reason enough? We *like* Yasuda. But we can't buy 'em *all*.

OID: Are there any other Japanese securities that you find attractive today?

Whitman: The only Japanese stock we own other than non-life insurers is Toyoda Automatic Loom Works. And it's selling for very close to what we paid. We paid $37.7 million — and it closed yesterday at $37.8 million. It's basically Toyota Motor at a discount.

OID: In Mary Rowland's very generous article in Bloomberg Personal, she says you read about it in OID. But since it hasn't worked out so far, where would you like us to redirect the attribution?

Whitman: Well, that's where I read about it. But it was mentioned in an interview with Peter Cundill. So if you prefer, I'll give the credit to him.

OID: Only if it doesn't work...

Whitman: I think it's a super deal. Before deducting the capital gains taxes that would result were Toyoda to liquidate its portfolio, it's a great company at a discount — which depending on how you value its operating business is probably 35-40%.

OID: Could you give us a breakdown of that value on as quick and dirty a basis as possible?

Whitman: Sure. On a per share basis, we estimate that Toyoda Auto Loom's operating business is worth between $4 and $6, that its shares of Toyota Motor are worth around $15.50 and that its other holdings (which are mostly suppliers to Toyota Motor) are worth about $6. Therefore, based on our estimates, Toyoda Auto Loom is worth between $25.50 and $27.50 per share — versus a current market of $17.20.

OID: That sounds like a discount of 35-40%, all right. On the other hand, as I recall, Toyota ain't so cheap.

Whitman: That's correct. Qualitatively, though, Toyota's probably the best auto company in the world.

OID: Yeah. David Briggs spoke very highly of it, too.

Whitman: Toyota's fantastic.

RETURNS OF JAPANESE INSURERS ARE MISLEADING.
THEIR NORMALIZED RETURNS MAY EVEN BE *HIGH*.

OID: At Berkshire's annual meeting this year, in response to a question about Japanese stocks, Buffett suggested that given their low ROEs, they didn't look so bargain-priced to him. What do you make of that?

Whitman: I don't know. Coming from the inventor of look-through earnings, that seems like a bizarre comment. Buffett knows the reported earnings of Japanese companies reflect only dividend income from their vast common stock holdings. Using look-through accounting and including

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(cont'd from preceding page)

their share of the undistributed earnings of the companies in their portfolios, they'd be earning *much* greater returns. And Warren Buffett of all people should know that — because not only did he coin the term, but he has a section in Berkshire's annual report each year on it.

So if it's good for Berkshire, why wouldn't it be good for Japanese insurers?

OID: Because he likes his stock fairly priced and his potential investees cheap? You tell me. I asked first.

And what sort of returns might your insurers actually be earning on a look-through basis?

Whitman: We tried to do a back-of-the-envelope analysis once. But I think the guys at Cundill Funds and Longleaf could tell you that better than us. Yang could tell you what kind of figure we came up with when we did our back-of-the-envelope.

Lie: As I recall, it was about 10%.

OID: But wouldn't even a 10% ROE imply a relatively low return business?

Whitman: It's actually a *high* return business. Insurers typically have three sources of earnings: The first is underwriting profit. And the average combined ratio for an insurance company in the U.S. in a *good* year might be around 105%. Tokio Marine's *average* combined ratio is probably down around 90%.

OID: Wow.

Whitman: So in terms of underwriting profitability, the worst Japanese insurance company is more profitable than the most profitable American company.

OID: For now — before the "Big Bang" opens up Japan's financial markets and thereby eliminates the current cozy oligopoly in insurance.

Whitman: For now, that's right. The second source of earnings for insurers is their equity portfolios. And very few U.S. insurers even *have* meaningful equity portfolios. However, there again, the returns of Japanese insurers are inherently understated because they include only the dividends from their common stock holdings.

OID: So, by implication, there's no reason why they should suffer by comparison to U.S. insurers — unless the future earnings and valuations of Japanese stocks lag those of their American counterparts.

Whitman: Exactly. And the third and final source of insurance company earnings is the earnings they derive from their fixed-income portfolios. And they tend to consist of performing loans and Japanese government bonds. That's where Japanese insurers suffer most by comparison with American insurers. With Japanese interest rates at 1-2%, they don't earn a satisfactory return — although they would if interest rates were to rise to Western levels.

So the only reason why their ROEs — either on a reported basis or a look-through basis — should be lower than those of American insurers is that they don't make as much money on their fixed-income portfolios right now. And we think they will at some point — because Japan won't ever get out of the mess that it's in today unless it makes things attractive for lenders.

OID: Including, as Peter Cundill points out, individuals saving for their retirement.

Whitman: He's probably right. However, even if these Japanese insurers were to sell their Japanese bonds and other fixed-income holdings and transfer the proceeds into U.S. Treasuries (which, incidentally, some seem to be doing) they should be *more* profitable than U.S. insurers — maybe *much* more profitable.

OID: Meaning ROEs of 15-18%?

Whitman: I think so — however, again, not while they're earning 2% on their bond portfolios. But let me give you the figure that counts for Tokio Marine — which is net investment income. Its net investment income last year was $340 million. And they earned that $340 million on a stated book of $18 billion. By comparison, Tokio Marine's net investment income in 1993 was around *$800* million.

OID: Wow.

Whitman: And the difference was primarily due to earnings on their bond portfolio. That's a published figure, incidentally, from their annual report.

OID: Although short-term and long-term interest rates in Japan were much higher and plummeted that year. Tokio Marine's net investment income wasn't inflated that year — due to capital gains or marks-to-market?

Whitman: Nope.

OID: What then could turn these things into mistakes?

Whitman: Basically the things we talked about....

OID: In other words, a continuation of the past.

Whitman: Exactly. However, everything we buy has something wrong with it. The next time we buy something that doesn't have anything wrong with it will be the *first* time.

OID: I'll count on you to give us a call.

However, what else could turn these into a mistake — a big earthquake?

Whitman: No. These guys are pretty well reinsured against earthquakes. The big catastrophe risk that they've faced historically (that we're familiar with anyway) — and one that they're *not* reinsured for — has been typhoons. Should there be a serious typhoon, they'll suffer losses.

LEUCADIA'S DISCOUNT TODAY IS *LESS* THAN 50%,
BUT WE'RE HAPPY TO MAKE AN EXCEPTION....

OID: Before we give you the rest of the year off, might we get your thoughts on a couple of U.S. stocks that I understand you've been buying — first, one that Bruce Berkowitz of Fairholme Capital told us about two or three years ago — Leucadia National...

Whitman: Leucadia is basically a closed-end fund with huge cash that's being run by very smart people.

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OID: Exactly what Berkowitz said. But what makes it a bargain today?

Whitman: Well, it's selling at a discount. It's trying to sell off businesses. And I think the workout's going to be in the low $40s or thereabouts — assuming that they can solve their tax problems.

OID: That's all well and good. But what makes a $30± stock with a mid-$40s workout so irresistible?

Whitman: We say that we don't want to buy a common stock unless it sells at a discount of at least 50% from private business value or takeover value...

OID: No problem. We say bi-monthly, more or less.

Whitman: But there is a risk arbitrage exception. Risk arbitrage exists where there are relatively determined workouts in relatively determined periods of time — like announced mergers. If you want to play in that game, which can be an inordinately profitable game, you have to pay up. And there, our 50% standard rises to 90%...

OID: Depending on the timing.

Whitman: That's right. I believe that Leucadia — and Chiyoda Fire & Marine, Imperial Mortgage Credit and Capital Re, as I say in my annual report — all belong to the risk arbitrage exception to a certain extent. In each case, there are announced events that make me think there'll be a workout in the next year.

In the case of Leucadia, as of September 30th, it has about $1 billion of distributable cash outside of its insurance business. They're talking about making a distribution of something between $648 and $811 million on a tax-free basis. So given their 64 million shares outstanding, that's between $10 and $12.50 per share.

So if it stays at the same discount percentage-wise, when you take its dividend and share buyback into account, and calculate the effective return on what's left — the stub — our return should be just fine.

OID: And you think that Leucadia will be able to make a tax-free distribution?

Whitman: I don't know. But they're very smart guys. So I suspect that they will...

NABORS' SHORT-TERM OUTLOOK AIN'T SO HOT,
BUT AT 3-4 TIMES NORMALIZED EARNINGS....

OID: I understand you've been buying Nabors, too?

Whitman: Yep.

OID: Contrarian's one thing, but an oil service stock?! What in the world could you be thinking?!

Whitman: Very simple. The short-term outlook in the oil service area is bad. But when the smoke clears, then I believe Nabors will demonstrate earning power of $3-5 per share.

OID: You're saying Nabors' current stock price may be less than 3 times normalized earning power!?

Whitman: Well, that's what the company says. And of course, I'm one of the directors. So I *have* to....

OID: Just between us, journalists' honor — if you don't mind us carrying oxymorons to a new height — you believe 'em?!

Whitman: I do.

OID: And again, I understand that you've been putting your money where your mouth is.

Whitman: Yep. Our average cost is around $20 versus a current market price of about $30.00.

[Editor's note: In his July 31st letter to shareholders of Third Avenue Value Fund, Whitman observes:

"Nabors Industries has been a spectacular growth story since [it] emerged from Chapter 11 in 1988. In great part, that growth attributed from the judicious acquisitions of other oil service companies and oil service assets. Corporate values in the industry are now so depressed again that new opportunities may open up for Nabors [which is] a well-financed company....

However, there are no signs that the industry will emerge from its depression anytime soon."]

OID: While it's hard to imagine, is there anything that we haven't asked you about that we should have?

Whitman: Only that some of what we talked about was excerpted from my forthcoming book: *Value Investing, A Balanced Approach* — which I expect to be published by John Wiley and Sons in March or April.

OID: If you're expecting some kind of shameless plug, you've come to the right place. But I should confess a deep envy of anyone who can meet a deadline...

Whitman: Actually, I'm only about five years late.

OID: In that case, we love your new book already. Feel free to fill in any testimonial you like.

Whitman: *You* don't have to say it, but I believe that my new book is the logical extension of Graham and Dodd. I really do. I believe it brings G&D up to date.

OID: Your ideas and insights were just as fascinating as always. Thanks again to you and your associates for sharing them with us.

Whitman: The pleasure was ours.

—OID

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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But rather than recount for the umpteenth time the equally remarkable way in which they've managed to do it, we'll simply refer you to past features and mention only that, as always, whenever Buffett (and/or Munger) speak, we listen and, whenever posssible, bring it to you.

Last edition, however, a shortage of available pages prevented us from including all the material we would have liked in our Berkshire Hathaway annual meeting coverage. Therefore, in the pages which follow, we're very pleased to bring you that material — first, excerpts from comments by Buffett and Munger at Berkshire's annual meeting and, then, selected excerpts from comments by Munger at Wesco Financial's annual meeting.

We believe their comments are, as usual, (fortunately for us) both classic and timeless. However, in our view, this year's are actually, if anything, *more* relevant today than the day they were made for several reasons: First, because two of the three major indices just hit new highs; second, because Japanese stocks are even lower today; and, third, because the price of silver bullion — after rallying dramatically in the wake of Buffett's comments and Berkshire's purchases — is back down around where it was prior to those events.

We'd like to gratefully acknowledge Mr. Buffett and Mr. Munger for their assistance and cooperation — both in the preparation of this feature as well as allowing us to share it with you. As always, we highly recommend that you read it (and reread it, etc.).

WE'RE CERTAINLY *LOOKING* OVERSEAS. UNFORTUNATELY, WE'RE NOT *FINDING*....

Rising stock prices hasn't been a U.S.-only phenomenon.

Shareholder: Given the current dearth of investment opportunities in the U.S., do you see yourself investing in *non*-U.S. companies which are well managed, understandable and growing?

Buffett: Well, if we find companies such as those you've described at a price that's half attractive, we'd be *perfectly* willing to buy 'em. So the answer is yes. However, we'd be looking to an extent worldwide *irrespective* of market conditions in the United States.

Also, market valuations in the U.S. today tend to be reasonably well matched in most of the major countries. There's been a bull market all over the world in a huge way in nearly all of the bigger markets. It would have been nice for us if the U.S. market had tripled while other markets remained largely unchanged. Then, we would very likely be finding things abroad. Unfortunately, that hasn't been the case. So we're not.

We're not finding bargains as we look around the world.

Buffett: We're certainly *looking* for the kind of thing you described. We're not reluctant to invest abroad. And our three largest holdings — American Express, Gillette and Coke (with $25 billion of market value among them) — have major businesses abroad. And Coke and Gillette earn the majority of their earnings abroad. So we're interested.

And there's better growth prospects in many areas abroad than there is here. But we're not finding bargains as we look around the world.

It's hard to get rich owning a low return on equity business.

Shareholder: According to various publications including *Outstanding Investor Digest*, many of the best value investors are buying high-quality, multinational Japanese companies below net-net working capital. Do you agree that these values exist? And would you consider purchasing some of them?

Buffett: Well, Henry Emerson, who publishes *Outstanding Investor Digest*, is here. So I'll give a tout on it. I read *Outstanding Investor Digest* — [also known as] *OID*. It's a very good publication. And I have read some of the commentary about Japanese securities.

We've looked at securities in all major markets. And we've certainly looked at 'em in Japan — particularly in recent years when the NIKKEI has so underperformed the S&P. But we're quite a bit less enthused about those stocks as being any kind of obvious bargains than the people you've read about in *OID*.

Returns on equity in most areas of Japanese business are very, very low. And it's extremely difficult to get rich by owning a business that earns a low return on equity.

We want businesses that are *going* to be good — and *better*.

Buffett: We always look at what a business earns on capital. And we want to be in good businesses. What we *really* want to be in is businesses that are *going* to be good businesses — and *better* businesses — 10 years from now. And we want to buy those businesses at a reasonable price.

However, many years ago we gave up what's been labeled the "cigar butt" approach to investing — which is where you try and find a really kind of pathetic company, but one that sells so cheap that you think there's still one good free puff left in it. We used to pick up a lot of stocks that were cigar butts.... And there *were* free puffs in them — and I made money out of that.

But (A) it doesn't work with *big* money anyway. And (B) we don't find any cigar butts around to be attracted to.

When you own cigar butts, time is *not* your friend.

Buffett: But those are companies with low returns on equity. And if a business [is] earning 5% or 6% on equity and you hold it for a long time, you are not going to do well investment-wise — even if you buy it cheap to start with. Time is the enemy of the poor business and it's the friend of the great business.

If you own a business that's earning 20-25% on equity and it does that for a long time, time is your friend. But time is your enemy if you own a low return business.

[Editor's note: Just what our late friend and contributor George Michaelis used to say.]

Buffett: You may be lucky enough to pick the exact moment that it gets taken over. But when we buy a stock, we like to think we're going to own it for a very long time. And, therefore, we have to stay away from businesses that

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

have low returns on equity. Charlie?

Munger: Yeah. And it's not that much *fun* to buy a business where you really hope this sucker *liquidates* before it goes *broke.*

You may even be *familiar* with one of our cigar butts....

Buffett: We've been in a few of those, too. Charlie and I — at least I — have owned stock in an anthracite company, (there are probably people in this room who don't know what anthracite is), street railway companies, windmill manufacturers.... What other gems have we had, Charlie?

Munger: *Textiles.*

Buffett: Yeah, that's a good one. Thank you, Charlie. Berkshire *itself* was a mistake, believe it or not. We went into Berkshire because it was cheap statistically just as a general investment back in the early sixties. In the previous 10 years, it had earned less than nothing. It had accrued a significant net loss over the previous 10 years. [But] it was selling well below working capital. So Berkshire itself was a cigar butt.

And had we been able to do the things we've done since from a *neutral* base rather than a *negative* base, it would have worked out *better.* But it's been a lot of fun....

FOR INVESTORS IN JAPANESE STOCKS TO THRIVE, JAPANESE BUSINESSES MUST DO THE SAME....

Low price-to-book means *nothing* to us, maybe even *less*....

Shareholder: Over the past decade, the Japanese stock market has been lagging the U.S. market. With Japanese stocks selling at very low price-to-book value ratios as compared to U.S. stocks, would it not make sense to invest in a basket of Japanese stocks or an index fund of Japanese stocks?

Buffett: I don't know the exact figures, but the reason Japanese stocks sell at lower price-to-book ratios than U.S. stocks is simply that Japanese companies are earning far *less* on book than American companies. And I look at the reports, but I don't see the earning power today. And earnings are what determine value, not book value.

Book value is not a factor that we even consider. A low price-to-book ratio means nothing to us. It doesn't intrigue us. If anything, we're *less* likely to look at something that sells at a low price-to-book than something that sells at a high price-to-book — because chances are that we're looking at a poor business in the first instance and a good business in the second.

Only if Japanese ROEs rise dramatically will you do well....

Buffett: Future earnings *are* a factor we consider.

(continued in next column)

And ... earnings have been poor for a great many Japanese companies. If you think their return on equity is going to increase dramatically and you're correct, then you're going to make a lot of money in Japanese stocks.

Maybe that will all change. There's been talk of — in fact, there's already been — a small, temporary tax cut. But corporate tax rates are quite high in Japan. They used to be 52% here in the U.S. vs. 35% today. So things *could* happen that would increase corporate profits.

But unless that happens, you're not going to earn attractive returns by owning the stocks of those businesses. You can't earn a lot of money by owning businesses that are only earning 5% or 6% on equity.

The return on equity of Japanese businesses has been quite low. And that makes a low price-to-book ratio very *appropriate.* If a company earns 5% on book value, then I don't want to buy it at book value — or even at a discount — if I think it's going to *keep* earning 5% on book value.

It could happen. But *we* have no basis for that conclusion.

Munger: I suppose anything *could* happen. After all, we bought *silver.* But we've never made a big sector play on a country. We've almost never made a big *sector* play.

Buffett: For us to be interested in Japanese stocks, we would have to conclude that Japanese businesses that are earning whatever return on equity they're earning now would earn appreciably *more* on equity in the future.

And I have no basis for that conclusion. I wouldn't argue with anyone else who feels that way. I don't have any special insight into Japan that anyone who reads the press generally would not have. But I have no basis *myself* for coming to that conclusion.

Judging corporate culture outside the U.S. is harder for us.

Munger: There are also appraisals of corporate culture that must be made. Owning stock in a corporation where you know that if shareholders or someone else has to suffer, the choice is likely to be someone else is one thing. It's another thing altogether to invest in a company that thinks the principal purpose of life is to keep going forever no matter how much its shareholders suffer.

And I think it's hard for us to *judge* corporate culture in a foreign country as well as we can judge it in our own.

PRODUCTION SHORTFALL + DEPLETED INVENTORY + INELASTIC SUPPLY = MUCH HIGHER SILVER PRICES?

Supply/demand data for silver is available for all to see....

Shareholder: When you announced [your purchase of silver last year], you said that you believed that supply and demand fundamentals could only be re-established at a higher price. I was just wondering if you could talk in more detail about what some of those fundamentals are. We've read a lot about battery technology and the like.

Buffett: We have no inside information about any great new uses for silver or anything of the sort. You can get these figures, too, although they're not all that precise. However, I think they're *generally* accurate. And you can see from looking at the numbers that aggregate demand — primarily for photographic, industrial and ornamental

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

jewelry-type purposes — totals something in excess of 800+ million ounces per year.

On the supply side, there's about 500 million ounces per year of silver being produced annually by mines. And on top of that 500 million ounces of mine production, there's 150 million or so ounces per year of silver being reclaimed annually — a large part of which, by the way, relates to silver reclamation associated with photography.

Supply shortfalls in recent years have depleted inventory.

Buffett: Therefore, [with aggregate demand up around 800 million ounces per year] and total production including reclamation down around 650 million ounces, there's been a supply shortfall in recent years of perhaps 150 million ounces per year — although, again, these figures aren't precise.

That 150 million ounce per year shortfall's been filled by drawing down above ground inventories of silver bullion — inventories which may have been 1.2 billion ounces or more a few years back, but which have since been depleted. Again, no one knows the exact figures. But there's no question that the inventory's been depleted significantly.

So a higher price will be needed to reestablish equilibrium.

Buffett: So the present price for silver is *not* producing an equilibrium between the supply — consisting of newly mined silver plus reclaimed silver — and usage. And, eventually, something will happen to change that picture. It could be changed by reduced usage, increased supply or a change in price.

On the other hand, some new production's coming on. And digital imaging may reduce usage in photography. But the imbalance is *sufficiently* large — in effect, the gap is wide enough — that we believe it will continue to deplete bullion inventories to the point where a new price will be needed to reestablish equilibrium.

Inelastic supply + inelastic demand = much higher price?

Buffett: Also, most silver is produced as a *by-product* in the mining of gold, copper, lead and zinc. And, therefore, the production level is not very responsive to price changes — because, obviously, if you're running a copper mine that also produces silver, you're going to be far more interested in the price of copper than you are in the price of silver. So your level of silver production will be far more closely tied to the price of copper than the price of silver. [In effect,] ... the supply of silver is inelastic.

And because ... demand is ... relatively *in*elastic, we don't think [that the] price change required to reestablish an equilibrium between supply and demand would necessarily be *minor*....

IF YOU DON'T TRUST SUPPLY AND DEMAND, THEN JUST ASK NEWTON AND THE MYSTICS.

According to Isaac Newton, silver's way undervalued today.

Buffett: It's interesting.... The price of silver's been artificially influenced for a long time. In the movie you saw before the annual meeting, it was William Jennings Bryan, editor of *The Omaha World Herald* and a congressman from Nebraska was the big silver man.

And people used to talk about a natural ratio of the price of gold relative to the price of silver as being 16-to-1. That ratio, incidentally, goes back to Isaac Newton when he was master of the mint. Charlie can tell you all about that. He's our Newtonian expert here. But that ratio had a mystical significance for a long time.

[Editor's note: With gold up over $286 per ounce as we prepared to go to press, that 16-to-1 ratio would imply a "natural" price for silver (for whatever it might be worth) of about $18 per ounce — or more than 3-1/2 times its current price (down near $5.00).]

Silver Purchase Act of 1934 led to a 10-year inventory.

Buffett: In 1934, the federal government passed The Silver Purchase Act of (not so surprisingly) 1934 which set an artificially high price for silver at a time when production and usage were much less. [As a result,] the government ultimately wound up with nearly 2 *billion* ounces of silver at a time when demand was only a couple hundred million ounces a year — [or roughly] a 10-year supply. And, so, silver was artificially high-priced for awhile.

Our last silver purchase — until last year....

Buffett: But by the early 1960s, it had become an artificially *low* price of $1.29 per ounce. At the time, I saw U.S. government inventories being depleted — somewhat akin to the way inventories are being depleted today. And despite Lyndon Johnson's administration saying it would *not* demonetize silver, it did. So the price of silver went up substantially.

And that was our last purchase — until last year. However, I kept track of the figures ever since.

Hunt Brothers were the Silver Purchase Act revisited....

Buffett: Incidentally, the Hunt brothers caused a great amount of silver — including a lot of silver coins — to be converted into bullion around 1980. Like the Silver Purchase Act of 1934, their actions increased the supply of silver in a very big way by pushing the price of silver way up [in 1979-80] — because [the higher price led many to melt down their] silver coins and silver jewelry. So dislocations ... over a 60+ year period have caused the price to be effected by these huge inventory accumulations and reductions.

FOR US, SILVER PURCHASES WERE A NON-EVENT. BUT WHEN YOU SEE IT JUST LYING THERE...

We like silver, but don't want to replay the Hunt scenario.

Buffett: Now we think — or we thought last summer when we began buying it — that the price didn't represent an equilibrium price. And we figured that, sooner or later, a new equilibrium price would be restored.

We didn't think it was imminent (because we don't *think* in terms of imminent). But we decided to buy a lot of silver. We didn't want to buy so much as to disrupt the market. We had no desire to replay the Hunt scenario. So we wanted to be sure that we didn't buy *that* much silver. But we like it. Charlie?

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

Our silver purchases are *not* a big deal for Berkshire.

Munger: Well, I think this whole episode will have about as much impact on Berkshire Hathaway's future as Warren's bridge playing. It's a line of activity where once every 30 or 40 years you can do something employing 2% of assets. This is *not* a big deal for Berkshire.

But the fact that it keeps Warren amused and not doing *counterproductive* things...

Buffett: And it does make me feel good to think about all those *pictures* people take over this weekend. They all use a *little* bit of silver....

It's close to a non-event. But if you *see* it there....

Munger: It's something that teaches an interesting lesson — the *discipline* it takes to think about something for three or four decades [Munger fights back a chuckle] waiting for a chance to invest 2% of your assets. But I'm afraid that's the way we are.

Buffett: Yeah. It's *less* than a billion dollars in silver [versus] $15 billion in Coke....

Munger: It's a non-event.

Buffett: And $5 billion in American Express. It is close to a non-event. But if you see it there...

Munger: It shows the human personality at work — a very *peculiar* personality, I might add.

Buffett: I reinforce my partner.

[Editor's note: Buffett and Munger say they limited the size of Berkshire's investment in silver to something like 20% of the world's above-ground supply to avoid a replay of the Hunt situation — price squeeze and all. Therefore, by implication, the acquisition of 20% of the world's supply of silver was a "non-event" for Berkshire.]

IN MCDONALD'S, WHAT YOU SEE IS WHAT YOU GET. BUT IT'S HARD TO ARGUE WITH THEIR RESULTS.

McDonald's and Dairy Queen use two very different models.

Shareholder: Are there major differences in the investment characteristics of Dairy Queen and McDonald's? And if so, would you explain them?

Buffett: There are major differences. McDonald's owns roughly a third of all its locations worldwide. And I can't tell you the exact percentage. However, if they have 23,000 outlets, they own many, many thousands of them and operate them. And then, of the remainder, they own a very high percentage and lease them to their franchisees — their operators. So McDonald's has a very big investment on which they earn very good returns in physical facilities all over the world.

In contrast, Dairy Queen, including Orange Julius, has 6,000+ operations — of which only 30+ are operated by the company. And even some of those are in joint ventures or partnerships. So the two companies' investment in fixed assets is *dramatically* different.

The fixed asset investment by the franchisee or the landlord obviously is significant at a Dairy Queen, but it's not significant to the company as a franchiser. So the capital employed by Dairy Queen is relatively small compared to the capital employed by McDonald's.

But McDonald's also makes a lot of *money* by owning those locations. So while Dairy Queen will, in most cases, receive 4% of the franchisee's sales as a royalty, McDonald's gets more than that for gross royalties. They're two very different models.

To have a good franchiser, it takes a successful franchisee.

Buffett: However, in the end, both depend on the success of the franchisee. You must have a good business for the *franchisee* over time to have a good business for the *franchiser*. And both Dairy Queen and McDonald's have that situation to deal with over time. Charlie?

Munger: If you stop to think about it, that 4% is not very much for the franchisees to pay in return for getting a nationally recognized brand, quality control and all sorts of desirable benefits.

Buffett: No. In fact, if you look at the whole industry, 4% is in the lower part of the range.

Munger: Part of what attracted us is the fact that the franchisees have a good deal.

Buffett: A successful franchisee can sell his operation for *significantly* more than he's invested in tangible assets. And we like and want that, obviously, because that means that he's got a successful business and that over time we'll have a successful business.

We want the franchise operator to make money. And we want him to create a capital asset that's worth more than he's put into the business. That's the goal.

McDonald's is probably right to own so much real estate....

Shareholder: I suspect that there's a great business buried in McDonald's mixed in with two good businesses and that their problem is that their real estate and operational businesses — at least as the company is capitalized presently — can't earn the same kind of returns as the franchising business.

You were, or still are, a significant shareholder of McDonald's. I think the solution is obvious. Why don't you push for a solution with McDonald's like the result at International Dairy Queen.

Buffett: Well, I don't know the details. But I'd *guess* that with 23,000 locations worldwide, it would be *extraordinarily* difficult for McDonald's to separate its real estate business from its franchising business at this point.

I think they could have gone a different route. But I'm not saying that it would have been a *better* route at all. In fact, I think the odds are that they're probably right in owning and controlling so much of their real estate.

I think you should look at McDonald's as is....

Buffett: So the problems associated with separating out the real estate would be horrendous. For example, you wouldn't want to sell it and lease it back — because you would *not* end up with more value by doing that. And spinning it off into a real estate trust or something that would be operating in 100+ countries with many of the franchisees screaming — I think that would be a huge,

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BERKSHIRE HATHAWAY'S
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(cont'd from preceding page)

huge problem. I wouldn't want to tackle it myself.

I don't know anything about their plans on this. However, I think that you should look at McDonald's as being a *very* good business, but one that will continue in its present mode vis-a-vis the real estate.

On the other hand, I think they *have* signaled that they're going to own less of their *new* properties — at least somewhat less — than they've owned to this point.

But there are 23,000 locations. Every operator has his own arrangement that's very important to him. So to do anything with their real estate would be a *mammoth* job.

A potential real estate spin-off wouldn't be a big deal....

Buffett: And I'm not so sure how much extra value would be created in the end anyway. Charlie?

Munger: The net returns on capital that McDonald's has earned all those years are *high* — even with them owning a lot of real estate. I think it's hard to quarrel with how they did it. They have the best record.

Buffett: And McDonald's P/E multiple is not all that different, in my view, with the real estate included or the real estate separate. If you could get the real estate *pretax* in some arrangement, you might get a little more out of it. But it doesn't strike me as a big deal. [For example], Berkshire is structured more inefficiently tax-wise ... than McDonald's — *much* more.

AT COCA-COLA, ONLY TWO THINGS COUNT. AND THE SAME THING'S TRUE AT GEICO....

The reason why Berkshire keeps Charlie around....

Shareholder: Do you think Coca-Cola will continue to gain market share versus Pepsi?

Munger: Yeah. Long term, I would expect Coke to continue to gain [market share] versus Pepsi....

[Editor's note: Buffett, who's been away from the stage very briefly, returns.]

Buffett: What's he been doing while I was gone? [Chuckling as he continues:] I *knew* I was taking a chance.

Munger: I said that long term I expected Coke to continue to gain versus Pepsi.

Buffett: That kind of insight is why we keep him on the job here. In a moment of *particular* confidence, he might be known to say the same thing about RC.

Bottling transaction gains will continue, but I ignore them.

Shareholder: What multiple do you put on [earnings associated with] asset gains such as the sale of [Coke's] bottling assets?

Buffett: Coca-Cola's bottling transactions are incidental to a long-term strategy which, in my view, has been enormously successful to date and which has more successes ahead of it. But in the process of rearranging and consolidating the bottling system and expanding into relatively undeveloped markets, there *have* been and *will* be a lot of bottling transactions. And some produce large gains. Some produce small gains.

But I *ignore* them in my evaluation of Coke.

Only two things count in the evaluation of Coca-Cola....

Buffett: In my view, the two important elements in Coke are its unit case sales and its shares outstanding. There have been transactions where people have purchased rights to various drinks — in fact, Coca-Cola's purchased some of them — around the world. And when you see what's being paid per unit of business — for 1 million cases or 100 million cases — and you think to yourself that Coke may *add* 1-1/2 billion cases a year, that's a ... *dramatic* gain in value. And that's what counts in terms of the Coca-Cola Company.

But I would pay no attention to asset gains. I'd just take them out of the picture.

If those two things go right, you'll make money in Coke.

Buffett: Coke's earnings are very easy to figure out. Just figure out what they earn per case from operations. And you'll see [that] over the years, [their] earnings per case go up, their cases go up and their shares go down.

If you think it'll sell a multiple of its present volume 15-20 years from now and there'll be a lot fewer shares outstanding, you've gone about as far as you *need* to go — because if shares outstanding go down and unit case sales advance at a good clip, you're going to make money over time in Coca-Cola.

It isn't much more complicated than that. Charlie?

Munger: It does wonderfully. I just wish we had more like it.

Buffett: Yeah.

Ditto for GEICO. Only it's two *other* things that count....

Buffett: GEICO's the same way. What unit case sales are at Coca-Cola, policies are at GEICO. At GEICO, it's policies in force and underwriting experience per policy. And that's exactly the way, as noted in the annual report, we pay people there. We pay 'em from the bottom to the very top based on what happens with those two variables — because it's those two things that are going to determine what kind of business GEICO is over a long period of time.

We don't talk about GEICO's earnings per share. And we don't talk about investment income. We don't get off the track.

WOULD WE QUARREL WITH DISNEY'S ACCOUNTING? NO. ITS EARNINGS MAY EVEN BE *UNDER*STATED.

We admire Briloff. But we disagree with him on Disney....

Shareholder: Criticism's been levied at Disney from an accounting professor at a New York state university in reference to its purchase of Capital Cities and the way it accounted for that purchase. In effect, he suggests that Disney created a slush fund to which it charges expenses associated with the merger rather than charge them directly to earnings. If you're familiar with his criticism, what do you think of it?

Buffett: Actually, Abe Briloff, who wrote that article, is a fellow I admire.... I admire ... his attempts to have accounting reflect economic reality. But we don't see it exactly the same on some points....

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

I don't think Disney is very complicated ... to evaluate. When Cap Cities bought ABC, there were purchase accounting adjustments. And those adjustments tend to wash through to some extent.

If you had programs that you're stuck on, you may write those down from their previous carrying cost.... And maybe the previous management should have written them down, too. But I think that with Disney, what you see now is what you get. Charlie?

Munger: I have no great quarrel with the accounting at Disney. Briloff's a wonderful guy. He has a great sense of humor. And he generally fights the right demons. But I don't think we could criticize Disney's accounting.

Economic earnings may be *higher* than reported earnings.

Buffett: I agree with Charlie that he's a good guy. However, we disagree with him on the amortization of intangibles *entirely*. So we would say that if Disney is charging whatever it may be — [say] $400 million a year — for amortization of intangibles (which isn't tax-deductible), we'd *include* the [$400 million] as a component of earnings. So if you were making adjustments, there might be some pluses *and* minuses....

And when you add back amortization of intangibles, we'd probably think Disney's economic earnings might well be *more* than reported earnings in the next few years.

Current intangibles accounting treatment is *nuts*.

Buffett: I think the current treatment of the amortization of intangibles — which the FASB [Financial Accounting Standards Board] is looking at now — should be changed. I think it absolutely distorts economic reality and ... influences whether people use purchase accounting or pooling. As a result of the current treatment, they do all kinds of acrobatics to ... get pooling accounting. And whether a transaction with exactly the same economics is done through a purchase or a pooling shouldn't make that kind of difference in the reported numbers.

But I've seen managements — including some I know quite well — arrange to do things on a pooling basis where if they were private they'd do 'em on a purchase basis. And I think that's *nuts*. I think if accounting is pushing people to do things that are nuts, then I think it's time for accounting to look at itself.

And I'd say that *net*, Disney's economic earnings, in our view, are somewhat higher than its reported earnings.

FANNIE AND FREDDIE ARE INTEREST RATE *RESISTANT*.
HOWEVER, THEY'RE NOT COMPLETELY *IMMUNE*.

In extreme scenarios, Freddie & Fannie could face squeeze.

Shareholder: We have large holdings in Freddie Mac and Fannie Mae. As you both know, Freddie Mac and Fannie Mae were hurt a lot when interest rates rose in the past. Do you think they'll be hurt again when interest rates go up in the future?

Buffett: Freddie Mac and Fannie Mae are not as interest rate sensitive as people formerly thought they were. But it would be the pattern.... If interest rates were to go *extremely* low so that there was a huge turnover in their portfolio and then rates were to rise *dramatically*, even though they have various ways of protecting themselves against interest rates scenarios, I have a feeling that it might get very tough for them. In that kind of scenario, I think that they might suffer some kind of squeeze.

They may have good answers as to why that wouldn't happen, incidentally — because they certainly worry about every kind of interest rate scenario. That's their job.

They have advantages, but they're still somewhat S&L-like.

Buffett: But I think in a sense very low interest rates are more of a long-term threat — because if you get a portfolio chock full of 4% mortgages or something of that sort and then have a huge move upward [in interest rates, it] would be quite painful for some period of time no matter *what* you've done in the way of hedging. That's what happened to the savings and loans, in effect, 25 years ago or whenever it was.

Freddie Mac and Fannie Mae have other functions. And they've got a lot of *advantages*. But they have a savings and loan-type operation. It's on a very big scale. And they get their monies in a very different manner. However, the basic economics have some similarities.

KKR'S SALE OF GILLETTE WASN'T MACH III-BASED.
BUT WE WOULDN'T CARE EVEN IF IT *WERE*....

I understand that KKR *had* to sell its shares of Gillette....

Shareholder: Another significant Gillette investor — KKR [Kohlberg, Kravis and Roberts] — recently sold over $1 billion worth of the Gillette shares that they acquired through Gillette's acquisition of Duracell. Knowing that KKR's also been a successful investor, do you see that as a negative signal about Gillette's future prospects — particularly on the eve of the launch of the Mach III razor?

Buffett: Well, I think KKR may have publicly stated — I'm almost sure they have — that those Duracell shares, which had been exchanged for those Gillette shares, were held by a partnership with a specific termination date. So they *had* to sell those shares — whether they were shares of Duracell or Gillette — [because they] were scheduled for disposition at some point in a fund with a set term.

I think KKR made the decision — and they've made it with other stocks, too — to have three or so offerings between now and the terminal date of their fund. Why they pick a given date's up to them. But they probably decided that given the *quantity* of stock involved, they should sell their stake in several pieces.

But we form our *own* opinion; (and the Mach III's terrific).

Buffett: However, their disposition of those shares means *nothing* to us. And even if they didn't have that kind of fund and were to decide to sell their shares, it *still* wouldn't make any difference to us — any more than it would to them if we decided to sell ours. We form our ideas of valuation independent of anyone else's....

The Mach III is terrific, incidentally. I've been using it since October....

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

RETURNS IN REAL ESTATE AREN'T INTRIGUING — AND NEITHER IS OUR TRACK RECORD....

We have a perfect record in real estate — perfectly *awful*....

Shareholder: Have you ever applied the filters you apply to operating companies — like competitive advantage and return on capital — to real estate? And if the answer is no, why not? Is it a circle of competence issue? Or is there something you find uninteresting about real estate?

Munger: Here's an area in which we have a virtually perfect record extending over many decades. We've been demonstrably foolish in almost every operation having to do with real estate that we've ever touched. Every time that we had a surplus plant and didn't want to accept the bid of some developer that planned a development, we'd have been better off later if we'd accepted the bid and done something with the sales proceeds in a field where we had expertise.

I developed a housing tract [in California at Wesco] because I didn't want to let the zoning authorities rob me the way they wanted to. And now I know that if I *had* let them rob me we would have had better financial results. We have a *certified* record of failure in the real estate field.

Buffett: And the funny thing is that we *understand* real estate.

Munger: And we're good at it compared to many.

We *understand* it, but we understand *other* things *better*.

Buffett: You're right.... Charlie got his *start* in the real estate business. Didn't you, Charlie?

Munger: Yeah. But we understand other things *better*. So the chances that we're going to be making significant real estate investments [are slim].

We don't see great *returns* available....

Buffett: We've seen lots of things. The prices just don't intrigue us — in terms of what we get for our money. I tried to buy a *town* when I was 21 years old. The U.S. government had a town in Ohio for sale. And it would have worked out very well.

There's nothing about the arena that turns us off. But we don't see great *returns* available. And like Charlie mentioned, in the few experiences that we have had — particularly when we've had an old plant or something — we haven't been great at working our way out of them. Fortunately, they haven't been very important in relation to the net worth of Berkshire....

WE'RE NOT PREDICTING DISASTER OR WISHING FOR IT. BUT WE'RE PREPARED FOR IT AND WOULD BENEFIT.

U.S. market isn't overvalued if two conditions are met....

Shareholder: Do you think the U.S. market is overvalued?

Buffett: As we said at last year's annual meeting and in this year's annual report: The market is not overvalued, in our view, if two conditions are met — namely, #1 that interest rates stay at or near present levels or go lower and #2 that corporate profitability in the U.S. stays close to present levels which are virtually unprecedented.

But those are a couple of very big ifs. A lot of the stories that came out after the annual report emphasized one aspect or another. And people said, "What does he *mean* by that?"

Well, it means what I *said*: If those two conditions are met, I think it's *not* overvalued. If either is breached in an important way, I think it will turn out it *was*. And I don't know the answer — which is why I put it in the form I did.

You'll only know the market was overvalued in hindsight.

Buffett: It's very tough at any point in time to look forward and know what level of valuation is justified. You do know when certain dangerous signs appear. And, certainly, if you're predicating your answer that stocks are OK at these prices — if you come to that conclusion — you have to *also* come to the conclusion that [the present level of] corporate earnings is likely to be maintained.

And that's a conclusion that *you'll* have to come to. But I don't think it's obvious that that's the case....

We're not *expecting* disaster, but we are *prepared* for it.

Shareholder: Is Berkshire prepared for a 1929-style depression or a prolonged bear market like they've seen in Japan? And will you be as successful in those situations?

Buffett: We don't *expect* what you're talking about. But we're probably about as prepared as a company can be for adversity — because Berkshire's been built to *last*.

Turmoil and terrible markets would *benefit* us long term.

Buffett: Net, we'd *benefit* over a 20-year period by having some terrible markets periodically. That doesn't mean we're wishing for 'em — or that they'll happen.

But we make our money by allocating capital. And the lower the stock market, the better we can do it. So we're well prepared, but we're not necessarily expecting it.

Munger: Yeah. We're never going to sell everything, go to cash and wait for the Crash so we can go back in. On the other hand, we are structured so that I think we could have a lot of turmoil over the next 20 years and it would help us, not hurt us. I don't mean it'll be *pleasant* to go through the downside. But it's part of the game.

Basically, we *hate* it when people follow us around....

Shareholder: What are the advantages of investing in Berkshire as opposed to investing in the stocks it owns?

Buffett: Well, a lot of people do one or the other — and some people do both. But you have to really make up your own mind on that. We're not going to go to great lengths to *tell* you about everything that Berkshire is doing as we go along. And there could be some changes. And there will be things that could happen within Berkshire that you might have trouble replicating. On the other hand, if you'd put all your money in Coca-Cola some years back, you may have done better than if you'd put it in Berkshire.

But we make no recommendation as to what people do with their money. We do not seek to become, in effect, investment advisors via our portfolio actions at Berkshire.

Munger: Basically, we *hate* it when people follow us

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

around as piggybackers.

Buffett: Nothing personal.

CALL IT NOSTALGIA, CHARACTER OR GOODWILL, IF A COMPANY'S GOT IT, WE MAY BE INTERESTED.

We do operate in a Norman Rockwell type frame of mind....

Shareholder: You seem to be quite a buyer of nostalgic assets. May I ask you whether nostalgia is one of your filters? Are there any assets like that left in the U.S. to buy? And, if not, may I suggest you come to the U.K. where all we *do* is sell them.

Buffett: If you send me a list of companies in the U.K. that are long on nostalgia, they might be to our liking because Charlie and I do tend to operate in sort of a Norman Rockwell frame of mind. The kind of companies that we like certainly *do* have a homey, Norman Rockwell, *Saturday Evening Post* type character.

They're the kind of companies people want to *stay* with....

Buffett: In fact, they have character — *period.* They're the kind of companies, really, that people, once they join them, frequently *expect* to spend the rest of their lives with rather than have [a fleeting experience] they expect to stick on their resume.

If you look at the businesses that we've bought in the last 3 or 4 years, they do have real character — both in the businesses and the people who built 'em. And that's why the people that built 'em want to stay on after they sell 'em and why they feel so strongly about continuing to run 'em right even though there may be no financial consequences to them as a result whatsoever.

So if you have a list of companies like that in England, please keep us in mind....

WE HAVE A MARVELOUS INSURANCE BUSINESS — BETTER ON THE UPSIDE *AND* WAY LESS RISK, TOO.

Our float isn't cheap or even free. It costs *less* than zero.

Shareholder: You said in the annual report — and you've said in the past — that your float has a greater value to Berkshire than an equal amount of equity. Is that because the float has been generated at such a low cost relative to an imputed cost for equity?

Buffett: It's because that float — which is now, let's say, $7 billion — comes to us at a *negative* cost. It comes to us with a cost of less than zero. In effect, it comes to us with a profit attached. We would not make that statement if our float were costing us a couple of percent a year even though it would then still be desirable — *highly* desirable. But our float is even *better* than that — or it *has* been.

So it's a liability accounting-wise, but not in reality at *all*.

Buffett: Therefore, if we were to get out of the insurance business and give up our $7 billion of float and replace it with $7 billion of equity, we would have less going for us next year than under the present situation even though our net worth would ... be $7 billion higher.

And as I've said, if we were offered the opportunity to exit the insurance business and that $7 billion liability would thereby evaporate entirely from our balance sheet — with no tax implications so that our equity would go up by $7 billion — we would turn down that proposition. Therefore, obviously, we believe that $7 billion item — which is categorized as a liability in the context of insurance accounting — is not a liability at *all* in terms of real economic value.

A marvelous business — better upside *and* less downside.

Buffett: Of course, the key isn't how much float we have or what its cost is *today*. The key is what it's *going* to be 10 or 15 years from now and what it's going to cost at that time. We'll work very hard at increasing the amount of float and keeping its cost down somewhere close to its present level.

When that can be done, it's a *very* attractive business. And GEICO's a big part of doing it. But we've got other insurance operations that will be important in that, too. And we may have others besides [them] in the future....

Munger: If our float keeps growing, it's a wonderful thing indeed. We really have a marvelous insurance business. In addition to having remarkable earning power, it's *way* less likely to get really clobbered than most insurance businesses. So I think it's better on the upside *and* safer on the downside.

We have certain exposures, but we're getting *paid* for 'em.

Buffett: And it may sound strange, but we wouldn't regard losing a billion dollars in a California quake as any great problem. That's [just] part of the game.

There are many companies that have greater exposure than that that really aren't getting paid for it. And you don't see it specifically. But any company that has a ton of homeowner's business in Florida or in Long Island or along the coast of Texas may have exposures many times our [$1] billion and really not be getting paid appropriately ... for those dangers.

INSURANCE MERGERS HAVEN'T HURT US SO FAR. AND YOU DON'T NEED TO WORRY ABOUT US THERE.

No merger out there has hurt GEICO or our reinsurance....

Shareholder: How do you think consolidation of the insurance industry will effect your insurance businesses and the long term development of your float?

Buffett: Insurance industry consolidation has been taking place for years. And there have been developments, for example, like the super cat-bonds (which aren't bonds at all). And that has an effect.

But I'd say that there's no merger that's taken place that I regard as having been detrimental to GEICO or our reinsurance business. It has not been a factor. And I think if there were more mergers, it would not be a factor.

[Editor's note: Of course, Berkshire participated again in the consolidation by acquiring General Re.]

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

In reinsurance, the problem is a general lack of fear....

Buffett: As for our reinsurance business, it's much more opportunistic. Consolidation isn't the problem there. The problem is just lack of fear generally by competitors who can price their policies — particularly the cat business — at a rate that may be totally inadequate (as I illustrated with an example in the annual report), but that nevertheless could *appear* to be profitable for a long time. There's probably more of that going on now. And there'll probably be a lot more still in that arena in the future.

You don't need to worry about how we'll do in insurance....

Buffett: We have a number of GEICO people here today.... And you saw GEICO's [Chairman Emeritus] — Lorimer Davidson — in the movie before today's meeting. And I was hoping he could be here in person. But Davey's 95 years old and it just isn't easy for him to get around.

He built a sensational company. It stumbled once, but Jack Byrne got it back on track. And Tony Nicely's got it going down the track at about 100 miles an hour and going faster all the time. So we have a great business there.

I see no way that *any* entity being put together would change the competitive situation with respect to GEICO. Operating just as it does — independently — GEICO is as competitive as it can be. And it would not benefit by being part of any other organization.

So we have some sensational insurance businesses. And I don't think that you have to worry too much about how we do in insurance in the future.

OUR INSURANCE OUTLOOK THE NEXT FEW YEARS?
LESS SUPER CATS, MORE GEICO AND WHO KNOWS....

Super cats can be mispriced unknowingly for a long time.

Shareholder: What do you think the long-term impact of catastrophe bonds and catastrophe derivatives will be on Berkshire's float and the growth of its float?

I understand that the mispricing of risk by these instruments doesn't effect the way you *price* your business. But I'm wondering how you think it effects your *volume*. Several years ago, you talked about how you can never be smarter than your dumbest competitor.... And, potentially, these sound like they could be some dumb competitors.

Buffett: You've got it.... You can price super cat business wrong.... You can be pricing it at *half* of what it should be priced at. I used an example in the [annual] report of a $50 million policy which should be receiving a premium of, say, $1-1/2 million.... And I pointed out that if you were to substantially underprice it — at, say, $1 million a year — how you would nonetheless think that you were making money, even after 10 years, more than 70% of the time. Interestingly, even if you were to price it at only *$1* a year, you'd have thought you'd made money over 70% of the time. When you sell insurance against very infrequent events, you can totally misprice it, but not know about it for a long time....

Heads, the general partner wins. Tail, the limiteds lose.

Buffett: Super cat *bonds* open that field wide open. You've always got the problem of dumb competitors. But [hedge funds, for example, have bought some of these.] And you have a much greater chance of having dumb competitors when you have a whole bunch of people who get 20% of the profits in a year when their *are* profits because there is no hurricane and who doesn't take the loss when there does happen to be a hurricane or earthquake — although, of course, some of his partners do. So it's very likely to be a competitive factor that brings our volume down a lot.

It won't change our prices.... The earthquake doesn't know the premium that you receive. The earthquake happens regardless. There's nobody out there under the San Andreas Fault saying, "Since you only charged a 1% premium, we'll only do it once every 100 years." It doesn't work that way.

So we will probably do a whole lot less volume in the next few years in the super cat business. We have these two policies that go on for a couple of more years. But in terms of new business, we will do a whole lot less.

GEICO's growth is fast and accelerating....

Buffett: But GEICO's by *far* the most important part of our insurance business. [To give you some idea of how it's growing,] in the 12 months ended April 30th, GEICO had a 16.9% increase in policies in force. At year end, I told you it was 16.0%. A year ago, I told you it was 10%. And the year before that, I believe it was a little over 6%. So its growth is accelerating.

It should be in a lot more homes around the country than it is now by a big factor — and *will* be in my view. So it will be the big part of our insurance business.

But we may be in the insurance business in some *other* ways, too, as time goes along. It's a business in which if you exercise discipline, you should be able to find some ways to make money. But it won't always be the *same* way.

COMPELLING VALUE + THE INTERNET
+ TRUSTED NAMES = HUGE POTENTIAL.

Borsheim's has a compelling offer and huge potential....

Shareholder: Looking out 10 years, what do you expect to most change Borsheim's ability to be dominant?

Buffett: Borsheim's is one of a couple of companies where the internet could have *huge* potential for us. I don't know whether that'll happen. But there's no question that we operate (and we've got a message on the internet) at considerably — *very* considerably — lower gross margins than does a Tiffany or any publicly-held jewelry operation.

We give customers considerably more for their money. We have *way* lower operating costs than any public company. As we say on the internet, our operating costs are 15-20 percentage points less than our publicly-owned competitors. So we have a lot to offer.

Berkshire name plus the internet could facilitate growth.

Buffett: The big question people have with jewelers is: "How do you know who to *trust*?" And it's an article that

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

most people feel very uncomfortable buying. I think that the Berkshire Hathaway identification will help people feel comfortable about it....

Also, it's a big ticket item. So saving money gets to be really important — like saving money in auto insurance. And I think the internet could [ultimately prove to] be of significant assistance to Borsheim's in facilitating [the expansion of] its reputation. So Borsheim's could have a lot of growth and the internet could be a big part of it.

We need to tell people about the value and convenience....

Buffett: Our job is to get the message out to people around the country that they can literally have us send half a dozen or so items to them that they can examine with no sales pressure or anything of the sort and that they can look at the merchandise and the prices and decide what they want in the comfort of their own homes — and that they'll do very *well* with us.

We have a lot of people taking advantage of that now. But we could have 10 or 20 or 50 *times* that number as the years go by. And I think we should work very hard on it.

Brand potential in GEICO is *very*, very big. And we'll *push*.

Buffett: GEICO has some possibilities through the internet, too. Anything where you're offering a terrific deal, but where one of the problems has been how you talk to the consumer, the internet offers the possibility of that.

But everybody in the world is going to be there. And one of the questions will be why they should click on you instead of someone else? And actually, on that score, the Berkshire Hathaway name may help a little bit — although GEICO's name is extremely well known, too.

I mentioned in the annual report that we were going to spend $100 million basically to promote GEICO. Well, we're going to spend *more* than that. The brand potential in GEICO is very, very big. And we intend to push and push and push on that.

It's not all *plus*. We paid our *entry* fee....

Munger: Having said that the internet *helps* some of our businesses, certainly the CD-ROM and the personal computer combined to *clobber* World Book.

Buffett: We paid our *entry* fee.

(continued in next column)

Munger: Yeah. It's not all a *plus*.

Buffett: No, it isn't....

PRIVATIZING SOCIAL SECURITY IS A REASONABLE IDEA — AS LONG AS THE SAFETY NET IS KEPT INTACT.

Senators Kerry and Moynihan have proposed small grants.

Shareholder: Nebraska Senator Kerry has proposed private investment accounts for up to 2% of the current payroll tax. His words were, and I quote, "People want more than just a transfer payment. They want wealth."

Do you approve of his proposal? If so, would you recommend passive investing — i.e., via indices? Or if you recommend active investing, would you and Charlie want to give it a shot?

Buffett: Well, I've talked with Bob Kerry about that. Bob does like the idea of giving everybody some piece of the American economy — an interest in it. He's proposed what amount to small grants to the 3-1/2 million or so children born each year and some buildup of that account. [And] Senator Moynihan has come up with something recently in conjunction with Kerry.

A substantial safety net should remain....

Buffett: However, speaking personally, I would not like to see any *major* amount of Social Security invested in equities. Moynihan was talking about 2 percentage points. And actually, I suggested the idea that maybe 2 points out of the 12 and a fraction points — at the option of the Social Security participant — could be devoted to some other system. But then they would only get 5/6ths of the basic Social Security benefit.

I don't think you could drop it below that level because you wouldn't want people turning 65 — or maybe a more advanced age in the future, say 70 — and not having the safety net of Social Security. So I wouldn't want to drop mandatory participation in the present system below a minimum of about 5/6ths of the present benefits.

Participants could build wealth *and* have a safety net.

Buffett: But I think it's a perfectly reasonable topic to discuss whether you want to take that 2% and let people build up an account — perhaps tax free ... as an IRA-type account — so they could have both wealth *and* a safety net.

Again, I wouldn't want to drop the safety net very far and I wouldn't want to turn loose an army of salespeople on the public with a *mandatory* 2% going in some direction. I don't think that would be particularly healthy.

The government promoting equities is asking for trouble....

Munger: I'm much less enthusiastic than you are.... Your conservative attitude is way more optimistic than mine.

I think anytime you get the government into promoting the value of equities, you're asking for trouble. For example, in Japan, you have [the aftermath of that policy] today. The Japanese government created a postal saving system to buy equities massively year after year after year. I think we need to keep the government *out* of the equities business.

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

EDUCATION SYSTEM IS BROKE AND NEEDS FIXING.
BUT REPEATING WHAT *DOESN'T* WORK WON'T CUT IT.

Jack Byrne made Berkshire big bucks.

Shareholder: In the late '70s, my parents made the wise choice of buying some Berkshire stock to pay for college for my brothers and me — and it did. And I suspect that there must be thousands of people like us whose education was paid for by wealth the two of you created. And we owe you, although we'd probably have done a lot better [had we] *skipped* college and [kept] the *stock*.

On the subject of education, Milton Friedman has written that if you really care about poverty in the U.S. and disadvantaged minorities, and you could cure a single thing, it would be the public education system.

I wondered if you two agree with what Friedman says, what you think the importance of a public education is and what you think might be done to improve it?

Buffett: Patrick Byrne (the questioner) is the son of Jack Byrne who made a fortune for us by resuscitating GEICO when it got into trouble in the mid-'70s. In fact, I met Patrick's dad on a Wednesday at about 8:00 at night in Washington. At the time, GEICO *was* bankrupt and very close to being declared so. But after talking with him for three hours that night, I went out the next day and bought over 500,000 shares ... at $2-1/8. Split-adjusted, that's about 40¢ per share on the stock we paid $70 for later on.

So we may have made the Byrne *family* some money, but Patrick's dad made us a *lot* of money.

Like father, like sons. Sadly, we're running out of Byrnes.

Buffett: Patrick is now running Berkshire's Fechheimer's subsidiary in Cincinnati and doing a sensational job. His brother Mark will be establishing a major operation in London and Bermuda shortly in which we'll be a very large partner.

[Unfortunately], Patrick only has one other brother left. And he's out in California. But if times get tough, we're going to try and recruit him, too.

It's gotten so bad some places that *evolution* won't *cut* it.

Buffett: Now Charlie, with all that time to prepare, what do you have to say about education?

Munger: Well, I certainly agree with Milton Friedman that it's hard to name a single thing in the U.S. that needs fixing that would be more worthy of fixing than education. And I think that's particularly so with the lower grades in many big cities where the failures are so horrible. So, yes — I think it's a *terrible* problem. And it needs fixing.

Of course, there's a huge debate as to the best way to fix it. I'm skeptical that some big city school systems can be fixed under their own momentums. I think we may have to go to alternatives like vouchers. The incentive structure has gotten so *bad* in some places that you *can't* fix it with evolution. It will take *revolution*.

Democracy without good public schools is a mockery.

Munger: Warren, you're more optimistic about it.

Buffett: Well, I'm not necessarily more optimistic — but I do feel that a democracy without a good public school system that's available to the entire population is a *mockery* given that there's so much inequality to start with....

And it isn't just inequality of money. Our kids, whether they inherit any money, compared to the kids of somebody whose parents are struggling to keep the place going or kids with one parent living in poverty — it's so unequal to start with. If you then *accentuate* the inequality by also giving those who are generally higher on the ladder a far better education than you give those children who've chosen the wrong womb...well, I don't think a rich society should tolerate that.

But that's much more easily *said* than *done*....

Buffett: However, that doesn't mean it's easy to *solve* — because unfortunately, as I've said, it seems that a good public school system is like virginity: it can be *preserved*, but not *restored*. It's very hard to do much about a system that's lousy — because wealthy people will opt out of it. They'll be less interested in bond issues. They'll be less interested in the PTA. They'll be less interested in the educational outcome of other people's kids education — because they *have* opted out.

And to have one educational system for the rich and another for the poor, with the poor getting a worse system strikes me as doing nothing but accentuating inequality and other problems that result from that in the future.

So I don't know the answers on improving the system. I've read about some of the experiments that take place. But I believe that if you have a good public school system to start with (as we do in Omaha) you do your damndest to maintain it so there's no incentive for the rich grandparent or parent to say, "I love the idea of equality, but I love my child more. So I'm yanking him from the public schools." And then you wind up with an exodus which leaves behind only those who can't afford to make that choice.

Vouchers, if poorly designed, can leave inequality in place.

Buffett: Competition I *like*. For example, I think a good parochial system creates a better public system. We've had that situation in Omaha. But I think the voucher system, if it simply amounts to giving everyone an additional amount, can wind up leaving whatever inequality there is in *place*.

For example, I play golf. And I don't play very often, but I play at the Omaha Country Club. And you could have a *golf* voucher system so that everybody in Omaha would have more access to the country club by giving everyone $1,000 a year to play golf. Practically speaking, however, it would just reduce my bill. It wouldn't do the job for the guy who's now on the public course because it would still be beyond his means to be on full-scale equality with me.

Nothing is *more* important. It ought to be a top priority.

Buffett: I don't think that anything's *more* important. I agree with Charlie totally. I think the first eight grades — you can forget it after that. If you have them right, good things are going to flow. And if you have those wrong, you're not going to correct it beyond that point.

It ought to be a top national priority. We have the *money* required to educate everybody well in this country. The question is, "Can we *execute*?" And that's something

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that I hope good minds like Patrick's work on.

Charlie, do you have anything?

The Munger-Buffett solution — means-tested vouchers....

Munger: Yeah. I think that when something has demonstrably *failed* at performing a function which it was assigned by a civilization, just to keep pouring more and more money into a failing modality — well, that is not the Munger system. So I'm all for taking the worst places where there's failure and trying a *new* modality.

It wouldn't bother me at all if vouchers were *only* for people otherwise destined for failed schools. But I think we have to do *something* in our most troubled schools to change our techniques. I think it's *insane* to keep going the way we are.

Buffett: So you would go for *means*-tested vouchers. I don't disagree with that....

Part of the problem is an absolute rule against what works.

Munger: All I know is that it's a *terrible* place to fail. And part of the trouble is that if you have an absolute rule that there can't be any tracking by ability no matter how much better reading can be taught by systems that involve tracking.... I'll just say that the people who got brainwashed into believing in a silly rule shouldn't keep the power to continue failing.

We *must* do something — besides repeat what *isn't* working.

Munger: I'm a product of the Omaha public schools. And in my day, the people who went to private schools were those who couldn't quite hack it in public schools. And that's still the situation in Germany today. The private schools are [for] people who aren't up to the public schools. I prefer a system like that.

However, once a big segment of that system measurably fails, then I think we *have* to do *something* different. You don't just keep *repeating* what isn't working.

Buffett: I don't disagree with that.

RECOMMENDED READING: BEHAVIORAL SCIENCE EINSTEIN, FERMAT AND YOURS TRULY....

The best work of its kind I've ever read....

Shareholder: Thank you for your letters to shareholders and Mr. Munger for your speech to the graduate students at USC. I've drawn a lot of insights from it not only useful in my investing, but also in my job as a business manager. Could you give me some suggestions for my reading list on investing and management aside from the standards of Graham, Fisher, etc.?

Munger: Yeah. I've recently read a new book twice — which I very seldom do. And that's *Guns, Germs and Steel* by Jared Diamond. It's a *marvelous* book. The way the guy's mind works would be useful in business. It's always asking *why* — why, why, why. And he's very good at coming up with explanations. I would say it's the best work of its kind I have *ever* read.

[Editor's Note: *Guns, Germs and Steel, The Fate of Human Societies* was published by W. W. Norton in 1997. Diamond also wrote *The Third Chimpanzee* which, as you may recall, Munger has recommended in the past.]

Buffett stuck to the *easy* stuff — Einstein and Fermat....

Buffett: I read a little *easier* book.... [And that was] *The Quotable Einstein*. It includes a lot of his commentary over the years. It's great reading.

Another is *Fermat's Last Theorem* — which is the story of the [300 year quest for a mathematical proof to a celebrated number theory problem that Pierre de Fermat said he had solved, but ran out of room in his margins to record]. That's a very interesting book. One of our shareholders from Sweden gave me a copy of it when I was in New York. And I enjoyed it.

[Editor's note: *The Quotable Einstein* was edited by Alice Calaprice and published by Princeton University Press in 1996. *Fermat's Last Theorem* was written by Amir D. Aczel and published by Delacorte Trade Paper in 1997.]

The best source on our philosophy — our annual reports.

Shareholder: Does Mary Buffett's book, *Buffettology*, present fairly in all material respects the calculations you use in evaluating a business for purchase?

Buffett: It has two authors. In a general way, it gets at the investment philosophy. It's not the book I would have written precisely, but I don't quarrel with it either. However, I would think that you should be able to get more of our philosophy by reading our annual reports than in any other manner.

The best job of organizing what's been in those reports....

Buffett: I think Larry Cunningham — the fellow who held the symposium at the Cardozo School at Yeshiva — has done the best job actually of reconstructing the various things that have been written at Berkshire into the best organized presentation of our philosophy....

Munger: He's selling it here today. It's very practical.

Buffett: Yeah. He had 'em at the mall outside Borsheim's yesterday. Larry did a very good job. And I had nothing to do with it. However, I believe he's done a first class job of organizing all of these things I've written and Charlie's written over time by topic.

So if I were going to pick one book to read, that would probably be the one.

[Editor's note: Lawrence A. Cunningham wrote *The Essays of Warren Buffett: Lessons for Corporate America* which was published by The Cunningham Group in 1998.]

Everybody would profit by reading Charlie's talk....

Shareholder: The next generation would like to hear from you — about your investment discipline, life-style and philosophy of contributing your wealth back to society — in a language they can understand and communicate to their friends ... at school.

Buffett: Thanks.... I get many requests to give speeches — perhaps because I don't *do* 'em. However, the only groups I talk to are students. I try to talk to university

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BERKSHIRE HATHAWAY'S
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(cont'd from preceding page)

students — high school students, too — whenever it fits in my travel schedule. And the reason why I speak to those groups is that I just think that if you're going to spend your time ... talking, that rather than simply entertain people, it probably *is* better to talk to young people.

Charlie and I have never been ones to be shy and withdrawn. Charlie's given a couple of talks — one I sent you a few years ago from U.S.C. and another one more recently — that I think everyone would profit by reading. It was [featured] in *Outstanding Investor Digest*. However, if you write Charlie, I'm sure he'll send you a copy.

[Editor's note: We've also made Munger's earlier talk available to subscribers and educators at OID.com.]

Phil says he'll definitely be back *next* year. And he *will* be.

Shareholder: I wonder if one of the two patriarchs of the investment business, Phil Carret, is with us today? Many friends and admirers would like to wish him well.

Buffett: Phil is 101 years old. He wrote a book on investing in 1924. And I've known him for 46 or 47 years.

He's made all of our meetings for a number of years. And he planned to be here today. But he broke his hip.... However, he sent us a message that he'll *definitely* be here *next* year. And he *will* be, *too*. Phil's a hero of mine.

[Editor's note: Ditto. Of course, sadly, Carret did pass away subsequently. But as we alluded to last edition and in our memorial to Carret on OID.com, but for the fallibility of doctors, Buffett would likely have been right. By the way, also at OID.com are excerpts from his memorial — some of which we found particularly uplifting.]

BERKSHIRE SHOULD DO JUST FINE WITHOUT US, BUT WE'RE NOT GOING TO LEAVE WILLINGLY.

Our doctors aren't dead yet, but we're *working* on 'em....

Shareholder: I'm very concerned about your health and your diet.

Buffett: These are our *products* that I'm eating.

Shareholder: Coke, candy, ice cream...

Buffett: And that's just what I do in *public*....

Shareholder: I want to know what your doctor says.

Buffett: My doctor says I must be heavily relying on my *genes*. Charlie and I are both very healthy. If you were in the life insurance business, you'd be happy to write us at standard rates — I can assure you of that.

Munger: They asked George Burns when he was 95, "What does your doctor say about you smoking these big, black cigars?" And he said, "My doctor's *dead*."

For some reason, I've gotten very big on George Burns....

Buffett: Charlie and I played bridge with George when he was about 97, I'd say, at the Hillcrest Country Club. And there was a big sign behind him that said, "No smoking by anyone under 95."

Actually, at his 95th birthday party, they had about five very good looking young girls who were there to greet him with a big cake and everything. Well, he looked 'em over one after another — and he said, "Now girls, I'm 95. *One* of you is going to have to come back *tomorrow*."

I've gotten very big on George Burns in recent years.

We're not *old* enough to be really good in commercials.

Shareholder: Watching you two eating See's Candy and drinking Coca-Cola the whole day...

Buffett: Here we go again.

Shareholder: Do you intend to do any commercials in the future like what Dave Thomas does at Wendy's?

Munger: Actually, we aren't *old* enough to be really good in a commercial. We'd like to have somebody up here happily eating See's Candy and answering these questions who's about 110 years old. That would *really* be helpful.

We're not obsessing about future management yet.

Shareholder: Would you comment on succession?

Munger: Well, in due course, this corporation will have a change in management. I'm afraid we have no way of changing *that*. However, apart from making sure that we've got good options and having some succession system in place, we're not obsessing about future management yet.

Fortunately, Warren plans to live almost indefinitely.

Buffett: Absolutely. Although I must say [that] on my last birthday somebody asked me how old I was. And I said, "Why don't you just count the candles on the cake?" And he said, "I *tried*. But I was driven back by the *heat*."

The directors know who — they have a letter that says who — *we* think should succeed us in both the operating and investment allocation aspects of the business. Those letters can change over time as we keep hanging around.

I can't think of a place I'd *rather* have my estate....

Buffett: But I don't worry that 99%+ of my estate will be in Berkshire stock or that the Buffett Foundation will eventually receive that stock. That doesn't bother me in the least. I can't think of any place that I'd *rather* have it.

And that includes my appraisal of the managers that we have who can step in and do what Charlie and I do. Who knows? One of 'em may even understand *technology*.

Charlie and I aren't going to leave willingly.

Munger: I think this place would continue to have very respectable prospects even if our top *25* managers were all to drop dead at once.

Buffett: That's not an experiment we intend to *try*....

Munger: I see no reason to think that it wouldn't continue to do quite well.

Buffett: Right.

Munger: It's been lovingly put *together* to have a certain margin of safety.

Buffett: Actually, given a choice, it will be managers *#3* through *#25* who go. We're not going to leave willingly.

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

WESCO FINANCIAL'S CHARLIE MUNGER
"AT TIMES, THE EASY ANSWER WAS TO BUY. TODAY THE DECISION HAS BECOME HARD."

STOCK OPTIONS?! IF IT WERE UP TO ME, WE'D CHARGE ASSOCIATES FOR *COFFEE*.

We have a liberal, old-fashioned stock option program.

Charlie Munger: This is the 39th annual meeting of the shareholders of Wesco Financial.... At the record date, there were 7,119,807 shares of capital stock outstanding. By the way, that figure has not changed an iota in decades.

Here at Wesco, we have a liberal option program — every 25 or 30 years, we *think* about it and decide *not* to....

Shareholder: I've always liked your policy (and I think all stockholders should) of having no stock options. But I don't know of any other companies with that policy. Could you list a few other companies that don't believe in stock options either?

Munger: Well I don't follow that issue very closely. However, certainly, stock options are in a vast majority of American corporations now.

The old Carnation Company never had them. It was family dominated. And when they carried coffee around the executive offices, you took a dime out of your pocket and paid for it. That was the way Old Man Stuart *liked* it. And I've always kind of *liked* companies like that.

[In due time,] the valuable executives at Carnation got rich. But they had to do it by saving their money and buying stock like other shareholders. That's a very old-fashioned way of thinking. It just happens to fit my personality. And maybe I'm too much like old man Stuart.

In some industries, you're *forced* to have stock options.

Munger: However, there aren't a lot [of companies like Berkshire and Wesco that don't have stock options]. You're right. These things just sweep through the world — it's a kind of "monkey see, monkey do".

Plus, there's a huge *incentive* to have them. In some lines of work you're forced into it. If you're going to play a cutting edge game in Silicon Valley, I don't think you could play to win effectively with old man Stuart's methods. Like it or not, I think, you'll have to issue stock options.

If we *had* option plans, we'd try to account honestly.

Munger: However, if I *were* doing it in Silicon Valley and I felt that I had to issue stock options, I would still perform honest accounting. But I think our accountants would probably tell you that I wouldn't be *allowed* to do what I'm calling honest accounting....

But we're horribly out of step....

Munger: At the Berkshire annual meeting, Warren said that where we have acquired companies that have existing stock option plans, we've changed those plans to be financially the same, but to trigger tax rules and accounting treatment that we regard as honest. So we shift to our system wherever we can.

We don't mind incentive pay tied to the performance of business units. In fact, we *like* it. However, we do *not* like the accounting treatment of stock options.

And, generally speaking, we think it's a dumb way to incentivize executives in most companies. So we're horribly out of step with the rest of humanity on that issue. But that doesn't bother us at all. And if it bothers you, well — you can own some *other* stock.

Please forgive the fancy digs....

Munger: I want to apologize for the elaborateness of this room. Many of you have come to our annual meeting when we held it in the cafeteria in the basement of the old Mutual Savings Building. And then we moved it to a rather modest room in a building we own which was leased to a cafeteria. But they gave up the ghost — and that building is now vacant.

We didn't move you into the building we own because it would have been more expensive to clean it up and move furniture into a vacant restaurant than it was to rent this room for a couple of hours. But I know that many of you are disappointed to see our annual meeting held in such an elaborate room — even if your heavy attendance has established a new record for occupancy per square foot.

Our cult and welcome to it....

Shareholder: I've followed Wesco for many years. And in the last couple of years, there seems to have been a lot more volume trading than there has been before. Would you comment as to the reasons why?

Munger: Well, we didn't set out to *do* it. But what we have created at Berkshire/Wesco is, to some extent, a *cult*. And you can say it's a nice cult and you like the people who join — and we *do* feel that way. But to some extent, we have followers who are unusually interested in what we do and feel comfortable about investing with us. I think it's had effects on the stock prices of Wesco and Berkshire.

I mean it's the kind of people that are filling this room that have *created* that effect. I can remember when we only had about 10 shareholders at the annual meeting — and most of them were from Pasadena.

BERKSHIRE'S VERY DIFFERENT THAN WESCO. IT'S AN ENTIRELY DIFFERENT ANIMAL....

Wesco's rather easy to value....

Shareholder: When you spoke to some students at Stanford, somebody quoted you as saying Berkshire's stock was *over*valued. And you quickly corrected them and said that what you'd actually said was, "It's not *under*valued — I never said it was *over*valued."

I'm sure you find yourself making that correction quite often.

Munger: Yeah.

Shareholder: Both you and Warren have been very helpful in previous meetings talking about whether the stock outperformed the company in terms of intrinsic value

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WESCO FINANCIAL'S
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(cont'd from preceding page)

the previous year or the company outperformed the stock. Would you be so kind as to tell us whether in your opinion — both at Wesco and Berkshire — the stock outperformed the company last year or vice versa?

Munger: Well, the companies are quite different. Wesco's so liquid and its operating businesses so moderate in size that it's rather *easy* to make a computation as to its asset value. You can figure out what would happen if you just closed the place and mailed checks back to all the shareholders.

We've valued Wesco in part because some love us *too* well.

Munger: So we've made an intrinsic value calculation for people at Wesco — which is something we've always refused to do at Berkshire. We've done that because it's so easy in one case and because we have these "stock touters" who love us too well and write up these theories like, "This is a baby Berkshire. And it's smaller, so it'll grow faster."

They were saying all kinds of things we don't believe. And as Warren's frequently said, we would prefer our stock sell more or less close to intrinsic value at all times.

That a management should *care* about having its stock sell too high as well as having it too low — well, that's a very unconventional attitude in corporate finance. But that's the way we are.

And since it's easy to make the computation and since it tended to tamp down unreasonable overvaluation, we undertook the system of reporting and discussion that we have at Wesco.

Berkshire's an entirely different animal....

Munger: Berkshire's an entirely different animal. First, it has a huge amount of intangible value — both in its insurance operation and its operating businesses. Second, its management has way more ability to change things. Berkshire gets all *kinds* of opportunities that Wesco doesn't. People who want to turn in their business for shares want shares of Berkshire, not shares of Wesco. So there are all *kinds* of things that Berkshire can do that Wesco can't.

Relatively speaking, Berkshire's valuation isn't crazy.

Munger: Obviously, Berkshire sells higher in relation to intrinsic value the way we used to think of it way back in the early days when we didn't have much in the way of operating businesses. If we were to use that same kind of construct today, you'd say that Berkshire is selling higher in relation to intrinsic value than it used to.

But it would be *inappropriate* to do that. Berkshire's a very different company today. All of the other companies in America that are any good are selling at huge multiples of book value. So in relation to other stocks, I would not consider Berkshire's [valuation] crazy.

But it has enough institutional momentum in place that it isn't the *least* bit easy to compute its intrinsic value. There's nothing easy about it. So computing the figure and explaining our rationale each year in Berkshire's letter would be way too hard for us to make it a regular habit.

Forget easy no-brainers. You're in the *hard* part now.

Munger: Take General Electric, for example. What is its intrinsic value? That's not an easy computation either. With General Electric, you're betting on its ability not only to maintain a bunch of good businesses, but also to continue growing a finance operation increasing assets at a rate of 15% or so per annum. And that finance operation contains an extra $10, $20 billion or even $25 billion a year of both assets and liabilities.

Well, there's no precedent for *that* in the history of the world. I'm not saying GE can't continue to do exactly that. Certainly, the market expects it. And it may. All I'm saying is that it's complicated to figure it out.

Generally speaking, I think that the world of [what you might call] easy, no-brainer investing is greatly diminished. You're in the *hard* part of capitalism now — all of you.

Berkshire's momentums would survive Warren's passing.

Shareholder: Would you say that you don't calculate Berkshire's intrinsic value any more because it's too hard?

Munger: No. Partly we would hate the promotional possibilities in that practice. That's why we have a rule that each person does his own. Warren and I never sit down formally and make calculations and compare mine against his. So we do it, but we have no formal system of doing it. We have a system where we put down all the data and each person can do his own calculating.

But there are momentums in place at Berkshire now that are very interesting. There are momentums in place at Berkshire that would survive Warren's untoward end.

Reinsurance savings can be interesting here and there.

Shareholder: Before being acquired by Wesco, Kansas City Surety reinsured almost half its premiums. Its acquisition basically eliminated that need. Are there other insurance companies like it available for acquisition where you could eliminate the need for reinsurance and thereby increase its underwriting margins?

Munger: Yes. When big, well-capitalized insurance companies acquire smaller ones, they can frequently reduce the amount of reinsurance because they mind the volatility less. So you're right that it's an advantage.

In one or two places in America, you might get interesting advantages by doing what you suggest. That's because some companies do pay a considerable price to reinsurers to keep the volatility of their reported earnings very low. And that expense *could* be eliminated if they were owned by somebody bigger and richer.

[Editor's note: One of the factors mentioned as a rationale for Berkshire's acquisition of Gen Re.]

GEICO — a hell of a business today and tomorrow....

Shareholder: At the annual meeting, Warren said that GEICO's going to be by *far* the most important insurance business that Berkshire has over the long term. Is that due to its market size, its current low penetration and what one can forecast about growth? Or is it the quality and controllability of risks that are being taken? What are the factors that lead you to that conclusion?

Munger: GEICO can deliver a tremendous value to the customer by virtue of being such a low-cost operator. And they're low cost in relation to a lot of people. And

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they're also getting quite good at the distribution system. So it's a marvelous business.

So if Berkshire's insurance business were to continue from this point just developing out what we already have — in other words, absent some large transaction that took in another insurance business — then I think that GEICO would clearly be the dominant business.

I'll be quite disappointed if 10 or 15 years from now, GEICO isn't *three* times more deeply entrenched in insurance buying and in the automobile liability and collision field than it is now. It's a *hell* of a business.

Lou Simpson's doing it on his own — and doing it *well*.

Shareholder: Charlie, both you and Warren have indicated that GEICO is Berkshire's shining jewel. And Lou Simpson, of course, runs GEICO's portfolio. It's been suggested in some circles that if something were to happen to either of you that Lou would become the decision maker on the securities end of Berkshire.

Do you or Warren have any input in GEICO's portfolio or does he run it exclusively? And is there a chance that we'll hear from Lou at Berkshire's annual meeting?

Munger: Well, that's a very interesting suggestion. Lou's a *very* intelligent man. He's outperformed the market for years with his common stock picking.

Entirely on his own, he developed a system which is very much the same system that Warren and I have.... So if you look at GEICO's portfolio, six or eight securities will typically amount to pretty much the whole portfolio. So he's *cognitively* reached the same way of operating we have. Again, he's done that, I'd say, entirely independent of us. In other words, his mind has reached the same conclusion.

That said, he searches out some securities that he's researched and worked over that we haven't found. And our system with GEICO is that we let Lou do all the common stock investing there.

We like the idea of having someone else independently managing a chunk of the money if that person is as talented as Lou Simpson. So Lou is doing it on his own. And he's doing it *well*....

HOW DID WE EVOLVE? BY GETTING BURNED, INSPIRED AND HAVING NO CHOICE, THANK YOU.

Business makes you better at investing and vice versa.

Shareholder: One of your influences on Mr. Buffett was with this idea of franchises — of buying a business with a franchise — because up to a certain point in time, Mr. Buffett was looking [mainly for ideas which were trading at deep discounts to their asset value].

How did you develop this idea of franchises? And did it come from having business experience rather than just being someone passively removed from the business world?

Munger: Well, Warren has frequently said that he considers himself to be a better *business* manager because he's been a professional investor and that he considers himself to be a better professional *investor* because he's been a business manager. And I would say exactly the same thing. So I do think it helps.

Getting burned is a way of learning that really works!

Munger: Also, if a child puts his hand on a hot stove and you ask him later, "Are you going to do that again?", he'll say "No, I'm not!" I mean there's a way of learning that really works!

And having some lovely money that you worked very hard for disappear because you made a dumb investment decision is much like putting your hand on that hot stove. It's a memorable experience.

Warren and I were helped by the duality of our careers.

Munger: How could it be otherwise? Common stocks are little pieces of paper. However, they represent interests in business. Therefore, how could it *not* help to know a lot about the real problems of business?

Conversely, if you were a very good sales manager at Glotz Tool Works and you knew a lot about selling tools, scheduling problems, etc., I should think it would also help you if you had a lot of experience trying to make investments in companies other than the Glotz Tool Works. You would better understand your customers and their problems — which is helpful to a sales manager.

So, *yeah* — I think that business experience and investment experience both help in making investments. And Warren and I were helped by the duality of our careers.

See's working so well opened our eyes somewhat.

Shareholder: But was there one specific incident or a point in time that led you to this revelation about franchises — of seeing the value of See's Candies for instance? Or was it an accumulation of time and experience?

Munger: Certain lessons happening early helped us. For example, buying See's Candy and having it work so *well* in spite of the fact that we paid a way higher price relative to liquidating value (which is the way we measured it then) than we'd ever paid before — certainly, that experience helped us.

But there used to be lots of rewards in *obscure* stuff, too.

Munger: Something else also helped us. You used to be able to easily find securities selling at a third or less of liquidating value per share by just rooting around in the less-travelled part of the world — the pink sheets, the small stocks — the stuff that the big boys weren't following. So somebody like Warren running a little partnership in Omaha could achieve relatively high returns in much the same way that Ben Graham had earned his high returns — by finding lots of relatively obscure places to put money.

And if you buy a security at a third of liquidating value, there can be a lot of mismanagement before you'll lose money — particularly if you buy a *package* of 'em.

Why'd we change? Inspiration and desperation....

Munger: However, that way of investing won't work with large sums of money. Over time, too many other people have tried to do that. For example, a man in this room runs around setting up savings accounts at various little thrifts hoping that they'll demutualize. And that's a way of making money. But it's *not* a way of employing

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huge amounts of money intelligently.

I think you'd have a *hell* of a time today finding a lot of things to buy at a third of their liquidating value — even if you were willing to root around....

So our success in See's combined with the drying up of formerly available opportunities forced us into a different reality-recognition mode. And, frequently, one's ability to change one's mind is the result of several different causes operating in the same direction at the same time. And so I'd say that something like that happened to us.

Bill Gates' style works for him and ours works for us.

Shareholder: You mentioned at the Berkshire meeting that the next Warren Buffett may have a different style. Who were the *past* Warren Buffetts? And what are the different types of styles you can imagine them having?

Munger: There are a lot of different styles that work for a lot of different people in life. Bill Gates and his crew have a particular style that works for them in their particular milieu. There are *lots* of very successful people who worked out styles that worked for them.

Even within a field like investment there are different people that have been successful with different styles. And I don't think this is a field where there's one style — and only one — that will work. I think the style you choose, to some extent, has to be adapted to your own temperament and abilities. Warren and I have chosen a style that fits our own idiosyncracies. And it's not necessarily the right style for everybody.

FORMULAIC INVESTING WORKS FINE IN THEORY. IN PRACTICE, IT'S ANOTHER THING ALTOGETHER.

Could we make money in small caps? I don't know....

Shareholder: One of your contemporaries at the Sequoia Fund has been very successful in finding companies in the small-cap area — and companies with low P/E ratios. In your talk at USC a couple of years ago, you mentioned that if you were to go out and start all over again, you would look at small-caps as a place to put your money. Could you share some thoughts or insights into that idea?

Munger: Yeah, we don't do that now because we can't possibly employ the kind of capital that we now have. So we don't even *think* about the method. I also mentioned in that talk that if I had to speculate in something in the ordinary commodity field, it would probably be currencies. However, I'm *not* speculating in currencies and I'm *not* doing small caps.

I was simply acknowledging that we don't have the only ways of intelligently making money. I do consider it quite possible that somebody might be quite good at handling small caps.

Shareholder: So you think there's still value there in small caps?

Munger: Well, I'm sure there are places in small caps where there's value. The question is whether there's value that given *your* intelligence and *your* diligence you can reliably root out. Since we're not trying, we're kind of like the man who when asked if he could play the piano said, "I don't know, I never *tried*." I don't *know* how I'd do in small caps.

Don't underestimate the value of holding great businesses.

Shareholder: I'm reading David Dreman's book — *Contrarian Investment Strategies*. And he points out how few people can even find the Nifty-Five to start with and how few people can outperform the S&P. However, by sticking to the cheapest 10% by P/E, price-to-cash-flow or price-to-book, people can beat 90% of money managers. Might you comment on that?

Munger: Well, I used to play a lot with those ideas. I was never totally convinced. And I've become even *less* convinced as the years have gone by.

The importance of being in really great businesses for long stretches, in my view, should not be underestimated. It's a *very* important factor. For example, look at Berkshire. We were better at Dreman's game, probably, than Dreman. And we shifted to this other game.

Formulaic investing works better in theory than practice....

Shareholder: He'd contend that you're the exception — that you guys *can* find those companies whereas the average investor *can't*.

Munger: Well, people have created funds based on this research where they own the cheapest stocks in the Dow and shift every year. And a lot of those things have gone some years now with rather subpar performances. Merely because something's worked over the *last* 20 years, that doesn't mean that it'll work over the *next* 20 years. That is very hard to know.

Shareholder: He shows data going back more than 50 years, I think, in his book.

Munger: Well, I would say that even *50* years.... You can have one world for 50 years and *quite* another world for the *next* 50. So I don't think we're in a world like physics. And I don't think you find things from past experience that are absolutely guaranteed to work in the future because they worked in the past.

I think the basic mindset of Ben Graham will always help the investment process. But mechanical techniques of sifting available stocks with computers — and then having some standard formula — that to me is like trying to turn lead into gold. I basically don't believe it — at least for the *long* pull, I don't believe it.

Physics was a total eye-opener. It's influenced me greatly.

Shareholder: Buffett had Graham and you to influence him. Did you have any special individuals or books that influenced the way you think today?

Munger: One of the things that influenced me greatly was studying physics. Of course, I didn't study physics way into quantum physics and the other hard parts. However, to me, physics was a total eye-opener. If I were running the world, people who are qualified to do physics would not be allowed to elect out of taking it. I think that even people who aren't [expecting to] go *near* physics and engineering [in their planned profession] learn a thinking system in physics that is not learned so well anywhere else. Physics was a total eye-opener.

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From physics — looking for the most fundamental answer.

Munger: The tradition of always looking for the answer in the most fundamental way available — that is a great tradition and it saves a lot of time in this world. And, of course, the problems are *hard* enough that you have to learn to have what some people call *assiduity*. Well, I've always liked that word — because to me it means that you sit down on your ass until you've done it.

LOOK FOR WHAT YOU WANT AND DON'T WANT.
KNOW WHAT YOU'RE LOOKING FOR AND WHY.

Only after I've looked at *Value Line* will I go to the annual.

Shareholder: When you look at an annual report, you mentioned at the Berkshire Hathaway meeting that you want something that's clear — like Coca-Cola's where they come right out and tell you what's going on. If you were to pick up an annual report, how do you look at it? How do you go about analyzing it?

Munger: Well, if it's something that I've never dealt with before — in other words, if something makes me want to learn more about a certain corporation — I don't start with an annual report. I start with the *Value Line* service where they have 15 years of data plus a graph on log paper. I regard it as the best *short*-hand description of a business and its history that you could possibly get.

Only *after* I've looked at it, if it's available, would I go to the annual report. It puts the annual report in context. It's very hard to deal with information if you don't put it in context. And that's the easy way to put it in context.

People will think I'm a paid salesman for *Value Line*. But I do think their graphs and reports are wonderful. Indeed, I would pay for a *Value Line* service that took all of the major corporations way back to 1910. And if I were running a business school, I'd teach it in part from those 80-90 year histories of leading corporations and relate the data to what was actually happening — like the invention of the automobile, the rise in dominance in one corporation and the fall from dominance of another, etc.

So I'm a great believer in all that background.

It would be refreshing to see some candor now and then....

Munger: And after you've gotten the background, then you go to the annual report. Certainly, I'm interested in the actual data — including the footnotes about the accounting treatment and so forth. And I'm also interested in the manager's account of what he's facing and how he's handling it and so on.

I'm frequently disappointed because people develop these reporting practices in fads. And a lot of people hire flaks to help them write their annual reports. Frankly, I get tired of 1,000 corporations [all of whom are] in "a wonderful growth mode" or something to that effect.

Nobody *ever* says, "This is a mediocre business. And I'm having a hell of a time keeping it *average* in its field." That's something you never read. Again, I find [the standard posture] quite tiresome.

But that's human nature. If you were in courtship, you probably wouldn't start by laying out all your defects. So if you're being paid to manage a corporation, I suppose it's [only] natural to puff it a little bit. However, I prefer it when it's told straight.

One way to avoid disappointing analysts — cook the books.

Munger: I also don't like the accounting games that some people play. One of the worst ones is when they can't stand disappointing analysts and face the impact on the price of the stock. So they start forcing orders that would naturally fall in the *next* quarter into *this* quarter. That's very easy to do once with sales incentives and so on. And, of course, some people get so that they're actually committing *fraud*. They're pretending that things are sales that *aren't* really sales in substance.

It's hard to catch sophisticated fraud....

Munger: And I think it's quite hard for accountants to catch it. Maybe our accountant will comment on that. How good are you at catching sales that are artificially accelerated forward a quarter?

Auditor: It depends how stupid they are.

Munger: If they're reasonably sophisticated, it's hard to pick up, isn't it?

Auditor: Anytime you get collusion, it's almost impossible.

Look for what you *want*, but also what you *don't* want.

Munger: There are a lot of subtle ways to mislead a little. They frequently leave telltale signs. So as you read an annual report, you're looking for things that you want — and you're also looking for things that you *don't* want. It's an interesting question of whether you should look more for what you don't want than you look for things that you do want. I'd say the right way to do it is to do *both*.

Study and research with *purpose*....

Munger: And you have to have some idea of *why* you're looking for the information. Don't read annual reports the way Francis Bacon said you do science — which, by the way, is *not* the way that you do science — where you just collect endless [amounts of] data and then only later do you try to make sense of it. You have to start with some ideas about reality. And then you have to look to see whether what you're seeing fits in with that basic thought structure.

Frequently, you'll look at a business having fabulous results. And the question is, "How long can this *continue*?" Well, there's only one way I know of to do that. And that's to think about *why* the results are occurring *now* — and then to figure out the forces that could cause those results to *stop* occurring.

EVERYBODY CAN SEE WRIGLEY'S IS WONDERFUL.
BUT IS IT WONDERFUL *ENOUGH* GIVEN THE *PRICE*?

If you want a great *sled* ride, pick a long *hill*....

Munger: So it's all about having a series of models in your head and running reality against the models. It may

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sound complicated. But if you have years of your life to devote to it, it isn't unduly complicated. A few big models do most of the work — like return on capital.

Shareholder: And is the compounding of interest — the Fermat — also a model?

Munger: Sure. That's the *basic* model. What you want is something that will earn a high return on capital for a very, very long time. Warren gave a talk at Cal Tech and said, "If you want a really great *sled* ride, you pick a long *hill.*" It's the same in investing. You look for whatever models cause the equivalent of long hills.

It's easy to understand why a dominant brand is valuable.

Munger: You can understand it easily in a company like Wrigley's Gum. It's such a *huge* advantage to be by far the best known gum company in the world. Just think of how *hard* it would be to replace that image. And it's not worth it for you to think about buying an alternative gum. If you know you like Wrigley's Gum and you see it there for two bits, are you really gonna reach for Glotz's Gum because it's 20¢ and put something you don't know in your mouth? It is a huge advantage. So it's easy to understand why Wrigley's Gum has such a big advantage.

Sadly, wonderful businesses usually have prices to match.

Munger: The trouble with Wrigley Gum-type investments is that everybody can *see* that they're wonderful businesses. So you look at it and you think, "My God! The thing's at 8 times book value or something." And everything else is at 3-times book value." So you think, "I know it's wonderful, but is it wonderful *enough* to justify *that* big a premium?"

On the other hand, if it weren't a *little* difficult, *everybody* would be rich.

THE IDEA OF BUYING NIFTY COMPANIES IS *OUT*. BUT IF YOU KNOW WHICH ARE *REALLY* NIFTY...

The sine qua non of investing — return on capital.

Shareholder: In one of your lectures, you discussed the matter of owning stocks in very good companies during periods of overvaluation and how it was often best not to try and trade in and out of a company you basically like even though it may get ahead of itself from time to time. And you offered as sort of a way of thinking about it that if you were able to sift the Nifty-Fifty for the five which really *were* nifty, it would have been better to have held those companies for decades irrespective of the market quote.

Munger: Absolutely.

Shareholder: In doing the sifting, in looking at factors like return on capital, durability of business franchise, growth rate — that sort of thing — in the end, which one or two factors dominate the equation?

Munger: When it comes to very long-term holdings, the absolute *sine qua non* — the one factor they must have — is a high return on capital. But since almost anything being considered in the Nifty-Fifty *will* have a high return on capital, that doesn't do much for you. It is not easy....

Over long periods of time, quality overcomes price....

Munger: Recently, someone in *Barron's* did an article where he took the Nifty-Fifty at its peak in 1972 and computed what would have happened if you'd owned them and held them all the way through. And remember — that was regarded as the top. The Nifty-Fifty had gone crazy. Companies making patterns for home sewing were selling at 50-times earnings because they had a history of growth — all *kinds* of odd things.

And there was a huge collapse — a 75-80% collapse — in many stock prices [subsequently in 1974 and 1975]. So it was regarded as great, horrible overvaluation.

Well, this guy calculated that if you'd held the whole Nifty-Fifty all the way through to now that your return would have only been about 1% per annum short of the return which you'd have earned had you avoided those very expensive stocks and instead bought the Standard & Poor's average. And that's picking the most extreme point of overvaluation in the Nifty-Fifty.

Of course, if you look at the best *five* of the Nifty-Fifty taken from that point — taken from the top in '72 — well, they beat the market by a *mile.*

And you can get huge *tax* benefits by sitting on your assets.

Munger: And as I said in that talk, taxable investors not only get a higher *total* return per annum in that fashion, but there are also huge *tax* benefits that result from just sitting there on your tail owning Coca-Cola for 30-40 years while it compounds ever upward.

You aren't paying the capital gains tax until the end. And that enormous deferral of the tax ... can add as much as two points per annum — sometimes a little more — to the returns of a taxable shareholder who's going to cash in gains regularly before he dies.

So there are *huge* advantages for an individual to get into the best five of the Nifty-Fifty and just *sit.*

The craze of buying nifty stocks may not be overdone yet.

Munger: That said, because it's such an obvious idea and such a good idea, it's likely to be overdone. That's the difficulty with market capitalism when it comes to tradeable common stocks — all the really good ideas are exceptionally likely to get overdone.

I'm not saying they're overdone yet. If I had to buy a bunch of stocks I didn't own already directly or indirectly through Berkshire and I had to commit to hold them all in my family until long after I'm dead — say for 30 or so years — without being sold, I'd probably pick a bunch of stocks that would look very expensive to you.

So by *that* standard, I'm saying in effect that I think the best companies are not crazily priced even at the prices you see today.

But I'm talking about the ones that really *are* "nifty"....

Munger: But that's my personal opinion. And, again, that would be if you put a gun to my head and said, "It has to be in common stocks and can't be touched for 30 years. Also, I'm talking about the part of the Nifty-Fifty that really *is* nifty. So I'm assuming that you're capable of figuring that out.

Also, when I use the word "nifty", I mean taking into account not only how good the companies are, but [how

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(cont'd from preceding page)

good they are] in proportion to the prices you have to pay for those great companies.

It's usually best to do nothing but sit on your assets.

Shareholder: You preach the virtues of never selling. Are there some times when the business dynamics change and it effects the business value so much — as it did with World Book — so that when you see that train coming that it makes sense to get out of the way?

Munger: That's a very good question. Yes, there are certainly occasions in investing life where you can see a tragedy coming — in effect, where you can anticipate it and avoid it by selling. You're not talking about a null class.

That said, I still think the average intelligent person is probably better off owning the best five of the Nifty-Fifty than he is running around owning 30 stocks and thinking that he can know better than other people when to buy and when to sell and when to shift. The evidence is that few people are good enough at that to do even as well as they would do buying a group of great companies and simply sitting on their tails.

Wise people think in terms of opportunity costs.

Shareholder: In GEICO's annual report, Lou Simpson talked about comparing his yield to a 10-year bond. But if you were buying something you had to hold for 30 years, would that color how you would look at the various yield yardsticks you might use?

Munger: I was trying to give an example indicating that I might well buy some of these really nifty companies if I were faced with a hard rule that I couldn't sell them for 30 years or more — if I had to buy 'em and put 'em away. Of course, that *isn't* the rule. When you buy a security today you *can* change your mind and sell it.

However, in deciding what price you're willing to pay for a common stock, one thing that you have to consider is the alternatives. Life itself is a series of opportunity costs. And wise people think in terms of personal opportunity costs. That's the right way to make decisions in life.

As I said at one of our Berkshire annual meetings, when it comes time for you to get married, you have to marry the best person who you can conveniently find who's also willing to have *you*. And the person who would have you whom you can't *find* doesn't do you any good. It's a game of opportunity costs.

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And Treasury bonds *are* available and *will* have you....

Munger: Similarly, if your grandmother passes away and leaves you $1 million, in deciding what common stocks to buy — or even whether to buy common stocks — you have to compare it with your alternative opportunities. Of course, an easy opportunity is a 10-year Treasury bond. And, certainly, common stocks could reach a price at which it would be quite rational for you to say, "I'd rather have the Treasury bond."

YOUR STANDARD WIRING MAKES YOU VULNERABLE. THEREFORE, YOU MUST *LEARN* CORRECT THINKING.

Influence should be required reading....

Shareholder: In your speech to USC Business School students a couple of years ago, you mentioned important models that a person should have. Specifically, you talked about the practical parts of psychology and misjudgment and permutations and combinations. Do you have any suggestions for readings for a person along those lines?

Munger: The best popular book that demonstrates six or eight ways in which the quirks of your own mind will frequently prove dysfunctional to your best interests is [Robert B.] Cialdini's *Influence*.

And it's *very* good. It ought to be required reading in every family. Not only should all of you read the book, but if you really want to improve your children, you should get all of them to read it. It'll prevent a lot of misery — because it describes some of the standard manipulations of commercial man and the psychological reasons why these manipulations work so *well*. So it's a marvelous book.

But there should be a far more wide ranging book....

Munger: On the other hand, it's very incomplete. *Influence*, as you may suspect, treats the part of psychology which interests Cialdini. However, there *should* be a book in psychology which goes way beyond Cialdini and correctly handles the full *range* of standard human stupidities and their psychological explanations. Unfortunately, I've never seen any such book.

With so many brilliant psychology professors at so many different universities, you would think that somebody would have *written* a coherent book like that. However, so far as I know, nobody has.

Correct thinking, like a golf swing, doesn't come *naturally*.

Shareholder: Do you have any suggested readings on the subject of permutations and combinations?

Munger: Permutations and combinations, of course, is high school algebra. A fundamental part of psychology is that your cognitive system as given to you by evolution is like the golf swing that evolution gives you — in other words, it's not worth a damn. And just as you have to learn an artificial way of swinging a golf club to play golf correctly, to *think* correctly you have to learn a way of thinking which isn't the natural way of thinking. It's high school algebra. Then you've got to *use* that way of thinking all your life — just as you have to use the correct golf swing....

So if any of you didn't appropriately learn that part of

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high school algebra, I would say go back and learn it. And then, once you do, the other trick is to use it every day of your life — because it's way better than the way of thinking that will just naturally come to you through an evolutionary set of causes.

A human defect: You tend to forget your own mistakes.

Shareholder: Believing that you can learn more from mistakes than from successes, I remember reading a couple of years back — I think it was in [Roger] Lowenstein's book where there was some kind of conference with you and Buffett and some other people about "The five most stupid or foolish things I've done in my life."

Would you elaborate a little bit on some of the things you wish you'd done differently and what we could learn from that conceptually?

Munger: I was the one who made the suggestion that we have that program.... And it wasn't the five — it was one of the dumbest things you'd ever done in your life. So everybody in the group had to get up with one. By the way, everybody was up to having had one really dumb idea, too — a dumb *mistake*. This is a very distinguished group with each member having achieved huge success in life. But everybody could come up with one lollapalooza.

It's rather interesting. I've forgotten what mine was.... And I'm not saying that to be a wise ass. I really *have*. Yet, I can remember all the dumb things these *other* people did. And that's a very interesting psychological defect that people tend to have: You tend to forget your own mistakes when reputation is threatened by remembering.

Regular post-mortems — a la J&J — are a *marvelous* idea.

Munger: For that very reason, one very wise company — Johnson & Johnson — has a system whereby two years or so after they've made some big acquisition they have a post-mortem. And they bring back the original projections and the original reasons for making the deal. They identify the people who made the arguments and what have you. Then they compare them with how the deal worked out.

That's a *marvelous* way to do things. However, so far as I know, Johnson & Johnson — and Royal Dutch a little — are the only companies I know of in the world that do it. I greatly admire Johnson & Johnson for doing it. I think that's a very smart way of doing things.

The ordinary tendency is to forget the dumb mistake the way I've forgotten mine.

BUYING BACK OUR SHARES WOULD'VE HELPED A BIT, BUT THE THINGS WE *DIDN'T* DO COST US A *FORTUNE*.

It worked. But *one* USAir experience was *quite* enough.

Shareholder: Speaking of mistakes, last year, I asked you about USAir. And you said that you'd been humbled by it. Now it's worked out so well. Do you still own it? And what do you think of its economics today?

Munger: We don't comment about the exact rates at which we buy and sell things. We disclose purchases and sales of securities only to the extent that we have to under the law.

It *was* a humbling experience. To sit there and watch that net worth melt away — $150 million, $200 million — to watch a lot of lovely money that used to be yours and see it melt away.... And all those unions that could only think about reality from their own point of view. And the idiot competition — including bankrupt competitors who stiff-armed their creditors while they lost their money ruining our business. It was a *very* unpleasant experience.

All that said, it's a very leveraged business. So when the industry turned, it turned beautifully — for USAir included. As you say, it worked out fine for Berkshire. But we're not looking for another experience just like it.

It's easier to admit a mistake than explain the difference.

Shareholder: At the annual meeting, Warren said that if he could fault Berkshire's management for one thing in the past, it would be for not having bought shares back. Have you done a post mortem on why management didn't realize there may have been value created by doing that?

Munger: Well, generally, we are so much in favor of successful corporations buying in their own shares at *all* the prices that have existed in the past that it's very awkward for us to say, "Berkshire doesn't do it because we're different." It's much easier for us to say, "Well, we made a mistake in the past."

We probably could have done a little better on buybacks.

Munger: And at the time when we weren't buying in our own shares, we were usually buying something *else* that went up like crazy. So measured against our opportunity cost, the fault that Warren is taking on himself for not buying in Berkshire shares at certain times may not be quite as big as you might think. Again, we have a pretty good record of finding something else to buy that works pretty well.

All that said, my guess is that we could have done a little better on that with 20/20 hindsight.

But things we decided *not* to do cost Berkshire a *fortune*.

Munger: We've made a lot of mistakes. Actually, the *big* mistakes in Berkshire that have cost the shareholders a lot of money — compared to what otherwise would be — are mistakes of *omission*. The things that we almost did but didn't have cost shareholders a *fortune*.

We haven't had huge mistakes where we did something and, as a result, lost a lot of money. We have a wonderful record of not having a lot of significant losses. But if you could count the mistakes that don't show up in any audit report — the things we almost did, but foolishly decided not to do — we've left so much money on the table that I'm almost ashamed to mention it.

WHATEVER THE EXCHANGE RATIO FOR DURACELL GILLETTE'S CORE BUSINESS IS MORE WONDERFUL.

Beware issuing shares in really wonderful businesses....

Shareholder: Do you think that the acquisition of Duracell has reduced the inevitableness of Gillette?

Munger: That is a very interesting question — and a good one. I don't think I'd want to.... Warren was there.

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He was willing to do the transaction. Therefore, I guess you could say he thought it was OK at the time.

But I don't have any real opinion either way. I think the odds of whether you'd be likely to look back in 20 years and conclude that Gillette was better off for having done it may well be 50/50. I don't think it's any sure thing today that Gillette was better off for having done it. And I don't think it's a sure thing that it was a bad idea either.

If a really wonderful business issues shares, I'm skeptical.

Munger: The dominance that Gillette now has in the razor blade and shaving business is a more *valuable* type of dominance than the *near*-dominance or rough equality — whatever you'd call it — that it has in the battery business as one of two great companies. To some extent, of course, that was taken into account in the exchange ratio during the deal that merged Duracell into Gillette.

Nevertheless, I tend to be quite skeptical about issuing shares in *really* wonderful businesses in order to acquire shares in a somewhat *less* wonderful businesses — even when the exchange ratio makes it appear as though you're getting a pretty good deal.

RAILROAD INDUSTRY LEAVES MUCH TO BE DESIRED, BUT I THINK SOME COULD WORK FAIRLY WELL.

Railroad field isn't one I've thought a lot about.

Shareholder: In the past, you've talked about the idea of owning a toll bridge — the one game in town. With the consolidation of the American railroad industry, do you think they're getting toward toll bridge status?

Munger: Well you know, in my whole life, I've never owned a railroad stock. I grew up around railroads in the Midwest. But, my God, the union rules were unbelievable. And the management sometimes made the civil service look good.

So it's not a field I've spent much time thinking about. Again, personally, I've never bought one in my whole life. I'm not saying I never *will*. I'm just saying I never *have*.

But they do have advantages. And some could work out.

Munger: All that said, it's entirely possible, I think, that certain railroads could turn out to be quite respectable investments. Fundamentally, with reasonable union rules and with the track already laid down and for certain kinds of freight, that system has an advantage which will remain. So I can conceive of some railroad investments working out fairly well.

I don't think they'll work out fairly well compared to the next Coca-Cola. However, yes — I think some *could* work.

OIL AND GAS PRICE PREDICTION ARE HAZARDOUS — ESPECIALLY WHEN THEY INVOLVE THE FUTURE.

I would have guessed that oil prices would be much higher.

Shareholder: I read that Richard Rainwater thinks the oil industry is reaching some sort of capacity problem that might allow his oil investments to do very well over the next 10 or 15 years. And you spoke about Treasuries. Berkshire's been doing some silver and a bit of oil stuff recently. Do you guys see some kind of long-term trend — impending capacity constraints — in those businesses?

Munger: Well, practically everybody I know who is very intelligent and has worked in the oil business and has tried to make predictions about the future value of oil, etc. has made the predictions *wrong*. If you'd asked me to guess that North Slope Oil would be selling at $12 a barrel or whatever it is today in Alaska, I would have guessed it would have been a lot higher by now. And people like Rainwater are probably betting that long term, all that will change.

In oil and gas, you have to be right on the timing, too....

Munger: Long term, I think they're right. However, the question is *how* long a term? I don't think that oil can stay at $12 a barrel forever. I think eventually it has to go much higher.

But that doesn't mean you've got a wonderful way of making money. If oil's gonna go from $12 to $15 over the next 50 years, Rainwater doesn't have a good investment. On the other hand, if the price goes up a lot [in relatively short order], then his strategy will work beautifully.

But I don't have a real opinion on the price of oil. All I can tell you for sure is that if I'd made guesses in the past, I think I would have been *wrong*....

MUTUAL FUND BUSINESS JUST GROWS AND GROWS, BUT I'M NOT CHARMED WITH ITS MECHANICS....

Most passive investors would be better off in index funds.

Shareholder: In the annual report, Warren Buffett said that index funds would be a good idea for investors. What do you think about that concept?

Munger: I think that the vast majority of professionally managed money, after taking into account the impact of fees [and transaction costs] *would* be better off in index funds. I think that's the hard reality.

Does that mean that *you* should be in an index fund? Well, that depends on whether or not you can invest money way better than average or you can find someone who almost surely will invest money way better than average. And those are the questions that make life interesting.

But index investing could get dysfunctional....

Shareholder: If the conventional wisdom is that the average person should put his money into index funds and everybody goes out and puts half of their investable money into index funds and those funds have to invest in the same securities, doesn't this drive the same securities up and render the index meaningless?

Munger: If *everybody* did it, it would not work. Right. It would become a totally dysfunctional system. However, if *8%* of the people do it, or something like that, it's not dysfunctional. At a point, you're absolutely right. It would get to be a dysfunctional system.

By the way, that or something like that *could* happen if the federal government were to mandate that 30% of Social Security has to go into equities — American equities.

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The funds would get so large.... And under a Social Security system — you can *count* on the fact that one way or another it would be roughly indexed. So we could very well *get* the world that you're fearing.

And I can't tell you at exactly what point the system would get quite dysfunctional. I don't think it's at 8%. But, at 60%, I think it would clearly be *very* dysfunctional. You raise a very interesting question....

Mutual fund business is amazing, but not charming.

Shareholder: Do you have any ... thoughts [on the mutual fund business]?

Munger: Well, mutual funds have been one of the great growth businesses in America. And these so-called "independent" directors just vote for anything that the management company asks for in every case. So the actual human behavior doesn't fit the law the way that you're taught it in law school — about duties of directors. So I find it very interesting that we have one set of rules in the legal system and another in the reality as it's existing.

It is, to me, just *amazing* what's happened in the mutual fund business. It just grows and grows and grows. And they get these fees just for maintaining shares in place — 12B-1 fees or whatever they call 'em. I am not charmed with the mechanics of that business.

Runs on mutual funds will make for interesting days....

Shareholder: Every once in a while, I hear concerns about a run on mutual funds like the run on banks in the 1930s and the calamity that [might ensue]....

Munger: Well, we've *had* little runs on mutual funds in the past. And, no doubt, we'll have them in the future. But I don't think that the whole system collapses because we get some runs on mutual funds. I just think it makes for some very interesting days or months.

THE EASY ANSWER USED TO BE TO *BUY*. TODAY, IT'S BECOME A *HARD* DECISION.

Juiced returns from stock buybacks can only help so much.

Shareholder: Conventional wisdom right now seems to be that we're in a new era of higher returns on capital. And, yet, I believe that you suggested three years ago that when you take out the accounting gimmicks, the returns may actually be lower. Which is it?

Munger: They're not ... [lower]. Returns on capital are going up. And in part they're going up because people have bought back so much stock. And ... they haven't changed the world totally in terms of returns on capital when they do it that way. In other words, some of the reported increases in returns have been caused by these heavy stock buybacks. And that game's potential is finite. So take that into account.

We haven't created a world where people can accumulate unlimited corporate capital and always earn 20% on all of that capital as they keep accumulating it.

Phony earnings or not, returns have gone *way* up.

Shareholder: You talked about stock options, too....

Munger: Oh, yes. And I also said that the earnings are a little phony because of the accounting treatment currently accorded stock options. That said, return on equity has still gone *way* up. In fact, it's gone way higher than I would have predicted.

Shareholder: When you say return on capital, do you mean return on total capital or shareholder's equity?

Munger: Shareholder's equity.

Some unprecedented things *are* overwhelmingly likely.

Shareholder: You said you don't think Berkshire's overvalued compared to other stocks or words to that effect.

Munger: I think I said it wasn't "crazy".

Shareholder: Do you consider [the valuations of] other stocks — the ones that typically Berkshire, Wesco or another insurance company would be invested in — as having valuations that are crazy?

And, second, it's true that the things that GE is doing are unprecedented. However, in the case of Coca-Cola, Doug Ivestor has said, "We want to double our share of the fluids that are being drunk in the world from what it is today." All of the things companies are attempting to do today are unprecedented. At the same time, don't some of them seem *inevitable*?

Munger: Well, I would personally bet that Coca-Cola *will* increase its flavoring of the world's water ingestion from the 2% or so they have now to the 4% its CEO says he's aiming for. I regard that as *overwhelmingly* likely — and overwhelmingly likely not *50* years from now, but before he retires. I don't think that's a crazy objective for the Coca-Cola Company.... In fact, I would consider that overwhelmingly *likely* to happen.

Others *aren't* so clear....

Munger: Now can G.E. take its finance operation from $200 billion in assets to $600 billion in assets soundly and at a growth rate of 15% per annum? Well, the answer is "maybe". They certainly have a wonderful record so far.

At any rate, that's the kind of questions you face. And at the current level of stock prices in the general market, *most* of the questions you face aren't all that easy.

It used to be *easy*. Now it's become a *hard* decision.

Munger: The question is whether you should buy. For example, if your grandmother were to die and you were to get another $1 million tomorrow, should you run out and buy all the securities that you like at current prices? That's a very interesting question. At times in the past, I'd say the prudent answer — the *easy* answer — was to buy. Now it's become a *hard* decision. As Warren's observed, the margin of safety has been reduced.

Now that may merely mean that securities are sort of fairly priced now. Of course, for people like you in a room like this, the very *last* thing you'd like to pay is fair prices. What you want is *advantageous* prices. And you'd rather be able to figure them out easily than to work hard at it. By the way, so would I.

However, I'm afraid that that's not the world we live in at the moment. It's gonna be harder.

—OID

SOUTHEASTERN ASSET MGMT'S
MASON HAWKINS ET AL.
(cont'd from page 1)

outperformance. Because its returns are net of fees and reduced by the drag of its cash and cash equivalents, Southeastern's stock selections have actually done better.

While we don't have access to those figures, we were able to obtain year-by-year, aggregate equity-only returns of the firm's non-taxable accounts dating back to 1980. (We understand that those figures include the returns of all non-taxable accounts at the firm exceeding $2 million and that they're audited.) Using those figures, we estimate that their equities generated a compound annual return of 21.4% and 20.3% over the last 10 and 18 calendar years (ending December 31, 1997) respectively versus 18.0% and 16.7% for the S&P 500 over the same periods.

Therefore, when Hawkins and some of his associates sounded downright excited about some of the opportunities that they were finding and buying recently, we wanted to learn more and thought you might, too. The excerpts which follow were selected from the remarks and answers to clients' questions by Mason and some of his key associates during their two latest client conference calls (one October 6th and the other November 5th) as well as an October 8th client luncheon in New York. We hope that you'll find some of their ideas and insights as intriguing as we do.

SHORT-TERM RETURNS HAVE BEEN NAUSEATING, BUT WE FEEL FABULOUS ABOUT THE LONG TERM.

Despite our recent returns, the future looks *marvelous*....

Lee Harper: Despite nauseating short-term returns, we've made significant long-term progress in the third quarter. So we don't feel good about the short term, but we feel *fabulous* about the long term.

For example, Longleaf Small Cap Fund is still one of the best performing small-cap funds — both long term and short term. Even though real estate has gotten clobbered, Longleaf Partners Realty Fund remains one of the best performing funds over the long term in that category. And Longleaf Partners Fund continues to be rated very highly.

We've been waiting and hoping for times like these....

Harper: Why do I say we've made long-term progress? First, we've put all of our cash to work in all of our funds over the last few months. And in each of our funds, we have the lowest price-to-value ratios in their history. So ... we think there are great times ahead — because we have both larger margins of safety and higher implied returns in our funds than we've had at any time since 1990. In fact, we've been waiting for a time like this to make that happen.

And because of the compelling opportunities we're finding — we see lots of 40-50¢ dollars — we've reopened Longleaf Partners Fund to new investors. There are many other businesses we could be buying, and others we could be adding to that we own already, at very low prices. So opening up the Fund will enable us to take advantage of them and further lower its price-to-value ratio.

And we're even more excited about international bargains.

Harper: We're introducing another fund — Longleaf Partners International Fund — which we seeded with $27 million of our own capital in early August.... And it opened to the public on the 26th of October — as soon as it got through the registration process with the SEC. Today, it has $35 million in assets [and $60 million as of 11/30/98].

We're finding *great* bargains outside the U.S. We're *really* excited about the opportunity there.... But rather than say anything more about it at this point, let me turn the floor over to ... Mason [Hawkins].

It's really all about three things....

Mason Hawkins: We do things fairly simply. As we've said before, it's really all about three things: businesses, people and price. First, we look for businesses that we can understand with reasonably good economics — or, at least, the prospects of earning reasonable returns on capital. Second, we look for the opportunity to be partners with people we think are not only honorable and trustworthy, but who are able to run a business, create free cash flow and allocate capital intelligently.

And the third ingredient is price, which has been the problem — the missing ingredient — for longer than we'd like to think. We wait for the opportunity to invest our capital at half or less of our estimate of appraised value.

Price gives us most of our return and our margin of safety.

Hawkins: Although we spend most of our time assessing people and evaluating companies, price is *terribly* important. I think an example will help explain why:

If you buy a business at half of its value, that value grows 12% per year and its stock price rises to its value in the fifth year, your compound return is 29%± per annum. That's the way compounding works.

Of course, if you buy the same business at fair value, then your compound return declines to 12% per year. And if you buy it at a premium, you may earn no return at all.

So we've been very hesitant historically to pay up for two reasons: First, the narrowing of the discount is usually the biggest component of your return — almost no matter how great the business. Second, the discount provides you with the requisite margin of safety to protect your capital that you need if you're an owner/operator like we are.

What we do is simple. The difficulty's in the execution.

Hawkins: Thus, we won't invest in a business unless it's worth roughly twice what we're paying for it, unless we're comfortable with who's running it and unless we feel like it has reasonably good economics, is competitively entrenched and, hopefully, can be the hunter and not the hunted.

Obviously, those things are pretty commonsensical. No computer is required. The difficulty's in the execution.

What we're calling 50¢ dollars may be cheaper still....

Hawkins: So we're not macro people, forecasters, clairvoyants or what have you. However, we do find one macro event very interesting. And I won't belabor it. But it's the first time most of us have experienced the decoupling of equity returns from bond returns. We've had a major divergence there.

That's *incredibly* interesting to us. And the reason why is that we have to make assumptions about discount

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rates in our appraisals — which usually swing off interest rates and inflation. And interest rates have gone to levels I would guess that no one in this room expected even as recently as one year ago, much less several years ago.

We haven't lowered the discount rates, by the way, that we use in our appraisals. Therefore, if we're buying businesses at 50% of our appraised value, you could say that those appraisals might be much higher and, therefore, our price-to-value ratios are much more appealing because we should be marking our discount rates down to reflect what the long Treasuries have done.

So with the long Treasury down around 5%, that's a whole lot different than the ... 10%± discount rate that we're using.... We could, therefore, be criticized for being too conservative in some of our appraisals.

However, that's our nature. We want to be sure that we're roughly right. And building in an extra point or two of cushion on our discount rates might cause us to miss an opportunity or two. On the other hand, it clearly builds in a greater margin of safety....

BARGAINS WERE AS SCARCE AS THEY'VE EVER BEEN. TODAY, RETURNS ARE MORE PROMISING THAN EVER.

Without knowledge, you *can't* stand apart from the crowd.

Hawkins: In Dr. Graham's parable about "Mr. Market" in the *Intelligent Investor*, he says simply that the market doesn't force you to play — that whether or not you play is your option. Yet 90% of people get forced by the market to do things that don't make good sense. And why is that? The reason that happens is that most people don't know what the businesses they own are worth.

That observation is particularly appropriate right now, I think, because lots of people today (I see it in their eyes) — lots of lenders, currency traders, hedge fund operators, former hedge fund operators or other equity investors — neither understand what they own or what it's worth.

And in our view, those investors are rudderless — because if you don't understand what you own and know what it's worth, you can't stand apart from the crowd and buy at discounted prices with lots of conviction and confidence knowing that one day you'll be rewarded amply.

That's why everything at Southeastern begins with establishing what the business is worth. We spend virtually all our energies trying to nail that down and trying to nail down what kind of people we're partnering with....

Bargains were as scarce as we've ever seen — 'til recently.

Hawkins: We closed Longleaf Partners Fund in September of 1995. And we closed it because money was coming in faster than we could find companies to put it in.

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In fact, we've had great difficulty — probably as much as we've ever had — finding qualifiers over the last *four* years.

For example, we saw over 200 large-cap companies during 1997 alone and bought a mere *three*: News Corp, U.S. West Media Group (today known as MediaOne) and Waste Management. And we almost doubled our money in each of them from their lows to the highs — [although] they've given up some of their gains recently. Normally, if we visit 200 CEOs and speak with them about their businesses, their capital allocation plans, etc., we come up with more than three qualifiers. That was an extreme case — the *most* extreme, in fact — that we've experienced in over 25 years of looking for good businesses at a discount. And needless to say, we found it quite frustrating.

When the opportunities finally came, we had dry powder....

Hawkins: But the third quarter has changed a lot of that and given us an opportunity — again for the first time in three or four years — to buy businesses on our terms. So, clearly, it's been a very welcome opportunity....

Fortunately, as of June 30th, we had significant cash reserves in Longleaf Partners Fund and Longleaf Partners Small-Cap Fund — 28%± cash in the Small-Cap Fund and 16%± in the Partners Fund.

Recently, we sold a number of businesses that had risen to their full value. Kansas City Southern, Quaker Oats and Ralston Purina had added materially to our results. And we sold a big piece of our MediaOne (the former U.S. West Media Group) which had more than doubled. We believe that we departed each at close to 100¢ on the $1.

And ... we've received some significant cash flows from what we consider to be the best partners in the mutual fund world. Therefore, between those three sources — between our cash reserves at June 30th, the sale of our fully valued businesses and significant cash inflows during the quarter — we had substantial resources available.

So we've been able to upgrade our portfolio dramatically.

Hawkins: Over the past 90 or so days, we've had quite a bit of opportunity to put those resources to work ... in equities at 40-50¢ on the $1.... With few exceptions, we believe that we've established stakes that leave us well positioned for the next four or five years.

The resulting impact on our portfolio and its prospects in our view has been dramatic. Here's why we say that: Twelve months ago, the composite price-to-value ratio of our equity portfolio in our large-cap world — in Longleaf Partners Fund — was 80%. [In other words, they sold at 80% of our appraisal of their value.]

At that time, about 20-25% of our portfolio consisted of cash.... So if you add that cash back into the portfolio at 100¢ on the $1, you see that the portfolio was selling at about 85% of what it was worth.

In contrast, our composite price-to-value ratio today in Longleaf Partners Fund is right at *50%* — which is the lowest price-to-value ratio ... it's *ever* had.

[Editor's note: As we go to press, we understand that the figure is slightly over 63%.]

We upgraded qualitatively and margin of safety-wise, too.

Hawkins: Why is that so important? Well, last year, with our price-to-value ratio at 85%, had our equities risen to match our appraisals, you would have earned less than

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20% on your capital. But today, with our price-to-value ratio down near 50%, if our equities rise to fair value, you will make roughly *100%.*

Thus, we would submit that as owner/operators today, we have a five-fold improvement in our profitability potential vis-a-vis last year at this time — 100% versus less than 20%.

Also, that's before those companies grow their value. And not only have we been able to purchase our stakes at what we believe are significant discounts to their underlying value, we're also quite excited about the opportunity to become partners with the managements of these companies.

Therefore, you can see ... why we're more sanguine about our prospects for the next 5-10 years. We are *far* more optimistic than we've been at any time since 1990. In effect, we've taken advantage of opportunities created in the recent market turmoil to capture higher prospective returns and a greater margin of safety.

Given our potential upside, the downside seems minimal.

Hawkins: Even though the businesses we bought qualified under our investment disciplines, the prices of a number of them have gone further south. Thus, in effect, we're paying a short-term penalty in order to be invested in those companies over the long run....

And don't get me wrong — the market could always take our stocks down another 10% or 15%. I don't want to minimize that possibility. But Southeastern associates are the largest group of shareholders in the Longleaf Funds. And we'd like to make it clear that ... any such declines wouldn't bother us in the *least.*

When we weigh the risk of a further 10-15% decline against the opportunity we're hoping to capture over the next four or five years, the perspective becomes clear. We're convinced and *very* confident that many of the companies in which we've bought stakes will be up four or five fold over the next four or five years....

THE TWO-TIERED STOCK MARKET 1990s STYLE....
THE "COMFORT" STOCKS MAKE US *UN*-COMFORTABLE.

A huge divergence between Nifty 30-40 and everything else.

Hawkins: Something else we find very interesting — the market seems to have divided itself into two groups. One group consists of companies that are perceived not to have any economic or cyclical exposure. [T]he ethical drug companies lead that pack [followed by] the utilities — be it the telephones, RBOCs [regional Bell operating companies], electric utilities or what have you — and, perhaps, a selected group of food companies.

Those companies (in effect the top 30-40 companies in the S&P 500) make up one group. And that's the group that's been driving the performance of the S&P 500. Then, the second group basically consists of everything else.

And it's amazing just how much of the world that is. The Value Line Index, for example, because it consists of 1,700 of the largest companies in the country that are equally weighted, provides a much better proxy of what's really going on out there. And there's been an absolutely huge divergence between the performance of the two groups. So when you leave the top 30-40 companies in the S&P 500, you get a very different picture.

"Comfortable" stocks are expensive for good reasons....

Hawkins: However, in the case of what amounts to aberrant, very highly valued, "comfortable" stocks — like the ethical drug companies — you're paying a high price for your comfort.... For example, Pfizer, Warner-Lambert, and Lilly have been trading at between 45 and 60 times their trailing earnings.

And it's not hard to understand why. Everybody knows that there are 6 billion people on earth who'll need to buy more drugs.

But they've been priced right before and will be again.

Hawkins: But there's a price you *don't* pay. We'd like to own a group of those companies, too — given their 30%+ ROEs [returns on equity] and their free cash flow streams. We understand that health care needs to be improved around the world. But there's a matter of *price.*

In fact, we bought Lilly back when Hillary [Rodham Clinton] proposed her famous healthcare plan.... At that time, their price was right. And we submit that it'll be right again to do something like that.

DISCOUNTS OF 55-60% + GREAT MANAGEMENTS
+ SHARE BUYBACKS = FOUR OR FIVE BAGGERS.

Our stocks aren't "comfort" stocks, but they comfort us.

Hawkins: Most of the opportunities we've found are in the stocks of companies with a modicum, at least, of economic exposure (which we'd be the first to admit) — companies such as FDX [FedEx/FDX/NYSE], Pioneer Natural Resources [PXD/NYSE], Marriott International [MAR/NYSE] and Canadian Pacific [CP/NYSE].... In effect, a number of businesses we've wanted to own for a long time that we never thought we'd have a shot to buy as a result of price considerations are now possible for us to own at less than half of their intrinsic value. Plus, we've gotten an opportunity to partner with some of the best people around.

Federal Express has declined from up around $82 to about $45. We think it's worth *$105....*

Wall Street's gone from loving oil to hating it....

Hawkins: And Pioneer Natural Resources is down from $34 to $15. Our appraisal is $38.... Pioneer is an oil and gas firm we've studied for a long time. It evolved from the combination of Parker & Parsley and Mesa.

Our partner in charge of allocating our capital and reinvesting our operating cash flows is Scott Sheffield. As you may know, at Parker & Parsley, he compounded the shareholders' money at a mid-to-high 20s rate for the last five years. And we're nothing less than ecstatic about the opportunity to partner with Scott and his group and one of his largest shareholders, Richard Rainwater — who we think arguably are the best operators in the industry.

By the way, our appraisal doesn't fully take into account their exploration acreage — especially the 13.8 million acres off the coast of South Africa where they've had a number of discoveries already. And we think their future exploration potential is very significant — it could be the next North Slope. And we're not paying for that.

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And why are we getting that opportunity? It's simple. A year ago, you couldn't pack *enough* oil in portfolios on Wall Street. Today, *nobody* wants 'em.

Common threads: 60% off, a great manager and buybacks.

Hawkins: These companies are all trading down around 40-something percent of our appraised value. They're all managed by great people — like Marriott International's Bill Marriott, FDX's Fred Smith, Pioneer's Scott Sheffield and Dave O'Brien at Canadian Pacific. They're all either aggressively buying back shares — reducing our denominator and increasing our ownership of their assets, revenues and profits — or they're getting ready to [buy back shares] as soon as they're allowed to do so because they have to wait for a pooling-of-interest period to run or what have you.

A business with more than a little in common with Coke....

Hawkins: We made 5 or 6 times our money on Marriott after we bought it at its lows in 1990. It's down from $38 to $20. And we value it today at $44. So it's a wonderful price-to-value relationship.

However, it's much more than that. In our view, it may be the best business in America — maybe the world. They have a gross profit royalty on an asset and on a revenue stream in which they don't have to *invest*. Somebody else puts up the hotel. Somebody else risks their working capital. Somebody else pays the capex [the required capital expenditures].... Between the franchise and the management fees, the money just rolls in.

And he seems to be reading Coke's playbook....

Hawkins: Furthermore, Bill Marriott learned a lesson — I guess he took a page out of Coca-Cola's book — because he separated out his hotels from his management company, similar to what Coke did with CCE [Coca-Cola Enterprises] [when they] separated the bottlers from the syrup company [and spun off a 50%± interest in it to the public].

So even today, as Marriott's stock gets beaten up and handed to us, it's a better company than it was in 1990 when it was at 1/6th, 1/7th or 1/8th of the price it rose to.

Marriott could be a triple even *before* factoring in growth.

Hawkins: Today, Marriott International is trading at less than 10 times the free cash flow they'll report next year. Its stock is now selling down near 40¢ on the $1. And, clearly, management [seems to] agree with our appraisal. Management bought over 6 million shares during the last quarter at prices in the high $20s. The company has approximately $2 billion worth of buying power [with which to purchase its stock] because of the free cash flow stream coming into Marriott. And while it's only our best guess, we'd guess management is buying even more aggressively at these lower price levels. At Marriott's current price, Bill could buy in 100 million of the 270 million shares that he has outstanding — in effect, take 'em down by 40%.

If he does that, our appraisal goes from $44 to the mid-$50s. Therefore, we're looking at tripling our money even before any growth in the value.

Over the next five years, these will be four or five baggers.

Hawkins: We firmly believe that these examples — FDX, Pioneer, Marriott and Canadian Pacific — are trading at 40-45% of appraised value. In the next five years, between retained earnings and share shrinkage, we believe their values will double. And we *surely* believe the market will price them efficiently at some point — just as it has in every other cycle.

So if they go from selling at 40-50¢ on the $1 to selling at 100¢ on the $1 and the underlying value grows from $1 to $2, then your stock quadruples or quintuples. From where we sit, the economics look pretty simple and straightforward.

So consider us perverse, if you wish. However, we're excited about what's been going on. [As Dr. Graham says,] Mr. Market is there for your benefit and not to penalize you if you're reasonably intelligent. You sell to him when he's irrational on the upside. And, hopefully, you buy from him when he's hung over and offering things to you at 40¢ [on the $1 as we believe he's doing today].

WHAT HAPPENED IN ASIA IS EASY TO UNDERSTAND. BUT THE RESULTING BARGAINS ARE HARD TO BELIEVE.

Too much of a good thing isn't always so wonderful....

Hawkins: That's not to say the market won't go down. We believe *every* bank in Japan has to have new owners, just as every bank in Texas did before.

And I'd like to comment on why all of that happened over there. It's quite basic, although the media makes it pretty complex. It happened for two reasons: First, there was too much borrowing. And, second, assets were financed incorrectly. Only 1-1/2 or 2 years ago, it looked like lending to Asia given all of its growth was something everybody needed to do. And if a little bit of it was good, then a lot of it was *great*. Therefore, they overdid it and loaned too much.

And all those bridges, highways, power plants and manufacturing plants were financed with short-term loans. So as long as the cash flow projections were headed north and the asset values appeared to be appreciating, lots of people were willing to lend 90-day money, 30-day money or on-call money. But when the psychology changed, the electrons flowed the other way and the money came *out*. And it's not more complicated than that.

Here in the U.S., we did it with barges, farmland, drilling rigs and stocks in 1929. It was the same thing: lots of borrowing and the financing of long-lived assets with short-term obligations — which doesn't make sense.

With mostly short-term funds, everyone can't leave at once.

Hawkins: The borrowers and lenders should have been less aggressive. And they should have financed a goodly portion with equity and the rest with long-term debentures or bonds. That way, when there is a little wiggle in the cash flow line, you don't have to pay it back right away. Again, it's not more complicated than that. That's what happened. And because it was overdone — and because of the mismatch between the nature of the assets and the term of the loans — currency speculators, lenders and hedge funds all wanted out at the same time.

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And there was just no way that was going to happen.

So there's a lot of culpability, I guess, for the problem. But any time you see lots of lending — especially when the lending isn't structured properly — it's generally not going to be long before you get an unpleasant surprise.

Overseas bargains are at once-in-a-lifetime price levels....

Hawkins: While we're on that subject, let me briefly talk about ... Longleaf International. We've been around in one form or another for almost 28 years. And throughout, we've always sought the same things: the biggest margin of safety, the best partners and underlying companies with virtually unassailable competitive positions and the potential to earn attractive returns on capital. Well, that's exactly what we'll be trying to do in Longleaf International.

However, just as Longleaf Realty enabled us to concentrate in qualifying real estate investments at a time when we were finding unusually attractive opportunities in that area, Longleaf International will allow us to concentrate in qualifying investments overseas....

We think the opportunity to invest offshore today is the best we've seen in our lifetime. We think it may be equal to the opportunities that the Rockefellers, the Carnegies, etc. had following the 1929 Crash during the Great Depression in the U.S.

The greater the chaos, the greater the bargains.

Hawkins: Asia's virtually become a four-letter word. It's the worst thing that you can say about a stock. Many of its foreign exchange markets, its capital markets and its economic underpinnings have deteriorated dramatically. The result has been chaos — both in those markets and in many of the funds which invest in those markets — to the point that some of those funds have even *closed*.

But from an investor's perspective, that's not bad. Quite the contrary — because the greater the dislocation that those markets suffer, the greater the likelihood that they misprice some very good businesses and make them available to us at huge discounts to their underlying value.

The result's been bargains better than '90, '87 or even '74.

Hawkins: And mispricing's exactly what we're seeing. It's the most capital-short environment we've ever seen. Mr. Market's *begging* investors to come help 'em out. And we've got capital that we *want* to provide. Only we want to provide it on our terms....

We're finding things that qualify. We're even finding companies at 50% of net *cash* — where we get the rest of the working capital and all of the fixed assets, the ongoing business and the management for *free*!

We didn't see that magnitude of opportunity in 1990. We didn't see it in November of '87. And we didn't see it in '74 except for isolated cases.... But we've visited with 45 or 50 companies throughout Asia and interviewed their managements. And some of 'em appeal to us.... Fortunately, as most of you know from being partners with us in other endeavors, we don't believe that we need to own very many companies in order to be very successful....

So we're very optimistic that we'll be able to put [our capital] to work in the financial markets of more than a few countries where there's been significant dislocation — economically, market-wise and currency-wise.... And we view it as a terrific opportunity to compound our estates, our foundation and our retirement plan.

If we execute, our returns should be the equal of any....

Hawkins: We believe it offers more opportunity than Longleaf Partners Realty Fund did when we opened it. And C.T. [Fitzpatrick] helped crank out returns of 41% and 31% during its first two years. So if we execute correctly, then Longleaf International's returns over the next five years could be exceptional.

That's not to say that we will execute correctly. However, the right cards are being dealt. So if we do execute correctly (which we're totally committed to doing) we're convinced that we should be very successful. And obviously, we're quite excited about it.

GEOGRAPHICALLY SPEAKING, OUR UNIVERSE IS HUGE.
BUT COMPANY-WISE, IT'S SMALLER THAN YOU THINK.

We look for the same thing within the U.S. and without.

Shareholder: [Would you] discuss the International [Fund] management team?

Hawkins: It's the same team that manages our other funds. Hopefully, we have some people with some talent. Everyone has the ability to look for anything that looks like it's [selling at] half of value with good people [in charge]. That may not be the most *efficient* [way to do it], but it's certainly the most entrepreneurial.

For example, when Kansas City Southern got cheap last time, three associates pursued it almost at the same time. And there was a battle over who should get credit for it.

And we use the same approach.

Hawkins: The same thing is true around the world. As soon as Cor Boonstra said that he was leaving Sara Lee and joining Philips [PHG/NYSE], two of our associates — *more* than two, actually — said, "We want to own it."

Staley Cates and John Buford hopped on a plane and flew over to Amsterdam the next week. They spent two days over there. And we were buying Philips at $32 or $33 when it had $34 of net *cash*. So we got Cor, downsizing and everything else for free.

We're each looking for opportunities. And if we find a small cap company, then we put it in Longleaf Partners Small-Cap Fund. If it's a realty company, then C.T. and Longleaf Partners Realty Fund get the first shot. If it has over $1 billion in market cap, then [it probably goes in the] Longleaf Partners Fund. If half or more of its assets, its revenues or its value is offshore, then it's a candidate for Longleaf Partners International.

Our investment universe isn't as big as you might think....

Hawkins: The world's not as big as you might think when you look at Longleaf International through our lens. If we can't understand something, we're not going to buy it. To be able to value something, you first must be able to understand it. If you can't value it, you can't know if you're buying it at a 50% discount. So we must be able to understand a company and its economics — how it gets its

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next dollar of revenue, how much it costs 'em to get it, etc.

In Sweden, for example, we may only be able to find two or three companies we're capable of understanding, that are large enough, that have only one class of shares, no minority interests, where we like our partner and there isn't too much debt. If it owes more than it's worth, we'll probably have a problem with it. And if it ends in "ology" or "onics", we're going to pass — because we know we can't understand that area very well.

Also, we want reasonably big companies that give us an opportunity to buy and sell their shares — like an Investor AB or a Philips. So if Brazil's melting down and we decide we want to look at it, there may be a Coke bottler there that we can understand. And there may be another company that does something that makes some sense to us.

So our universe isn't nearly as big as you might think.

We have an international quarterback, but everyone plays.

Hawkins: Andrew McDermott is in charge of Longleaf Partners International Fund. We're opening a Tokyo office. He's spent a lot of time in Hong Kong, Singapore and Tokyo. He speaks Japanese and his closest partner is Japanese.

And his role is to be the quarterback. He'll be held accountable for making sure we manage the cash inflows, that we don't take oversized positions and that we comply with all of the applicable laws, make our filings correctly, etc.

However, any of our people can look. The whole team is responsible for finding great opportunities. Then, when those percolate up through our analytical process, we decide where we'll put it.

A Tokyo office doesn't mean a greater allocation to Japan.

Shareholder: You're opening an office in Tokyo. Yet, today, the majority of the Fund is invested in Canada. And most of your Japanese investments are concentrated in the insurance industry. Could you talk a bit about how you expect your portfolio allocations to change in the future?

Andrew McDermott: We do have a large investment in Japan. But that's not premeditated. [Our investments will be wherever] the opportunities are.

However, by being in Japan, we'll be able to cover the Asian region [as well as] Europe. It's the same trip from Asia to Europe as it is from Memphis to Europe. So we'll be able to get to a lot of the companies that we're covering.

Also, frankly, it takes a lot more effort to spend time with managements in Asia and it's a lot harder to get there if you're based here. So [the fact that we're opening an office in Tokyo is] not a statement that we're going to put more assets there. However, it is a statement that it's going to make it a lot easier for us to visit managements.

Flexibility pays....

McDermott: And let me mention one more point. We don't *have* to own any company in Japan or anywhere else. And that's a major advantage that we have over people who are Japan-focused, regionally focused or otherwise focused. For example, if we find eight companies in the U.K. that are firmly entrenched competitively, that are likely to earn high returns, with managements doing the right thing that are selling at the right price, we'll happily buy those eight.

So we don't have to be in Japan. We're only there because it's cheap. And I think that's very important....

Hawkins: We're spreading out companies every day in Memphis. And as we spread them out and we think we uncover extremely exciting values and we like the ongoing business, that will determine whether we take a trip to Germany or Seattle and on up to Vancouver....

Our portfolio allocation isn't about geography.

Staley Cates: To amplify on Andrew's remarks, we obviously believe we can cover Canada from here. And we believe that we can cover Europe from Memphis and Tokyo. However, we don't think there's any way you can cover Asia without having somebody there — because, as you know, there's murkier governance, more complicated disclosure [and] more tight-lipped managements. You can't cover that part of the world, we think, without investing the time to get to know the managements, the culture, etc. better. So Andrew's there for that purpose....

But the country allocation will be totally bottoms up. It will have nothing to do with EAFE index weightings or GDP weightings. It'll be strictly opportunistic.

The Fund's 50% allocation to North America is misleading.

Shareholder: Yet, 50% of your International Fund is still in North America. Are you looking to change that? That doesn't sound much like an international fund....

Cates: Our U.S. allocation as reported is misleading. We have one company that literally has not one penny of revenues or profits in the United States. But it has its headquarters here — which is why it's listed under "U.S." However, it's 100% a foreign company. And that's a pretty big chunk of the 15% of the Fund that's in the U.S.

Then 35% of the Fund is invested in Canada. And that's because Canada is having a fire sale right now because anything related to Asia in the whole world is cheap, the Canadian dollar is cheap and the most economically sensitive things are cheap. And that pretty much describes a lot of the companies in Canada.

So we love what we own there.... I wouldn't anticipate Canada constituting 35% of the Fund over the long run. However, if it does, that would be great — because we feel wonderful about the things we have there.

Hawkins: Our current deployment of assets in Longleaf Partners International ... in rough figures [is] about one third in Japan and about one third in Canada.... And we have, I think, one position in Hong Kong, one in Singapore, one in the Netherlands and one or two in Great Britain. So we have holdings around the world.

International Fund's one U.S. holding is turning "foreign".

Shareholder: So do you consider the International Fund to be a global fund? Or when you buy U.S. stocks, will it be primarily because the companies, although they're based in the U.S., have an international focus?

Cates: The latter. Our U.S. holdings in the International Fund will be more international — with only a few U.S. holdings. The only sheer U.S. company in the Fund currently is FDX. And, frankly, [because of] the way their foreign business is growing, we think even that one will fit our definition of "foreign" within a few years. So

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even FDX is more in the latter category you mentioned.

Bargains are no longer scarce in Europe either....

Shareholder: Could you comment on the opportunities you're looking at in Europe other than Philips? Why don't you have more investments in Europe?

Hawkins: We don't invest in countries. We invest in individual companies. Our geographic allocation is simply a function of the opportunities we find. And our bottom-up investment discipline hasn't turned up a lot in Europe.

Cates: A few months ago, we were having every bit as much difficulty finding qualifiers in Europe as we were in the U.S. But, interestingly, two of the places we liked best over there — some of the British small caps and some of the Scandinavian big caps — that were way out of range got crushed along with U.S. small and mid caps.

So all of a sudden we have about eight or nine serious U.K. candidates that we'll be visiting in the next few weeks. Andrew will be in Britain for a month or so. And in Scandinavia there are some things we've owned in the past that we're familiar with that we're surprised that we're getting a chance to look at again.

Therefore, I'd expect our European weighting to go up.

Longleaf International is one of the cheapest we've seen.

Shareholder: Which of your four funds offer the most promise today?

Hawkins: We think the best indicator of a fund's future returns is its price-to-value ratio — which, again, is the current price of its holdings divided by their value.... And by that measure, Longleaf International Fund is the cheapest today followed by Longleaf Realty.

[Editor's note: At press time, we understand that they believe the two funds offer price-to-value ratios slightly over 40% and 50%, respectively.]

OFFSHORE OPPORTUNITIES ARE MORE CHALLENGING. THEREFORE, WE TEND TO BE MORE DEMANDING.

We tend to be more demanding of offshore opportunities.

Shareholder: Do you do *anything* differently in your evaluation process when you're looking at foreign stocks — [such as adjusting for] accounting differences?

Hawkins: When a company that we're evaluating is located offshore, we're usually more demanding in our evaluation than we might be of a similar U.S. company — and generally require a much greater burden of proof. For example, we have to get comfortable with its accounting — which, needless to say, may or may not resemble U.S. GAAP. If there are majority/minority issues, they'll need to be factored into our appraisal. (As you probably know, we don't like being minority shareholders under *any* circumstances.) Third, we've got to deal with the currency risk — although we try to eliminate that risk whenever possible by being short that foreign currency against the dollar.

Fourth, geography generally presents a greater hurdle since we have to travel a lot further to visit a management that's located in [another country]. And fifth, there's usually a cultural barrier in companies located offshore....

Finding qualifiers overseas is, understandably, tougher.

Hawkins: And when we find an overseas qualifier, we want it to be subject to what you might call normal corporate governance.

So when you add up all of the discounts that we apply for each of these risks, ... it's easy to understand some of the reasons why we usually *don't* reach a conclusion that leads us to buy something and why a company located offshore tends to represent a greater challenge....

One of the best elevator companies — at working capital.

Hawkins: And we don't have to play internationally, but we think it's a *very* good place to look. For example, we recently visited an elevator company in Osaka which has the fastest elevator in the world. And to demonstrate their elevator, this guy placed a ball point pen on the floor of the elevator balanced on its point. Believe it or not, that pen stayed balanced all the way up and back down again. And we visited their plant in Ohio.

So it's one of the best elevator companies in the world. And, believe it or not, you can actually buy the company today for less than its working capital.

Last, but not least, is management....

Hawkins: But we couldn't get to a buy decision. And the reason why we couldn't is that we couldn't get together with management on where they needed to go in the future to compound shareholder value....

The guy owns 16% of the company. However, he still can't understand that a 30¢ dollar below working capital is the best reinvestment opportunity for his cash flow or his liquidity that he has. He'd rather build another plant and earn 4-5% on his capital — because that looks pretty good when you can borrow money at 1% in Asia in his currency.

So although we were very *intrigued*, it's not for us....

Cates: Incidentally, when we do those appraisals, we're using much higher real discount rates to value those than we would in the U.S.

Shareholder: So your typical Japanese company — or foreign company in general — would probably require better value characteristics than a domestic company that you were looking at.

Cates: Exactly. For example, Japanese interest rates are at 1-2%. So if we used local currency discount rates, we might use a 4-5% discount rate. But we use 10-11%. So we're using the same discount rate we use elsewhere. But when you compare our discount rate to local inflation and local interest rates in Japan, it's way, way above it.

If they're not compelling from afar, why go any farther?

Shareholder: You said Mr. McDermott will be based in Tokyo. So if you had something that looked interesting let's say, in Singapore, how will it work? Do you send someone over, does Mr. McDermott go there directly or what?

Hawkins: Well, we do all of the analytical work first. We read everything that we can about a company's CEO, perform our competitive analysis, etc. until we think that we have a very good handle on it and know what it's worth before we ever buy a plane ticket.

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And unless we conclude that the company's value exceeds its price by a tremendous amount and all of our other criteria are met (for example, there's not too much financial leverage, etc.) we're not going to fly to Singapore, to meet Andrew and visit the company — as we did with Haw Par, for example....

Shareholder: So you start with public domain information and analyze that as best you can?

Hawkins: That and talking to competitors and/or people who are on the board of directors that we know. There's a heck of a lot of ways to get to know a business before you fly off and interview its management.

We're seeking to capture only two things....

Shareholder: Some international funds *don't* hedge. Do you expect to always hedge your currency exposure?

Hawkins: Our hedging policy is based on the fact that we're owner/operators managing assets. And we don't want to be exposed to the vagaries of volatile currencies. We're basically trying to capture two things: (1) The growth of corporate value and (2) the closing of price to that value over time. And we know that we'll make a lot of money with little risk if we buy a good business at half of its value and its price goes to its appraised value in the future.

To the degree that we're exposed during that time to very volatile currency changes, we're not comfortable. So we try to take currency out of the equation.... So far, that's been a very good thing to do. We believe it will continue to be because we think that you can still have volatility in the currency markets.

When we short the yen against the U.S. dollar, we get a positive carry. And that carry contributes about 4% to our returns over time. Hopefully, that return will offset some of the other hedging costs that we have to take on.

We hedge our holdings on a case-by-case basis.

Shareholder: I see that your exposure in Canada accounts for about 36% of the Fund. But your contracts to hedge Canadian dollars don't seem to represent that much. What accounts for the apparent discrepancy?

Hawkins: That's a good question. We look at each addition to our portfolio and assess its currency exposure. And if a company's asset and revenue base is denominated in U.S. dollars, it doesn't matter where its headquarters is.

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The assets of some of the Canadian companies in our portfolio, for example, are denominated in barrels and/or thousand cubic feet. Needless to say, I'm talking about energy companies. For instance, Gulf Canada [GOU/NYSE] is the International Fund's largest position — representing 10%± of the Fund. But because all of its assets and liabilities are effectively denominated in U.S. dollars, there's no need for us to hedge.

On the other hand, another company in our portfolio is Shaw Communications [SCLB/TSE] — a cable company in Canada. And we're 100% hedged on that one in case the French and the British were ever to decide to split the country in two and the Canadian dollar were to decline substantially.

So we might *not* hedge foreign stocks and hedge *U.S.* stocks.

Hawkins: Similarly, if a company's earning power and/or its assets are spread across lots of countries, then the need to hedge it goes down.

McDermott: Coca-Cola's a good example there. A substantial portion of its net income is derived from outside the U.S. So it's an international investment. But it wouldn't necessarily be a holding we would hedge. Conversely, we *would* hedge a company whose headquarters was located in the U.S. that had most of its operating assets and liabilities in Japan or Canada.

So we're really hedging based on our evaluation — as opposed to the corporate location or the currency in which the company trades.

A NINE-YEAR BEAR MARKET THAT'S DOWN 67%? THAT SOUNDS LIKE OUR KIND OF ENVIRONMENT.

A nine-year bear market that's off two-thirds? We like it.

Shareholder: Given the low returns on equity, would you comment on the opportunities that you're seeing in Japan and whether you think that market's bottoming?

Also, would you mind commenting on ... the continuing appropriateness of Japanese P&C insurers as investment vehicles in the Funds?

Hawkins: First of all, we have *no* idea when the Japanese markets are going to bottom. The Nikkei is down from a high around 39,000 to not much over 13,000 today. And it's been in a bear market for more than nine years.... In other words, it's the kind of environment we *like*....

Stated returns in Japan are, understandably, pretty low....

Hawkins: There are many companies with low ROEs in Japan that *don't* appeal to us. However, that's not a universal phenomenon by any means. There are a number of companies we think have very *high* implied returns — including a number of non-life insurers. Those companies are comparable to our property and casualty insurers here in the U.S.

For example, Japanese non-life insurers have substantial percentages of their assets — some of them as much as half — invested in equities. And as you know, those equities rarely pay much in the way of dividends. Therefore, the GAAP income from up to half of their assets doesn't even show up on their net income line. Therefore,

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if you take net income and divide it by stated book value, almost by definition you're going to get a pretty low ROE.

But we view their returns, and their appeal, as quite *high*.

Hawkins: However, we believe that Japanese equities will eventually recover. In fact, we even think they could recover very *nicely*. Thus, we don't think it's unreasonable to assume that the equities in their portfolios earn a 10% annual return. And when we do that and add that figure to their underwriting profits, we conclude that their ROE — far from being pretty low — is actually quite *high*.

Therefore, the opportunity to buy a non-life insurer at a very substantial discount to book value where much of that book value itself consists of very depressed equities — well, as you may imagine, we find that opportunity somewhat appealing, especially if we believe that they'll continue to underwrite with caution and discretion....

The case for Japanese P&C insurers remains unchanged....

Cates: Basically, the case for our Japanese non-life (property and casualty) companies remains unchanged. The Japanese market has been incredibly weak. Therefore, our adjusted book values (the book values that we write up to U.S. accounting) really haven't changed much. In fact, they've even come down a little. However, we've accounted for most of the big hit that they took from the equity market as we took our positions.

We're excited to report our competitors are cutting corners.

Cates: I guess the only new thing to report (and this is something we're excited about) is that the typical M.O. [*modus operandi*] of people buying this type of company or going to Japan to invest is that they fly over for a week, undertake their visits and go back home to the U.S. And there's so little anyone can glean from that type of visit. For example, the meetings aren't very efficient — because of the need for translators and because it's the first time you've met the person and whatnot. Therefore, it's hard to make accurate judgments based on quick visits the way most people try to do it.

Having people on the ground is paying benefits already.

Cates: One benefit we've seen already of Andrew going [to Japan] more than once, having follow-up conversations and getting to know some of these managements is that we've been able to discern which ones allocate capital the way we like to see it done and which ones do it in what you might call the worst-case, Japanese way that you read about today in all the headlines.

So if you look at the seven Japanese non-lifes that we began buying within the last year, you'll notice over time, as we disclose more and more, pretty radical differences in our weighting. We've totally blown out two or three of these companies. Even though the values are still there, we think [management] will keep us from ever getting to that value. By the same token, we've really added to our stake in a couple where we think we have a great partner.

So the statistical work is unchanged. However, the people behind the statistics is something we're just getting a much better handle on. So the case is still intact. However, we're refining which names we're in.

We don't need a crystal ball to know we'll do fine in Japan.

Shareholder: Japan's been in a recession now for about eight years. When do you anticipate a change there?

Hawkins: We're very aware of their economic status and have built it into our appraisals.... We don't add a lot of value by being macroeconomists or prognosticators ... in terms of when their economic status is going to change or by how much. However, we do have every confidence that the process to create the necessary change is underway.

And in certain companies, we believe that we enjoy such a margin of safety — in terms of value over price — that regardless of how quickly or how slowly Japan comes out of its doldrums, we're going to make a lot of money.

Japanese stocks don't rely on rosy scenarios. Au contraire.

Cates: We're certainly not assuming any big recovery. In other words, when we appraise Japanese companies and try to determine their values, we're assuming that they stay in the current economic environment. These things aren't cheap because we assume the Japanese economy is going to come screaming back or anything like that. We're trying to keep our pessimistic, conservative goggles on as we look at these.

We're buying *cash* at a discount. The businesses are *free*.

Cates: The reason why they show up as cheap is that the ones we're looking at are actually very good companies that have maintained their operating profit levels even though the economy's been horrible. But we're paying less than net-net working capital. We're usually paying about the same as their cash on the balance sheet net of all debt. And then we're usually paying about 2/3rds of their value if you throw in their inventory and receivables.

So even though they are continuing to make money, we're not even treating them like an ongoing business. So, in other words, any kind of profit growth from here or any kind of recovery from recession would be a total bonus. We're not baking that into our valuation at all.

WE'D LIKE TO BUY COMPANIES UNDERTAKING CHANGE BEFORE THAT FACT IS WIDELY RECOGNIZED.

Unwinding Kieretsus make some mgm'ts more responsive.

Shareholder: Is corporate governance in Japan still evolving in our favor — in terms of incentivizing managements, share buybacks and things like that? And do you notice those developments specifically in any of the Japanese companies you've bought?

Cates: I'm going to let Andrew speak to this mostly. But I'd like to say one thing first: The most tangible thing that I see is that a large chunk of these companies have an incredibly tangible unwinding of cross-holdings going on. In some companies, the managements are terrified because they all know that they're selling at 40¢ per $1 of cash.

They weren't terrified before because thanks to their cross-holding-friendly companies protecting 'em, it was business as usual. However, today, it's easy to detect where those cross-holdings are coming unwound. It gets manifested in how managers suddenly become receptive to

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their shareholders — because they know that if they're not that they'll be vulnerable.

By the same token, some managements today remain protected by members of the Kieretsu, customers or whomever in a group holding situation. And they still look at you like, "Well, yeah, you're a common shareholder. But that only puts you about #7 on our priority list."

Our opportunity is to buy the firms implementing change.

McDermott: There definitely has been a change. But one of the things that's amazing about Japan is that the whole country tends to get painted with the same brush when, in fact, there are two separate types of companies: There are companies like Toyota, Bridgestone and others whose products are not only competitive worldwide, but they also have a U.S.-style investment relations staff and they're buying in shares and incentivizing management with stock options. So the argument that Japan can't do those things for cultural reasons is not true.

But companies a long way along that path are also incredibly expensive. So we've seen tremendous progress. Everyone's aware of what these industry leaders — really *world* leaders — are doing.

But the real challenge and opportunity is to find companies implementing those changes before they're recognized by the market....

Hawkins: And we think that they're still only in the second inning of this evolution in Japan, but that you want to be there before it evolves completely.

THANKS TO HIDDEN &/OR UNDERSTATED EARNINGS, GENDIS IS SELLING *WAY* BELOW ITS TRUE VALUE.

Gendis is actually a play on Pioneer.

Shareholder: I've seen some press lately regarding your investment in Gendis [GDSA/TSE] up in Canada. What do you like so much about it that would cause you to go to court in order to hold onto nearly a 20% position in it?

Also, could you comment on the recent news out of Canada [which] has been less than good and how the economy up there has been impacting that business?

Cates: Mason talked about Pioneer as an example of things that are near and dear to our heart. Gendis is actually one of the largest shareholders of Pioneer. How that happened is that Gendis sold its oil and gas company — Chauvco [CHV/TSE] — to Pioneer for stock. That's how we began to follow Pioneer before it dropped precipitously and became a purchase in and of itself.

Gendis is selling way, way, way below its underlying value.

Cates: And if you look at Gendis' interest in Pioneer and what we believe it to be worth and add the value of its other assets — which include a large retail chain in Canada, a portfolio of real estate properties and a 50% joint venture in a private oil and gas company — we arrive at a total value way, way, way above the price.

The reason why we had to make those filings is that you have to obtain exceptions to Canada's federal statutes in order to acquire a 20% interest.

Why is it cheap? Depressed/understated earnings.

Cates: The reason why Gendis is very cheap is that those different pieces which clearly have large asset value don't contribute a lot to the P&L [profit and loss statement] — either because the dividends are very small compared to the asset value or, in the case of the retailer, because its earnings are a lot less than the actual free cash flow.

Hawkins: Or the pipelines.

Cates: Right. They have a position that came out of Chauvco in the Alliance Pipeline which will be shipping a lot of gas from Canada into Chicago. It'll be onstream in about three years. That was a residual of their oil and gas investment. So there's a publicly traded common stock that's worth quite a bit — but one, again, which doesn't contribute much to Gendis' earnings.

We generally don't make big picture-type judgements.

Shareholder: I'm very concerned about the exposure in Canada because of political instability in that country. I realize that you're hedging the currency. But were Quebec ever to begin to secede from the rest of Canada, I think the whole Canadian stock market would tank.

Cates: We don't make stock market judgments and we don't make economic judgments. And the reason why we don't isn't in order to be ignorant. In Buffett's vein, when we look at a company, we do it with the mindset of a private investor. Before we buy anything, we ask ourselves whether we'd be happy owning it if the stock exchange were to shut down for a long time. And we believe the answer better be yes — because the management, the company and the price are right. If they aren't, there's no need to look at it any further....

Whatever nation Gulf Canada's in, its reserves will be fine.

Cates: One company in which we have a large position is Gulf Canada. And one of the reasons why is that those oil and gas fields and the incredible reserve position that they have in Indonesia aren't going anywhere. You can build in whatever scenario for Quebec you like. Our valuation of that oil and gas isn't going to change.

We know that the management of that company is going to build its value and, we think, get it recognized. And that's what ultimately carries the day. We'd never say we don't want to own Gulf Canada at 30¢ on the $1 because of some short-term, or even long-term, problem with the government.

McDermott: Needless to say, that's assuming the government isn't a candidate to expropriate its assets and the country isn't at risk of being destabilized by a revolution or something of that nature — which, of course, *is* a risk in some emerging markets.

If we can't trust the banks, how can we trust the stocks?

Shareholder: Might you one day invest in Malaysia, Latin America or other similar, smaller markets?

Cates: There's no reason per se that we couldn't. As we've said, we're *company* specific, not *country* specific. However, we don't want to invest in a market that's

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inherently unstable. That's the one country-specific thing we do: We don't want to go into a country with serious risk.

As I heard Andrew tell someone earlier, if it's too risky to leave money in a savings account in a country, then you probably shouldn't buy stocks there either. So countries like Malaysia and Indonesia are probably too gamey for us right now. We'll let somebody else make the money there.

Latin American stocks have massive hidden costs....

Cates: Something like Latin America is much more up our alley. And we've looked a lot there recently since those markets got really cheap. However, we just haven't quite gotten there yet in terms of the price-to-value ratios.

Those stocks look very cheap in local currency terms. But when you account for the incredibly high interest rates — which, after all, relate back to the discount rates [that we use in our appraisals] and the massive cost of hedging the currency — you're really making a bet on the currencies and the interest rates in a lot of these equities. In other words, if you strip that part out, some of these equities aren't that cheap. However, that's the only reason why our exposure there is currently zero.

REAL ESTATE FINANCIAL MARKETS ARE IN DISARRAY. BUT BELIEVE IT OR NOT, THAT'S VERY GOOD NEWS.

A disconnect between real estate stock prices and reality....

C.T. Fitzpatrick: [W]e run Longleaf Partners Realty Fund the same way we run all of our funds. We just focus on real estate as opposed to other types of businesses.

As of yesterday, the publicly traded real estate indices have turned in their worst performance so far since '74. The year-to-date declines ... exceed those for all of 1990. However, those capital market results contrast very sharply with the conditions at the companies in which we've invested. Rents, cash flow and profits are rising — and should *continue* to rise — at a much faster pace than those of most other common stocks through 1999.

The way real estate market cycles worked....

Fitzpatrick: Moreover, the severe retrenchment in debt markets that's occurred so recently *vastly* improves the long-term outlook for our companies. And here's why: It's a unique situation today. In the past, when times were good in the real estate market with rents rising and vacancies falling, developers would begin to develop new space and bring on new supply — and it would generally get overbuilt.

Therefore, credit would pull back from the markets as banks quit making loans so new buildings couldn't be financed. [And without any additional supply, demand would eventually catch up with the existing supply until there were good times in those markets again.] And then the cycle would repeat itself....

Pre-bust credit shrinkage = prolonged good times....

Fitzpatrick: But for the first time ever, to my knowledge, the credit crunch has come *first*. A number of capital providers to debt markets declared bankruptcy. Banks have tightened their real estate lending standards.

Every company we own is telling us that the projects they saw coming down the pike that would compete with their properties two or three years from now have all been cancelled. Any developer without a letter of intent from a bank to begin construction isn't going to get one.

Therefore, major new supply isn't going to happen. The wonderful fundamentals that we've enjoyed over the past three to five years are now going to be extended for several more years into the future. Consequently, we're finding better price-to-value ratios today than we've ever found....

Public markets threw out the baby with the bath water.

Fitzpatrick: However, the public markets have taken a very different view. They haven't differentiated between property quality nor property type nor the quality of the cash-flow streams among various real estate companies. Instead, traders and short-term investors have sold entire sectors of the market with little or no regard for the quality of the businesses or the price at which they are selling these businesses....

For example, there are companies in the industry competing in commodity-oriented markets with commodity-type products that we wouldn't touch with a 10-foot pole. However, we're buying companies like Marriott International which possess a stream of fees and free cash flow that's going to grow at a mid-teens rate for the next three years at least — and very solidly thereafter — which is *not* exposed to the concerns that a lot of people have about the industry.

All hotel stocks have been tarred with the same brush.

Fitzpatrick: That lack of differentiation, incidentally, is most pronounced in the hotel industry. Year to date, believe it or not, that industry as a group is down *52%*....

Hawkins: [Wisecracks:] They must have rallied...

Fitzpatrick: The hotel group includes companies that own Comfort Inns and broken down Holiday Inns located on rural interstate interchanges as well as the companies that own the Waldorf Astoria, the Marriott Marquis and the Ritz Carltons. We own those — full service, branded hotels in supply-constrained markets like Manhattan.

Host Marriott's being priced like trash — which it's not....

Fitzpatrick: I'm going to mention a couple that will prove the point. Last week, we were sitting around the office saying, "My goodness. Can you believe that we can buy Host Marriott [HMT/NYSE] today for only 5 times its cash earnings — only 5 times?! And its dividend yield is 9%!"

Well, *this* week we're saying, "Can you believe that we can buy Host Marriott for only *4* times its cash earnings?! And its dividend yield is now *11%*!"

And we're not talking about some low-grade company. Host Marriott owns three of the top 20 hotels in the country. It is literally the finest collection of U.S. hotel assets that you could assemble anywhere. They're geographically dispersed in the very best hotel markets in the country. And they include properties like the Marriott Marquis here in Manhattan, the Marriott Moscone in San Francisco, the Marriott Marina in San Diego, the Palm Desert Resort, the Ritz-Carlton Buckhead Atlanta, the Ritz-Carlton Naples — and I could go on....

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Host Marriott today sells at an implied cap rate of about 12%. They sold the East Side Marriott located here on Lexington Avenue earlier this year for a *6%* cap rate.

At today's price, who needs growth?

Fitzpatrick: Ask yourself, "How likely is it that you'll be able to rent a hotel room in New York five years from now cheaper than you can today?" I think you'll agree that the answer is, "Probably not."

However, even if Host Marriott never grows again, ... we'll earn 25% at today's price. Or I could go buy a 30-year Treasury bond and get a 4.75% return. It seems like a very easy decision to us, but the markets seem to disagree.

Host Marriott may be selling at 3 times cash earnings next week. But as long-term investors, when we look at the carnage, we get more excited than we've ever been. Longleaf Partners Realty Fund's price-to-value ratio is at an all-time low. Currently, our ideas *greatly* exceed our capital resources. The Fund's implied returns over the next five years make our mouths water. So you may not be surprised to know that we've all personally added to the Realty Fund in the last several weeks and months. And, quite frankly, we would encourage you to do the same — because the returns over the next five years from these prices should be nonpareil....

[Editor's note: As we head to press, we understand that they believe Longleaf Realty Fund's price-to-value ratio is slightly over 50%.]

MARRIOTT'S A VERY LONELY POSITION TODAY
— AND VERY MISUNDERSTOOD. BUT THAT'S OK.

We didn't target the hotel area. It just fit our criteria....

Shareholder: Hotel and lodging seems to be a theme running through your portfolios. Would you elaborate on what you like about them? I know those stocks have really gotten hit — perhaps because of their economic sensitivity.

Hawkins: First, we don't buy *themes*. We buy *businesses*. But it just so happens that there are a number of good businesses in the hotel world being run by good partners. We've alluded to Marriott International. We've also taken a big stake in Hilton [HLT/NYSE]. And there are others we find attractive that we don't want to talk about right now. As you know, we've owned Host Marriott — which we think is the best hard real estate portion of the whole hotel industry worldwide.

So we do have a growing exposure to the hotel area.

Marriott International is a lonely position today.

Hawkins: Our firm and the managements of these companies seem to be the sole buyers of the shares of these companies today. So it's a lonely position for now. And our stakes have been marked south. But that's fine.

Again, the opportunity to own Marriott International around $20 with a mid-$40 value, to be in a business that generates that kind of free-cash flow and to be in partnership with Mr. Marriott is something that we relish.

People fear cyclicality. We just find the package awesome.

Cates: One of the fears in this area seems to be what you might call cyclicality worries. Everybody's worried about the supply coming from new hotels. And that supply *will* hurt hard asset competitors.

However, as Mason said earlier, Marriott International takes its fee right off the *top*. So for the next three years, it's almost baked in a cake that Marriott's room number will grow about 10% a year. And on top of that, we expect RevPAR [revenue per available room] to be in line with CPI or exceed it over that period.

Marriott highlighted all of that in a recent conference call and said that they expect their fee streams — and their free cash flow — to grow at a rate in the mid to high double digits despite the increased supply coming on across the country. So at a P/E of 10, with the company confirming those numbers as well as our own long hand, we find it amazing that it trades at this price.

Far from *hurting* Marriott, dislocations could *help* it....

Hawkins: We might add that the more pressure there is in the hotel market to achieve occupancies, etc., the better for Marriott — because it allows them to reflag some lesser hotels that are having these troubles and further build their fee income.

Cates: In 1990, which was a far worse downturn than anything we could experience today because of the current supply situation, Marriott's fees did not go down. So we certainly think they'll keep growing pretty much regardless of come what may over the next few years.

WE CAN LIVE WITH ECONOMIC UNCERTAINTY
IF THE MARGIN(S) OF SAFETY ARE RIGHT.

We have *several* margins of safety: First, financial strength.

Shareholder: Earlier, you referred to the credit squeeze in real estate and how it might actually accrue to the benefit of companies that own real estate. I get the sense that the credit crunch is affecting other companies — that it's not limited exclusively to the real estate sector. Might you speak to the impact it might have on corporate profits and your investment strategy?

Hawkins: First, we intend to own companies with good enough fundamentals to make it through an economic slowdown. We only want companies with strong balance sheets that generate more cash than is required to run their businesses. Relative and absolute financial strength is important in order to be able to go on the offensive, take out weaker competitors, build your strengths and/or retire shares.

Margin of safety #2: Conservative assumptions....

Hawkins: Second, our appraisals are based on conservative estimates of the free cash flow streams our companies will generate over the next six or eight years. Our people *better* have built in very conservative growth to reflect the fact that we will have future recessions and occasional bouts of tight credit. Those things will impact our companies' future free cash flow streams.

Margin of safety #3: Price....

Hawkins: Still, despite our conservative assumptions

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and our focus on financially strong companies, we know we'll occasionally experience challenges even *more* severe than those we've built into our assumptions. That's one of the reasons why we require such a large margin of safety. If we make an error in our appraisal and the value turns out to be $80 rather than $100, if we've only paid $50, then we still have $30 of protection.

As Mr. Buffett has said, "We want to be roughly right, not precisely wrong."...

What's a little economic impairment if the price is right?

Hawkins: With that background in mind, will what's been going on in the financial markets affect the economy? Of *course* it will — because it's destroyed personal savings. And when personal savings are destroyed, it's bound to impact consumer spending and so forth. You'd have to live under a rock not to believe that....

But does it mean the end of the world? Not at all. And will it even affect America? Even *that's* debatable. The stock market has discounted what — about nine of the last five recessions? So we don't have the answer there.

However, in our view, once again it gets back to *prices*. In some cases, the declines in stock prices have much more than compensated for the potential economic fallout. The average company in the Value Line index, for example, has declined more than 40% peak to trough....

For people like us who believe prices correct a lot more than the economics, that's *good*. Whenever markets swing from greed to fear, capital markets react *much* more than the fundamentals [would justify].

HOW MUCH A STOCK'S FALLEN IS MEANINGLESS — ESPECIALLY IF IT'S A LEVERAGED FINANCIAL COMPANY.

Some financial companies were just egregiously *overvalued*.

Shareholder: A lot of value managers have more significant holdings [in] financial companies than you do. Given the fact that ... some financial companies are down 60% and even 70%, do you see bargains in that area?

Hawkins: How much they're down from their highs is meaningless to us. It's all about price-to-value. We think they were egregiously *overvalued* in certain cases. If you own a regional bank at 3-times book that earns 15% on book, to us that's a 5% return. Does that appeal to us? Not at all....

As for the ones we like best, it's been close but no cee-gar.

Shareholder: I'm thinking more of a company like a Merrill Lynch that's down 60%.

Hawkins: Some companies that possess recurring free cash flow fee streams — and Merrill Lynch derives a preponderance of its income from such repetitive fees — are very appealing and interesting to us. In fact, there are two or three such companies where we think the businesses have untapped international growth potential whose stocks are within a point or two of prices which would virtually make us come out of our shoes to own them.... However, we haven't pulled the trigger yet.

We've owned attractive financial companies before.

Hawkins: We had a huge stake in Kansas City Southern [KSU/NYSE] which was really Janus Fund Group, a railroad and DST [DST/NYSE]. We were one of the largest shareholders of Mellon Bank where a big free cash flow stream was being generated by the money management operation at Dreyfus. And we were a major shareholder of American Express.

However, those companies got *to* our appraisals and went *through* our appraisals by quite a bit. So we left them. But we feel like they left us. In any case, we sold them at quite a discount to the prices they eventually reached. Their prices have now come back through our appraisals and descended towards our threshold of 60% of value.

Highly leveraged financial companies merit extra caution.

Hawkins: But for a company with only 6-7% equity that borrows the other 94% the way a bank does, you *want* it cheap — because if you only make a *little* error on the left side of the balance sheet, the result is a very *big* error in your appraisal.

This is something we deal with a lot in our shop. And it's not just price-to-value. It's price-to-value with consideration as to how much financial leverage there is. Unfortunately, we're not perfect. We make errors in our estimates of future free cash flow streams and asset values and our appraisals based on comparable sales. And if we make an error in our appraisal of a company's assets on the left-hand side of the balance sheet and the company's financed a whole lot of its assets with debt, the impact gets really magnified on the right hand side of the balance sheet in our appraisal of equity.

Thus, when we own lots of a financial company — such as a bank that borrows 16 or 17-to-1 vs. its equity — we want to be *right*. And we just saw an extreme example of that at Long Term Capital.

WE LIKE UCAR'S BUSINESS, IT'S STAYING POWER AND ITS 40% MARKET SHARE ACROSS THE GLOBE.

It seems price-fixing allegation was more than allegation....

Shareholder: You made a sizeable investment — in the second quarter I believe — in UCAR International [UCR/NYSE]. Would you [comment on] what's happened since you bought it?

John Buford: Two things have happened since we bought it. First, they pleaded guilty and settled, more or less — they still have a few settlements to make, but they've settled [with] the lion's share [of the claimants] including the government — in a price-fixing allegation which has turned out to be more than just an allegation.

That was a major event for the company. They took a $300 million reserve — which, incidentally, is in our appraisal. So, by and large, they have settled it. The settlement with the government was for $110 million — which is payable over six years at no interest. And the rest of their reserve will go to customers.

We like growing companies with 40% global share.

Buford: UCAR sells graphite electrodes to mini-mills.

(continued on next page)

SOUTHEASTERN ASSET MGMT'S
MASON HAWKINS ET AL.
(cont'd from preceding page)

They're in kind of a razor blade-type business. When the mini-mills melt a load of scrap to produce steel, they have to burn graphite electrodes.

UCAR has a 40% share of that global market. It's a *growing* business. [Up until recently,] their unit growth [had been running] about 4% per year. So we like the business. And we like companies with 40% market share across the globe.

UCAR is cheap for a reason....

Buford: What's happened, however, is that since Asia and some other emerging markets have melted down, Asian steel-makers have been inundating steel consumers — in other words, the customers of UCAR's customers — with cheap steel. We've seen a lot of that here in the U.S. And our steel industry just recently filed lawsuits against foreign steel producers for dumping steel here in the U.S. — i.e., for selling it below their cost.

Therefore, the market is very concerned about the current environment and its potential impact on UCAR — fearing that UCAR's customers very likely have some tough times ahead. And over the short term, UCAR's customers are reducing production, cutting back from three shifts a day to two, cutting back their work week from seven days to six and generally reducing production at the margin. So that will hurt UCAR's earnings.

But we're not very worried about UCAR making it through.

Buford: However, we believe — and people in the steel industry agree — that if *anyone* can survive this environment, it'll be the mini-mills and that the lost sales will come out of the hide of the integrated steel-makers.

I say that because the integrated steel producers are simply not as cost-effective as the mini-mills. For a variety of reasons, it costs integrated steel producers $200-300 more per ton to produce steel than it does the mini-mills.

So we're not very concerned about them making it through today's unusually difficult market conditions. And we think UCAR will be fine long term — that once the environment returns to normal, they'll once again enjoy growing volumes, be able to initiate price increases, etc.

THREE COMPANIES IN THREE INDUSTRIES,
BUT A FORMULA THAT SOUNDS FAMILIAR....

Waste Management has huge opportunities ahead.

Shareholder: What's your take on the criminal indictments filed against Waste Management [WMI/NYSE] and its officers?

Hawkins: We think that John Drury — formerly with USA Waste and now the CEO at Waste Management — is a fabulous manager. He's as good as we get. And we're very, very glad to be in business with John.

We think there are *huge* economic opportunities to put Waste Management and USA Waste together in terms of savings, marketing capabilities and the opportunity to capture more free cash flow and make it a business with *tremendous* economics over the next decade.

So we're very excited to be major shareholders of Waste Management. We've made a lot of money there. It's still selling below our appraisal. And we think that they'll have very clear sailing in the next few years — not only as they receive normal garbage volumes and collect tipping fees, but also as they improve their cost position by consolidating the two operations.

As for the litigation, we don't think it's material. And that's all we'll say at this point.

A very undervalued stock run by a fantastic partner....

Shareholder: Might we get your take on United Healthcare [UNH/NYSE] in light of the rather flat earnings and difficult pricing within that industry?

Hawkins: We think that United Healthcare is the best in the industry. We have a very major position in it — one that we bought very cheaply. And unlike some of our other recent purchases, we have a tremendous profit in it almost out of the box.

We think Bill McGuire is a fantastic partner and a good operator. Its cash flow next year — its *free* cash flow (GAAP earnings plus amortization) — should approach $3.50. We think it's a very undervalued stock. Our appraisal is *substantially* greater than the high $30s [where it's currently trading]....

We have *very* fond memories of Chuck Lillis and MediaOne.

Shareholder: MediaOne Group [UMG/NYSE] is no longer among your top holdings. Could you say a few words about it?

Hawkins: We'll let the quarterly report speak for itself when it comes out. It's been a *tremendous* investment for Longleaf Partners Fund and clients of Southeastern Asset Management.... Chuck Lillis is as good a partner as we've found in quite awhile....

Cates: I think it's fair to say that the reduction of that position has nothing to do with the fundamentals of the company — because we're still very excited about that. It's much more a function of trimming back what had become a very large position.

WHETHER OUR FUNDS ARE GROWING OR SHRINKING,
IF WE'RE RATIONAL, WE CAN USE IT TO OUR BENEFIT.

Would we buy more of our 35-40¢ dollars? You *bet*.

Shareholder: When you reopen Longleaf Partners Fund, do you expect to buy more of your existing holdings or significantly expand the number of your holdings?

Hawkins: Great question. I might get into the logic of reopening. If the Fund's composite price-to-value has now gotten down to about 50%, clearly that's an average. That means that a number of companies are down in the 35-40% range. We would be *magnetized* by the opportunity to build those positions. Therefore, the answer to your first question is "Yes, we'd buy more."

Also, we know those companies better than we might a company at the margin that we're just learning about. We know more about the people, the business and its competitive position, etc. So our proclivity would certainly

(continued on next page)

SOUTHEASTERN ASSET MGMT'S
MASON HAWKINS ET AL.
(cont'd from preceding page)

be to buy more of a good thing that we understand and have lived with and trust.

Opening looks like a win/win/win situation to us....

Hawkins: Opening will allow us to bring in cash when we can reduce our price-to-value ratio and enhance the prospective returns.... Most likely, we'll reduce our price-to-value ratios with some companies we already own, although there are a couple on the drawing board that are enticing.

Incidentally, as you may recall, we elected to move all of our funds to the IRS test for diversification from those that the SEC imposes.... It means that we can buy more of a good thing.... That gives us more flexibility to concentrate in Marriott if we want or in any other company that really, really qualifies in terms of business, people and price. That's a great benefit....

Two factors that might lead us to close the Fund again....

Shareholder: If you do buy more of the companies that you already own, if they don't get larger, don't you ultimately face an increased risk of a liquidity squeeze?

Hawkins: Well, we don't have that problem today. And we'll be mindful of that risk as we go down the road. That's another issue that might cause us to shut down cash inflows — if size becomes an anchor to performance. Size was *not* our problem the last time we closed in '95. The problem then was that we were able to find very few qualifiers ... that met our disciplines.

So there really are two major issues impacting our decision about whether or not to accept additional cash — first, that we not get so large that size hinders us and, second, regardless of size, that we're able to find investments that meet our criteria....

We don't worry about redemptions....

Shareholder: We've heard statistics about [how] 90% of mutual fund shareholders have only been in mutual funds for about five years and how today's long-term investors could become short-term investors and capitulate under certain circumstances. Do you have any concerns about having adequate liquidity in the event shareholders rush to sell and you're thus forced to sell positions you really like because you're holding so little cash?

Hawkins: We *don't* worry about that. Fortunately, we haven't had outflows. We've had inflows all through the third quarter — even in Longleaf Partners Realty Fund. We've got the greatest group of shareholders I know.

That's not to say that they won't ever capitulate. However, I think they understand that lower is better for long-term future returns. They've already paid the price in a short-term mark-to-market sense.

Redemptions can actually benefit remaining shareholders.

Hawkins: If they *were* to behave irrationally, it wouldn't necessarily hurt us. Let me explain why: If you're responsible for a portfolio, as we are, and a shareholder says that they want their money and we're 100% invested, what we're going to sell to give 'em their money is the thing that's most fully valued. So if we sell a company that happens to be in the telephone business out of Longleaf Partners Fund that we think is very close to full value, ... we've just improved our price-to-value ratio. What's left — the remaining assets — are, therefore, more concentrated in the cheapest companies.

So if you act rationally as an operator/manager, you use redemptions to your benefit just as you use cash inflows to only buy those things that are *most* attractive.

We don't just pay *lip* service to having the right partners....

Hawkins: So we don't stay up at night worrying about whether someone's going to be a short-term investor. We've done everything in our power to associate with the right kind of partners. We can make shareholders take their money out. And we *do.* Lee Harper is an *assassin* when it comes to identifying short-term timers. I can't tell you how many letters she's written to close shareholders out of our funds. We tell 'em to get out. And we don't let 'em come back....

WHATEVER THE CONVENTIONAL WISDOM MAY BE,
DOWN ISN'T BAD. IT'S WHAT WE'VE BEEN *HOPING* FOR.

Most people are rear-view-mirror investors....

Shareholder: Given the increased volatility of late in financial markets, why do you think so many investors have favored growth as an asset class so much over value?

Hawkins: One word — "comfort". Those stocks have been the ones that have been going *up.* And people want to own things that have been going up. They don't value the businesses. They just figure that if something *has* gone up, it's *gonna* go up — regardless of what it's worth and regardless of who your partner is.

But that is changing. Why? Because investors see Coca-Cola's stock price fall from more than $80 to $50 [and] Gillette's stock price get cut in half.... And that comfort goes away when P/E multiples fall from 60 back to 20.

But, again, in answer to your question, most people are rear-view-mirror investors.

All you can do is stack the deck. And we think we have....

Hawkins: That's not the way we do it. We all wash our slates clean every day and ask, "What would we buy?" And our answer's always, "Something worth more than its current price with good partners and financial strength."

Unless you have a connection with someone who can correctly predict the future, that's about all you can do. We *don't....* And in any case, as Dr. Graham pointed out throughout his teachings, investing based on that kind of prediction isn't built on a solid foundation.

It gets back to the basics of trying to buy very low and sell very high. It's tough to buy low when markets move up every quarter for seven or eight years. Without volatility or declining prices, it's almost impossible to build the kind of foundation that we want to build for the next decade.

So let me make one final point — that *down* isn't *bad.* Quite the contrary, it's exactly what we've been *hoping* for over the last four years. And now we've gotten it — and we've taken advantage of it.

—OID

JOHN C. BOWLING, BOWLING PORTFOLIO MANAGEMENT

"Investors in the large growth stocks within the S&P 500 have done extraordinarily well. So they are beating the socks off almost everybody.... The Russell 3000 measures the performance of the 3,000 largest stocks. During the third quarter, only 168 of these 3,000 stocks outperformed the Index, while 2,832 did worse. Intuitively, this seems impossible. However, the large stocks are weighted at their lofty market values and pull up the whole index....

"As we began writing this letter ... the Dow Jones Industrial Average and the S&P 500 both made new all-time highs. And to add to the fun, we learned on November 23 that Tyco will acquire AMP for $11.3 billion, Deutsche Bank will buy Banker's Trust for $9.7 billion, Provident Cos. has agreed to merge with Unum for $5.2 billion and America Online will acquire Netscape for $4.2 billion. But that isn't all. A guest on CNBC mentioned that the market value of Yahoo! Inc. with its 600 employees exceeds the market value of Sears Roebuck with its 334,000 employees. We couldn't believe it, but when we checked, it turned out to be true. Those internet stocks may have bright futures, but are wildly overpriced....

"Typically, high turnover is something to be avoided. But when there is a big market decline — and at the very bottom the Dow was off almost 20% — taxable investors have to grab their chance to realize taxable losses. Realized capital losses can be used to offset realized capital gains and thereby reduce taxes. We've been diligent in our efforts to realize any significant losses in taxable accounts and will continue this process through December.

"We like to follow the performance of well regarded investors who manage value based mutual funds. Results for the first three quarters for prominent value oriented mutual funds relative to the S&P 500 were as follows (percentage shows how much each lagged the S&P): Davis N.Y. Venture -11.47%; Mutual Shares -17.39%; Oakmark -13.83%; 0' Shaughnessy Dogs of The Market -10.45%; Strong Schafer Value -28.00%, Third Avenue Value -16.98% and Vanguard Windsor -17.16%.

"These funds are exceptionally well-known and highly regarded. That they trailed the S&P by such significant margins shows the adverse climate for value managers this year. In the past, value has beaten growth most of the time — and we think value is likely to be the more successful approach in the future.

"The inclusion of O'Shaughnessy Dogs of the Market Fund in the above table deserves some explanation. This fund began in November 1996 to exploit the Dogs of the Dow strategy with a more diversified approach. This strategy is usually applied by buying the 10 highest yielding stocks in the Dow Jones Industrial Average. The high yield assures that they're reasonably unpopular and thus cheap. Membership in the Dow assures that they're large and likely to stay in business. The Dogs of the Dow strategy can create very undiversified portfolios and it makes sense to include more issues. This is what Jim O'Shaughnessy's done with his fund.... We include it to show how even a perfectly rational long-term strategy with a well documented record of success (at least in back tested results) has been performing in the current market."

Letter to clients of Bowling Portfolio Management — December 16, 1998

Dear Subscriber,

What better sign of the times could there be today than for a blue chip stock like FedEx to soar (whether a higher valuation was warranted or not) because it was written up in *Barron's* as an internet play!? What better? Maybe Yahoo! having a higher valuation than Sears as described by Bowling Portfolio Mgm't's John Bowling in his latest letter (see above).

Fortunately, there remain more than a few have-*nots*. Among them, as Longleaf's Mason Hawkins describes, are the common stocks of companies whose prospects are considered inadequately predictable or, God forbid, any that are small and/or natural resource-based.

Hawkins and his associates discuss a couple of ideas which meet all three criteria. Based on their assessments, one of them is exceptionally well managed and sells today at what may be 25¢ or less on the $1.

Third Avenue Value Fund's Marty Whitman talks about what sounds like a very similar opportunity in a closely related sector. Also very well managed, it sounds more or less equally cheap. And based on his assessment of its earning power (and he knows the company very well), it's selling at only 3 or 4 times normalized earnings.

Whitman talks about more than a few other securities, too, that he believes remain priced at 1974-level valuations. But rather than spoil your fun, we'll just let you read about those yourselves. One security he doesn't discuss, however, but mentions in his latest letter to shareholders of Third Avenue Value Fund as having similar return potential, is Glenayre Technologies. Priced down near 60% of book and 60% of sales per share and no long-term debt whatsoever, Glenayre seems to qualify, in Whitman's shorthand for having the right stuff, as "safe and cheap".

Until next edition,

Henry J. Emerson

Your Editor

P.S. Happy Holidays.

P.P.S. Thank you for your patience and support.

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