

Outstanding Investor Digest

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

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OID MAILBAG: GARDNER INVESTMENTS' TOM RUSSO AND DUNCAN ROSS ASSOCS' ROBERT ROSS & MARK HUGHES "WE KNOW WHY OUR STOCKS ARE DOWN. IT'S WHAT'S KNOWN AS OPPORTUNITY."

Tom Russo of Semper Vic Partners and Robert Ross of Duncan Ross Pooled Trust have several things in common — including a history of excellent performance, negative returns for the first nine months of 1999 and thoughtful letters that educate their clients (and certain journalistic hangers on). We're very pleased to bring you their latest:

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VALUE INVESTING PANEL DISCUSSION
CHUCK ROYCE, CHRIS BROWNE & MARTY WHITMAN
"THE FUTURE OF VALUE INVESTING:
IN PARTICULAR, DOES IT HAVE ONE."

With small-cap value stocks in a prolonged slump, especially alongside the high flying large-cap growth stocks in today's two-tiered market, who better to address the future of value investing — and, in particular, whether it has one — than Pennsylvania Mutual Fund's Chuck Royce, Tweedy Browne's Chris Browne and Marty Whitman of Third Avenue Value Fund. All long-time *OID* contributors, the three participated at the first annual Value Investing

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TWEEDY, BROWNE'S CHRIS BROWNE,
WILL BROWNE & JOHN SPEARS
"WE'VE SEEN INVESTORS GET CARRIED AWAY BEFORE.
WE'LL NO DOUBT WATCH 'EM BE CARRIED AWAY AGAIN."

Tweedy Browne's storied past — first as a broker, then as a securities dealer and, finally, as a money manager — dates back nearly 80 years. In the 1940s, for example, the firm moved to 52 Wall Street to be near its largest customer, the late, great Ben Graham. In 1955, the firm gave space to super investor Walter Schloss when he left Graham-Newman — an arrangement it continues with Schloss and son Edwin to this day. Schloss introduced the firm to Warren Buffett

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
"WE SHOULD ALL HAVE LOWER EXPECTATIONS —
IN FACT, MAKE THAT *DRAMATICALLY* LOWER...."

Amazingly, \$10,000 invested in Buffett Partnership, Ltd. in 1956 and reinvested in the stock of Berkshire Hathaway at the partnership's termination in 1969 would today be worth well over \$200 million — *after all taxes, fees and expenses*.

Incredibly, even those figures understate Buffett's feat. Believe it or not, before fees, but after all taxes, the \$10,000 would have grown to more like \$400 million.

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OID MAILBAG:
GARDNER INVESTMENTS' TOM RUSSO
(cont'd from page 1)

NARROWER AND NARROWER MARKET LEADERSHIP
PLUS "NIFTY" VALUATIONS = GROUNDS FOR CONCERN.

I must have missed a class. And now I'm missing the party.

Tom Russo: In light of some of the questions that arise when I observe today's investment markets, I wonder whether I may have slept through some important classes at Stanford Business School. Possibly there was an additional class given in our investment seminars I missed that would have helped explain some of the frenzied passion that besets pockets of today's investment world.

I'm reminded of the metaphor a colleague of mine once used. He said he felt like he was at home studying while others were living it up at parties. That feeling surely describes my present in which I find myself focusing on ... value while the world seems to be drinking deeply of the internet/technology elixir. But focusing on proven lessons has always rewarded more predictably than partying and punting on exams in the past. And I trust that the past will remain prologue to the future in investing, too.

It's all about beating estimates. To hell with everything else.

Russo: Today's markets are increasingly volatile — with returns generated by an increasingly narrow subset of companies. Market volatility, which seems greater than any time in recent memory, relates to several factors. Investors seem more interested in whether companies can meet or exceed their quarterly earnings estimates than in whether they're fairly valued relative to ... earnings. A company that can modestly exceed its quarterly estimates may very well advance sharply in today's market, despite P/E multiples of annual earnings that cannot be justified by long-term growth rates nor by prevailing interest rates on alternative investments.

Obviously, company managers aware of these rewards increasingly try to game the system for personal reward — thereby increasing the focus on nearest-term results. Those that disappoint see their share prices ravaged (e.g., Gillette, Coca-Cola, Avon Products, Xerox, etc.).

Volatility has also surfaced markedly in the field of merger-related disappointments. Companies merging with great promises of operating synergies and cost savings all too frequently report to investors on the difficulty of accomplishing sought-after merger benefits. Share prices of many well-known companies (e.g., Mattel, Federal-Mogul, Newell-Rubbermaid, McKesson, Unum, Waste Management, to name just a few) have been halved as merger diseconomies became public. So much for the efficient market theory...

Returns are coming from a narrower and narrower group.

Russo: The market performance of the S&P 500 provides stark evidence of how narrow is the subset of companies generating positive returns that most investors hear about when they review year-to-date performance. Attached is a table (see page 10) highlighting just how dependent have been the S&P 500's year-to-date returns on the performance of its 20 largest companies. The top

20 companies (names you will easily recognize) have on a weighted-average basis contributed the majority of the entire S&P 500's year-to-date returns. (They've cumulatively contributed 4.4% of its 4.6% total return.)

[Editor's note: As of 12/10/99, we calculate that they've cumulatively contributed 8.8% of the S&P 500's 14.4% year-to-date returns.]

The group's really nifty — a P/E of 64 and 38 times EBITDA!

Russo: Narrowness alone would not be so worrisome were it not for the seemingly high valuation multiples which this "nifty" group enjoys. On a weighted-average basis, the members of this group have a P/E multiple of 64 and an EV-to-EBITDA multiple of 38. (sic.)

[Editor's note: As Russo explains, EV-to-EBITDA means enterprise value divided by earnings before interest, taxes, depreciation and amortization.]

Despite their promised high growth, these multiples require far greater faith in future prospects than do the holdings that make up the portfolios I oversee — which have weighted-average P/E and EV/EBITDA multiples on average of 20 and 10, respectively. While foregoing the promise of rapid growth, our portfolio's lower valuation should provide stronger protection should results fall short of such enthusiastic expectations or should interest rates increase, pressuring overall multiples downward.

WE KNOW WHY WE'RE DOWN: INTERNET FEARS,
A RISING DOLLAR AND TOBACCO LITIGATION WORRIES.

Markets' attention span has gotten shorter. Mine hasn't.

Russo: Against this backdrop of increasingly volatile markets whose returns are generated by fewer and fewer stocks, I endeavor to keep my investment time horizon long — seeking to identify and hold on to solid companies capable of generating consistent cash returns. What this often means is that [stocks] which performed strongly in one year lag in another, awaiting another leg up.

This happened to Heineken several years ago, when its performance lagged for nearly two years. Heineken's 1998 performance, however — up nearly 95% — made up for that wait. A similar, though slightly less robust, pattern of market performance was true in 1998 for Telegraaf, Weetabix and Diageo, whose share prices appreciated 42%, 26% and 24%, respectively.

While all four have declined in dollar value this year, all have the capability of strong repeat performances — and I plan to stick around for the show. In the meantime, continued holding of these stocks helps to defer realization of embedded capital gains, which continues to have investment value even in today's world of reduced federal capital gains taxes (now 20% for long-term realized gains).

We enjoyed 1998 much more than we've enjoyed this year.

Russo: Year-to-date, our holdings remain down — even though some have recovered in value since the close of the third quarter. In part, this decline reflects the strength our investments enjoyed last year relative to many other value investors and international investors.

Our relatively strong performance last year may have borrowed in part from this year's performance. Heineken's

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GARDNER INVESTMENTS' TOM RUSSO
(cont'd from preceding page)

strong performance in 1998 in part set the stage for its 1999 pull-back (down nearly 25%). While the two-year return remains attractive, decline years are never pleasant. However, I am patient in absorbing such swings due to the continued positive outlook for Heineken and our other investments over the long term.

[Editor's note: Through 12/10/99, Diageo, Telegraaf, and Heineken were down 25.8%, 26.2% and 32.2%, respectively, year-to-date in U.S. dollars.]

Three main factors have influenced our year-to-date results: First, our newspaper industry holdings have been under pressure induced by fears about threatened competition from the internet. Second, our international holdings have come under pressure, in part due to the strength of the U.S. dollar. Third, our tobacco holdings have been adversely impacted by threatened federal lawsuits, a Florida class-action lawsuit and adverse jury rulings in two West Coast individual-plaintiff lawsuits.

RUMORS OF NEWSPAPERS' DEMISE
HAVE BEEN GREATLY EXAGGERATED.

The flip side of the internet craze has descended on papers.

Russo: For much of this year, investors in newspaper company shares would probably agree that the old description of a newspaper ("black and white and read all over") could be slightly modified to describe them ("black and blue and red-faced" from embarrassment). Newspaper-company shares have trailed the market, and in some cases declined, this year due in large measure to investor fears over the threat from the internet to newspapers' core advertising franchises — most notably, classified advertisements.

The flip side of investor fear for newspapers' future is their greed expressed through their desires to participate in internet start-ups (those businesses intended to dislodge traditional media at almost any price to existing earnings). Because investment capital is finite, dollars moving from traditional media to new media has an effect in the near term of lowering values of traditional media companies — which, in part, has occurred year-to-date in 1999 for several of our large holdings.

Rumors of newspapers' demise have been much exaggerated.

Russo: Headlines often signal investment opportunity. I'm reminded of the headlines that appeared last October in *The Economist* in which they declared that oil prices, then hovering around \$11 per barrel, were surely heading lower for a variety of knowable reasons. I'm reminded similarly of this by the article which I received from many

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of my investors in late summer, also from *The Economist*, entitled, "Caught in the Web" similarly forecasting the demise of the newspaper industry.

Newspaper executives, better than any other group of businessmen, stay close to headline-breaking news stories. And I believe managements at the newspaper companies in which we've invested are working hard to ensure that rumors of the demise of their industry remain premature. They've taken many steps to make it more difficult for anyone to unseat them from their dominant positions in local news, information and advertising.

They continue to localize and regionalize their product. Increased attention is placed on stories of local interest and on running separate zoned editions in larger markets where zoning may be necessary to increase local feel. Newspapers have increased color capabilities to enliven their stories and broaden appeal to advertisers. Newspapers modify production schedules and delivery patterns to insure that they can go to press as late as possible while still arriving ever earlier on subscribers' doorsteps. Newspapers introduce increasing numbers of sections, offering readers more dedicated content and advertisers with special needs ways to appeal to targeted audiences.

Even Microsoft hasn't managed to crack the newspaper nut.

Russo: Finally, they're deeply engaged internally in ways to expand their offerings using the internet. They deliver constantly updated editorial through internet sites. They offer internet complements to printed advertising. They increasingly offer community portals, whereby newspapers attempt to ensure that they remain the site sought after for relevant community information.

Evidence of newspapers' lasting relevance abounds. Internet-only entrants into major markets have been largely unsuccessful in unseating embedded newspapers. Microsoft's ambitious efforts to penetrate the newspaper's domain in content and advertising has proven to be an expensive, unrewarding experiment. They could not compete on content. Even for advertisers adventurous enough to advertise on its content-lacking sites, Microsoft's Sidewalk.com found it difficult logistically to guarantee advertisers that the advertising for which they contracted would indeed run and that advertising for which they were billed in fact ran.

The new media seems to think newspapers remain relevant.

Russo: Another telling expression of the remaining vitality of newspaper advertising is the extent to which newspapers (and other traditional media) are being used by internet start-ups for their *own* advertising. In their efforts to establish brand awareness quickly and to capture the internet world's goal of "first mover advantages," dot-com companies dedicate enormous percentages of their finances towards advertising through newspapers.

In light of the enormous amount of capital raised by new media companies intent on directing large amounts of money to newspaper advertising, this new category seems capable of helping newspapers to rapidly grow their national categories for a long time.

The internet isn't only a threat; it's also an opportunity.

Russo: Managements of all our newspaper holdings are themselves taking steps to embrace new media and

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new technologies. Central Newspapers, Inc., for instance, is investing directly in their internet newspapers' editorial and advertising capabilities. Central Newspapers has co-invested with numerous internet newspaper joint ventures, contributing investment capital, editorial content, and classified advertising where appropriate. And it's expanded its job-fairs business to the internet, offering electronic resume services and electronic job fairs.

E.W. Scripps Company has taken similar steps. They've also funded a venture capital investment pool (which has now committed over \$150 million) to seek out investment opportunities in the new media area. Many of Scripps Ventures' earliest internet investments, moreover, have had direct value/applicability to efforts underway in its parent's other business units, such as Syndication and its fast-growing Category Television ... division (which includes Home and Garden Television Network and The Television Food Network).

Efforts similar to both those at Central Newspapers and at E.W. Scripps abound at The Washington Post. In addition to its newspaper-related internet activities and extensive internet industry venture stage investments, it's developing extensive new media applications through its Stanley Kaplan division, focusing on career training, education assistance and lifetime learning (even going so far as to open up the first-ever internet Law School!!).

Two capital structure challenges with the same solution.

Russo: All these efforts at new media for each of our portfolio companies present capital structure challenges and opportunities. The main capital structure challenge is how to make these needed investments without disrupting equity valuations. Mature companies with existing profit streams are typically valued on the basis of their present earnings. Internet-related investments cost money and generally generate losses. Losses reduce earnings, weighing on valuations of traditional media companies.

Internet-only companies, by contrast, are valued by the market seemingly based on the order of magnitude of the business they seek to someday capture. Accordingly, the market doesn't penalize such new ventures for losses incurred up front. In fact, the investor relations director of one prominent internet-only company recently suggested the market ought to increase the value of his company's shares because they were committing to lose more money than originally forecast....

The second capital structure challenge our companies face involves managing their new ventures. How can traditional media companies retain and reward required talent when internet start-ups lure that same talent with promises of enormous stock option largesse?

Both challenges — dealing with start-up losses and attracting/retaining key talent — lead our managers to consider separately listing shares of their new ventures. Doing so may indeed be a capital structure opportunity, as it will allow the market to independently value these embedded new business opportunities.

THE PRICE OF NEWSPAPER SHARES IS RIGHT —
AND CATALYSTS TO CLOSE THE GAP ARE IN PLACE.

A few words on private market value and enterprise value.

Russo: The final attraction to our holdings in the newspaper industry has increased this year even as some of their share prices have declined. Our companies' stocks trade at prices that value their overall enterprises at substantial discounts to their private market values. A company's enterprise value is the sum of the market value of its equity and liabilities less the value of its financial assets and other assets not related to its core business. Private market value is the price a buyer — presumably a reasonable one — would pay to buy the entire company.

Private market values far exceed stock market valuations.

Russo: When we first became involved with our direct cable investments (primarily Comcast), a similar situation prevailed. Cable companies traded in the public market at valuation multiples far lower (around six times operating cash flow) than those prevailing in the private market (around nine to ten times). And Microsoft's willingness to commit meaningful funds into Comcast's shares triggered a sharp revaluation of cable companies overall.

Similar disparities between the private and public market valuation levels exist today in both our domestic and our international newspaper companies.

Private market value levels have been established recently by acquisitions in the U.S. and elsewhere. The San Francisco Chronicle, for example, recently sold for a price (i.e., ...[in excess of] \$500 million) estimated to be well in excess of 13 times EBITDA.

This valuation contrasts with the public valuation of under eight times EBITDA for Central Newspapers (which is essentially a newspaper company) and of eight or less for the newspaper-only operations of The Washington Post and E.W. Scripps, adjusting for the value of non-newspaper investments and operations held by both.

Though it is somewhat startling that such a high multiple would have been available for a paper in a large urban area (with so many competitors for readers' eyeballs) and in an area so close to the very heart of Silicon Valley, it was less surprising to read that even *higher* multiples of EBITDA were paid recently by Pulitzer Publishing for a cluster of regional newspapers recently sold in the Midwest by the Chronicle Publishing Company.

Outside the U.S., the valuation story is much the same.

Russo: Private market valuation multiples similarly exceed the public market multiple afforded our largest non-domestic newspaper company investment, De Telegraaf. Two recent acquisitions in Europe show that private market multiples remain high for newspaper companies. First, Gannett Company recently acquired Newsquest, a United-Kingdom-based newspaper chain. Gannett is reported to have paid more than 11 times EBITDA in order to acquire this dominant chain of regional newspapers.

Second, VNU recently sold a portfolio of dominant regional Dutch newspapers for over 13 times EBITDA. Ironically, our Dutch newspaper company, De Telegraaf, was the ultimate buyer of one of the former VNU papers, presumably paying at least that multiple.

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Telegraaf remains dirt cheap.

Russo: Telegraaf's substantially lower public market valuation than that which prevailed in both Britain and The Netherlands provides a substantial margin of safety for our investments in this leading publisher. Ironically, this margin of safety has actually increased this year in light of the fact that its share price has declined. A brief review of Telegraaf's enterprise value to EBITDA reveals how undervalued it is relative to its private market value:

Equity market value (52.5 million shares)	930 million ¹
Less: Net cash	275
Less: Investment in Wegener	100
	<u>Investment in television</u>
	100
Equals: Adjusted enterprise value	455 million ¹
Divided by: <u>1999 Estimated EBITDA</u>	140
Equals: EBITDA multiple	3.25 times

¹Euro

Forces are underway that could unlock embedded value....

Russo: Investors often ask, "So why should we care if a company's undervalued. If it will remain so, who cares?" Aside from the obvious response that it's always better to underpay versus the alternative, two reasons underpin my continued holdings in our newspaper investments:

First, the environment is not static. Also, forces are underway that could unlock embedded value. Again, many of our domestic investments are considering offering public shares in their own internet operations to unburden their core businesses from losses, to offer shares in a discrete entity to better serve employee recruitment and retention and to highlight their values.

Second, the regulatory environment is fast changing, forcing companies to rethink their portfolio of activities. For instance, FCC regulation changes have accelerated the pace of industry consolidation amongst cable operators. This development may force The Washington Post Company to review whether it makes sense to realize the rapidly appreciating value of its cable operations, avoiding the risk that its cable competitiveness declines due to increasingly small scale.

Similarly, rules allowing multiple television ownership in cities must force The Washington Post and E.W. Scripps to consider how best to realize and/or protect the value of their television-station portfolios. Finally, proposed relaxation of the FCC consent decree that's long prevented television operators from owning stations and newspapers in the same market would surely increase the pressures for newspaper-industry consolidation, potentially leading to mergers among our domestic newspaper holdings.

Depressed prices create an opportunity to buy back shares.

Russo: The second reason for my continued excitement is that depressed stock prices allow our managers to buy more of their company's shares below intrinsic values, increasing the intrinsic value *per share* of the shares which remain outstanding. Central Newspapers has taken advantage of this opportunity by retiring nearly 25% of its

outstanding shares over the past year. E.W. Scripps and The Washington Post remain buyers of their own shares.

Sadly, the one company that enjoys the largest discount in its public market valuation, Telegraaf, is not now actively repurchasing shares. Needless to say, I lobby aggressively to encourage Telegraaf to take advantage of the market's myopia despite protestations on their part about domestic tax law restrictions, etc....

INVESTOR MIGRATION FROM TOBACCO CONTINUES.
BY CONTRAST, I'VE CHOSEN TO REMAIN INVOLVED.

Investors have continued to migrate away from tobacco.

Russo: As I review market declines in the value of our portfolio tobacco holdings, I find it useful to consider the long view..., as clearly many of my investors wonder why I would bother with such controversial holdings.

Holdings in tobacco-related investments have been increasingly controversial since as early as the Cipollene case in the mid-1980s. Political landscape and investor sentiment towards the group began their present decline around the time of the 1993 Congressional Hearings. Since then there has been a steady migration of investors away from the industry, both by fiat from investors and foundations uncomfortable with such investments and by investor preference to avoid complexity.

For a handful of reasons, I've chosen to stay.

Russo: I, by contrast, have remained involved for several reasons. First and foremost, I have been impressed with global brands and global growth prospects enjoyed by brands that our major holding, Philip Morris, possesses both in tobacco and non-tobacco product lines (e.g. Kraft Foods, General Foods, Miller Brewing Company, etc.).

Second, I have been impressed with the ability to purchase shares at substantial discounts to intrinsic value due to litigation/judicial/regulatory fears and investor antipathy. Third, I've been encouraged by their potential to accelerate growth in per-share intrinsic value through share repurchase at steeply discounted valuation levels.

Fourth, I've long believed the industry, disliked though it is by many, would ultimately be able to defend its conduct based on traditional tort defenses, buttressed by several tobacco-industry-unique defenses (e.g. FDA-mandated warning labels, etc.).

And up until recently, we'd been well rewarded.

Russo: Despite a declining political environment, we've been rewarded for our patience over the five years prior to 1999. Our largest holding, Philip Morris, has generated a compound annual return of 29% over the five prior years (compared to a 24% [compound annual return] for the S&P 500). And Rothmans Inc., Philip Morris' Canadian joint venture, has produced attractive, albeit slightly lower, returns over this same period.

Tobacco industry suppliers have been a different story.

Russo: Our returns from investments in tobacco industry suppliers, DiMon and Schweitzer-Mauduit, however, have been disappointing, even prior to this year, as both companies faced significant shortfalls due to sharp changes in consumer behavior in emerging markets.

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Economic turmoil in those markets caused reduced consumption and an adverse change in product mix away from the once-popular more expensive Western-style products.

Both DiMon and Schweitzer-Mauduit responded to resulting declines in their product demand by reducing operating costs, closing facilities around the world, etc. Operating leverage from now-lowered cost structures have positioned both companies to enjoy strong profit growth as Asian economies recover and their demand for more expensive Western-style products recovers. Prospects for such recovery and unusually low valuations (nine and six times year-2000 earnings for DiMon and Schweitzer-Mauduit, respectively) underpin my continued holdings.

IF BUSINESS DOESN'T HANG TOGETHER,
IT MOST ASSUREDLY WILL HANG SEPARATELY.

To invest in Philip Morris requires courage in our system.

Russo: Investing in Philip Morris and related suppliers, nevertheless, despite low valuations, sound management, solid brands (for Philip Morris) and strong cash flow, remains an act of courage in our political process. Will these companies, despite great public censure, enjoy rights in law available to all "citizens"?

Continuing with the metaphor with which I began this letter, a final school memory that relates to this political question arose this fall when my family and I attended a presentation of Robert Bolt's play, *A Man for All Seasons*. The play has left an important impression on my thoughts about government ever since Professor Anthony Scalia (then a visiting professor at Stanford from Chicago) used it to introduce his first-year course in Constitutional Law. Though the characters and setting are centuries old, the play's message seems unusually relevant today.

"When the last law was down, where would you hide?"

Russo: The play's central message, that no man is above the law and that laws are established to protect individuals against overzealous state governments (and/or monarchies), seems relevant to many of the legal challenges confronting the domestic tobacco industry and increasingly awaiting other industries.

The following exchange, between play characters Will Roper and his father-in-law, Thomas More, about why More would not arrest a person simply because he seemed a threat to Sir Thomas's welfare, suggests why it is so dangerous to seek outcomes, without regard for legal rights, just because an individual or industry is deemed "bad":

MORE: And go he should, if he was the Devil himself,
until he broke the law!

ROPER: So now you'd give the Devil benefit of law!

MORE: Yes. What would you do? Cut a great road
through the law to get after the Devil?

ROPER: I'd cut down every law in England to do that!

MORE: (*Roused and excited*) Oh? (*Advances on ROPER*)

And when the last law was down, and the Devil turned round on you — where would you hide, Roper, the laws all being flat? (*He leaves him*) This country's planted thick with laws from coast to coast — man's laws, not God's — and if you cut them down — and you're just the man to do it — d'you really think you could stand upright in the winds that would blow then? (*Quietly*) Yes, I'd give the Devil benefit of law, for my own safety's sake.

Page 66, *A Man for all Seasons* (Robert Bolt, Vintage Books: 1966)

Once the genie's out of the bottle, it won't stop with tobacco.

Russo: While the above excerpt may not convey the full force of the play's message, I commend the play heartily as it sets the stage for how important principles of proof, causation, proper rules of procedure, etc., are for the protection of both individuals and corporations. Unfortunately, just as Thomas More suggested to his son-in-law, Will Roper, I fear that it will prove hard to rein in litigation once legal defenses are denied to industries even as out-of-favor today as the tobacco industry.

IF YOU THINK RUNAWAY LITIGATION IS LEGAL FICTION,
THEN THINK AGAIN — BECAUSE IT'S ALREADY BEGUN.

Even a company with as solid a record as AHP can be cowed.

Russo: Evidence of this threat abounds in business today. American Home Products was recently forced into a \$4.8 billion settlement to a class of plaintiffs potentially harmed by their weight-loss pills. The path to this expensive settlement was speedy. Health fears caused a product recall. Individual suits followed, resulting in a recent \$25 million verdict in Texas. A nationwide class-action lawsuit of all potential plaintiffs was soon certified.

Shortly later, the supposedly apolitical FBI announced an investigation into allegations American Home Products might have lied to the FDA in its application for this particular drug. Such allegations by the FBI coupled with the threat of a nationwide class-action lawsuit capable of asserting nearly limitless punitive damages for "fraud and lying," going before a jury, led the company — even one with as solid a record as American Home Products — to feel the need to settle quickly.

Impartial justice? It's becoming more like a beauty contest.

Russo: General Motors recently lost a \$4.9 billion verdict (reduced on appeal) involving personal injuries arising from a fiery crash. No defense General Motors could mount would likely have been able to dissuade the jury from its view the company behaved badly and that they based product-design decisions on profit over safety.

Whirlpool recently suffered a sizeable jury verdict against it (\$670 million) when a jury ruled two plaintiffs were overcharged several thousand dollars for a satellite television dish by a wholly independent sales agent who happened to finance the purchase through Whirlpool's Credit Corporation. Such large verdicts, moving increasingly away from recovery for proven, actual harm, increasingly punish for the *appearance* of being bad.

First, tobacco. Next, insurance. Then the auto industry.

Russo: The insurance industry seems particularly

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**OID MAILBAG:
GARDNER INVESTMENTS' TOM RUSSO**
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ripe for such lawsuits. State Farm Insurance recently lost a case (\$450 million in damages, with additional punitive damages claimed of \$4.5 billion) due to their efforts to reduce auto repair costs by using parts not manufactured by big auto companies. And this verdict may prove to be only the first of many. A second class-action lawsuit is now being threatened against State Farm by the same plaintiffs' attorneys for the same activities — in this case for acts occurring after February, 1998.

Finally, not content with just suing State Farm, similar suits are being prepared against the entire automotive industry alleging conspiracy and fraud (vaguely reminiscent of the tobacco claims insofar as they no longer even have to rely on establishment of specific harm).

And HMOs are unpopular. So damages could be huge.

Russo: The State Farm verdict is particularly ironic for two reasons. First, consumer advocates generally sided with State Farm as its practices in effect allowed for lower premiums by avoiding higher-priced parts manufactured by car manufacturers. Second, "manufacturer authorized" parts that would have presumably saved State Farm from suit are increasingly manufactured by the same independent suppliers with whom State Farm dealt. They simply weren't marked "manufacture approved" — markings which presumably would have increased costs. Ironically, State Farm is a mutual insurance company, owned by its policy holders. So allegations of "profiteering" at the expense of the insured seem unusually out of context.

Finally, just this month the HMO industry finds itself before the class-action plaintiffs' bar for allegations of "fraud" in representing how they will offer and supervise health care. Damages in this latter case potentially could dwarf those discussed above, precisely because the industry is so broadly unpopular.

At first, the public may applaud; but the bill will come due.

Russo: I hope, by these examples, to highlight how legal principles and practices, applied with public fanfare and applause when directed against tobacco, may over time leave the public surprised by their broader application. The main legal concern with these cases is that lawsuits attempt to accomplish through litigation that which has

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not succeeded through legislation. Manufacture and sale of cigarettes remain legal. Policies relating to HMO immunity from liability have long been set by ... legislation. State law typically sets the standards for auto insurance practices, legislatively enacted laws that will now in effect be overridden as a result of the recent State Farm decision.

Moreover, all these decisions in the end work their way back to consumers through higher prices. Cigarette prices go up to cover settlements. Auto insurance premiums will rise if insurers, by recent court decisions, are forced to use more expensive replacement parts. Health insurance and HMO services will rise in cost if practices intended to control expenses expose insurers to open-ended damages. The many will bear the costs for the few of such decisions.

I expect tobacco to prevail, but I'll also watch things closely.

Russo: While over time popular displeasure about the costs and effects of such litigation may lead to legislative/judicial reform, I will not base my decisions about our investments in tobacco companies, insurance companies (cf., Berkshire Hathaway's GEICO subsidiary and American General's small health insurance activities), etc., hoping for such reform. In fact, fears that two adverse jury awards could augur a trend underpinned my decision to reduce our Philip Morris stake earlier this year. I'll continue to monitor tobacco litigant cases for further such developments, but I take comfort in the industry's record of six wins following the two West Coast cases.

Similarly, claims by third parties for recovery on behalf of large classes have largely been dismissed on the basis of remoteness. A similar fate will likely await the recent Justice Department suit, even despite its novel claims for equitable relief under RICO. Class-action cases like the Engle case now in Florida against the tobacco industry will likely prove to be unsupportable upon appeals. Nevertheless, despite the above observations, I continue to watch for contrary evidence.

In the meantime, shares of Philip Morris and other tobacco-industry suppliers continue to have unusually low valuations (seven times, nine times, and six times, respectively for Philip Morris, DiMon and Schweitzer-Mauduit). Managements at both Philip Morris and Schweitzer-Mauduit are taking advantage of these low valuations through share repurchase.

WE KNOW WHY ITS STOCK PRICE HAS DECLINED,
BUT FEARS ABOUT BERKSHIRE ARE MISPLACED.

Its holdings are down, but they're less important than ever.

Russo: ...I felt it would be helpful to address ... questions I hear from [you]: First, what should we make of [the decline in] Berkshire Hathaway's share price?

Berkshire Hathaway's share price has taken an uncharacteristic decline — down nearly 20% year-to-date — following several years of dazzling outperformance. Several factors appear to be behind this weakness. First, many investors fear loss of value triggered by declines in prominent Berkshire Hathaway portfolio holdings (e.g., Coca-Cola, Freddie Mac, Gillette and, to a lesser extent, The Washington Post).

While disconcerting, such declines mean less to its value than in years past, as Berkshire's future growth in

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value will depend increasingly on the performance of its wholly-owned insurance businesses (e.g., GEICO and General Reinsurance) and operating companies (e.g., Executive Jet, furniture retailers, jewelers, etc.).

Fears about GEICO are misplaced. It wants lower margins.

Russo: Second, many investors fear softness in GEICO's results — fearing prolonged downturn in automobile insurance and threats from internet-based insurance competitors. Both fears seem misplaced. GEICO's operating-result declines appear largely to be of their own making. GEICO aspires to a far greater share of the domestic auto insurance market. And they're taking advantage of their remarkable cost advantage to lower premiums in an effort to gain market share.

Berkshire has also sharply increased advertising of GEICO to increase consumer awareness and demand. The High policy-renewal frequency and the resulting operating leverage ... should make these moves pay off long term even though they reduce reported profits in the near term.

General Re came loaded. Its cash will be put to good use.

Russo: Third, **Berkshire's** acquisition of General Re seems to have had a dual adverse impact: They acquired it just before the reinsurance industry's operating results turned sharply worse. And General Re shareholders who received Berkshire shares seem to be net sellers of those rather illiquid shares.

What investors are overlooking, however, is that Berkshire issued shares at considerably higher prices when they bought General Re. And it acquired an enormous pool of investable cash with its reserves. I feel comfortable that the cash will be put to good use, especially in light of increasingly volatile domestic-securities' markets. On balance, principal investor concerns over Berkshire seem focused on problems that will likely pass.

AT MARTIN MARIETTA, THERE'S A LOT TO LIKE:
HIGH QUALITY EARNINGS, GREAT PROSPECTS & MORE.

For several reasons, Martin Marietta's prospects are great.

Russo: What has caused **Martin Marietta Material's** shares to decline?

Martin Marietta Materials is the second largest producer of crushed stone in the U.S. Martin Marietta's quarries are well located throughout fast-growing regions (with dominant market shares in much of the Southeastern U.S.) and are particularly well located to benefit from the multi-billion-dollar increases already funded in federal highway spending bills. And they largely face little competition, given the competitive advantage well-located quarries have due to crushed stone's heavy shipping costs.

Finally, Martin Marietta Materials is well managed by the same shareholder-value-minded leader, Stephen Zelnak, Jr., who first interested me in this business over a decade ago when it was still a division of Martin Marietta Corporation. (Shares of Martin Marietta Material's former

parent, now named **Lockheed Martin**, remain a drag on our performance as they have encountered program-specific problems. I am tiring of management's promises of decisive action to restructure and review their shares for sale.)

A discount to PMV + super prospects = our kind of stock.

Russo: **Martin Marietta's** share-price decline this year stands in sharp contrast to significant gains over prior years. More importantly, its present share price overly focuses on near-term-earnings' disruptions experienced due to costly hurricane-related flooding. (Hurricane Floyd particularly disrupted Martin Marietta's sizeable quarry presence in North Carolina.)

Martin Marietta's shares trade for less than 13 times expected 2000 profits — a substantial discount to recent prices paid for acquisitions of less valued properties and far below a price that would reflect the certain, strong growth prospects the company faces due to large, future spending programs.

THE INTERNET WILL TRANSFORM THE WORLD.
BUT THE QUESTION IS, "AT WHAT PRICE?"

Investors risk greater harm from good ideas than bad ones.

Russo: What is an investor to do with the internet?

When asked by investors about how they should position their portfolios to best profit from the internet, I'm reminded of an expression which has often been used at **Berkshire Hathaway's** annual meetings when Berkshire's chairman, **Warren Buffett**, responds to questions about investment trends. Mr. Buffett, who attributes this observation to his mentor, **Benjamin Graham**, replies that investors risk greater harm ... from good ideas than from bad ones. Bad ideas are usually palpably so, and soon die of their own inertia. Good ideas, however, can truly take wing and soar, lifted by investors' boundless enthusiasm.

Paying too much turns investing into "musical chairs".

Russo: Investor peril rises with such good ideas for a couple of reasons. First, valuations simply become overly enthusiastic. Ultimately, investors must rely on business cash flows to underpin their long-term returns. However, short-term returns can, of course, occur by selling their fast-moving shares on to the next investor. Unfortunately, no one rings a bell to announce the end of such short-term trading opportunities, leaving long-term investors with cash flow requirements to underpin their returns.

Accordingly, overly optimistic investors can face harm from "good ideas" simply from paying too much for their future cash flows. (Today's internet arena has some of these characteristics, especially as newly public companies can trade for 50 times future sales, not cash earnings!)

The second peril involves Wall Street's ability to take public endless copycat companies, all seeking the same, albeit "good," business ideas. Easily available low-cost equity capital chases away returns on Wall Street, as newly funded competitors chase ultimately finite opportunities, driving away profit potential in the process.

I'm not suggesting the internet will not transform our lives.

Russo: Despite my concerns for investors who pursue short-term profits and do not remain long term in

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GARDNER INVESTMENTS' TOM RUSSO
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their focus, the internet does truly stand to transform our business and personal lives. The risk is that one is asked to pay too much for this future promise — not that the transformation will not occur. One only needs to look locally to witness this transformation.

For instance, many long-standing local bookstores, selling both new and used books, have shuttered due to lost new-book sales to Amazon.com and the superior efficacy of offering used books over the web. Landlords with now-vacant retail space will surely confirm the web's business-transforming effects. I recognize this potential for change (both positive and negative) when reviewing all of our investments, not just our newspaper holdings. Internet banking and finance, for example, are pieces of the attractions of our investments in Wells Fargo, Citigroup and Morgan Stanley/Dean Witter.

Wells Fargo best epitomizes this, given their early launch of internet banking. Wells Fargo now leads the nation in numbers of customers active on the internet (over one million). While this should come as no surprise, given Wells Fargo's base just north of Silicon Valley, what is surprising is the sensible way in which senior management of Wells Fargo regards their internet activities as just one part of their overall client service offerings.

Internet-only companies will need more than enthusiasm.

Russo: The merger of Wells Fargo and Norwest Bank has combined Wells Fargo's expertise in technology with Norwest's skills at marketing and at cross-product customer solicitations. Norwest's efforts will become more cost efficient with Wells Fargo's technology. Wells Fargo's banking activities will become more effective once guided by Norwest's retail-oriented culture. The internet will simply be another tool in the technological array of serving customers' needs. Wells Fargo's clients will be able to conduct business seamlessly through traditional branches, supermarket-based branches, ATMs, telephone banking centers and internet banking centers. Broad choices should increase the likelihood that customers will take multiple banking products, leading to higher bank margins.

Excess enthusiasm over internet competitors to traditional businesses appears to boost valuations of internet competitors to two of our portfolio companies: Wells Fargo and Hasbro. Internet-only banks, over time, will likely find it hard to compete with Wells Fargo's more complete offerings.... Nonetheless, this does not prevent markets from richly valuing internet-only banks in the near term. Net.b@nk, Inc., for instance, at its peak was valued in excess of \$2 billion, despite then having only 30,000 banking customers. (Compare this to Wells Fargo's over one million active customers.)

E-companies will change things. It's a question of price.

Russo: internet-only consumer-products companies' share prices also flourish over promised changes to shopping patterns. eToys Inc., for instance, at its peak enjoyed a market value of nearly \$10 billion — despite having estimated revenue for the current fiscal year of only \$113 million (which compares to prior fiscal-year revenues

of \$30 million) and no profits.

Contrast this to toy-industry supplier, Hasbro, who not only has the dominant line-up of brands across all categories (e.g., board games, boys' toys, puzzles, electronic toys, and video games), but also has an internet gaming site (Games.com) and plans to participate in e-commerce. Hasbro's equity, by contrast, sells for only \$3.6 billion, despite enjoying estimated 1999 revenues of \$4.0 billion and estimated 1999 net cash earnings of \$400+ million. eToys undoubtedly will disrupt traditional toy retailing. However, the present valuations of both eToy and Hasbro suggest that the market feels that eToy's long-term success and Hasbro's long-term decline are far more certain than I believe either to be.

Old media holdings let us participate at old media prices.

Russo: Finally, recent events should highlight how our holdings have been able to participate in the internet activity — even if indirectly. Central Newspapers, Inc. recently received a rich bid of \$85 million from Homestore.com, Inc. for its stake in Homefair.com. — a 1999 start-up which provided home moving and relocation information on-line. Homestore.com ... could afford to pay a lofty price for this privately held subsidiary of Central Newspapers because of its own lofty stock market valuation (\$2.6 billion). Central Newspapers will likely redirect proceeds back into its core newspaper business and internet extensions.

Comcast has enjoyed similar internet success — turning a small seed investment in an internet venture pool into a holding (Internet Capital Group) with its stake now valued at more than \$1.2 billion. This internet investment largesse is in addition to growth in Comcast's value coming from applying its core businesses to the internet (e.g., cable modem sales, @Home offerings to cable customers and iQVC development of an internet commerce extension of its dominant television retailer).

While neither Comcast nor Central Newspapers appear to offer direct internet exposure, they, like many of our holdings, do in fact participate in these developments and allow us to participate at more conventional valuations (with Central Newspapers certainly at a lower valuation than Comcast).

HIGHER INTEREST RATES = LOWER STOCK PRICES.
HOWEVER, THAT MAY BE GOOD NEWS FOR US.

Rate increases make sense. Therefore, lower P/Es do, too.

Russo: What are your thoughts about the current investment environment?

Equity markets, particularly in the U.S., face a fairly strong headwind from rising interest rates. This is because interest rates directly affect P/E multiples. Declining rates support rising P/E multiples. Rising rates support lower P/E multiples. Last year at this time, the Federal Reserve had just completed its third (and quite unexpected) interest-rate cut of the year in an effort to provide liquidity to markets beset by global financial meltdowns. As a result, U.S. long-term interest rates ... declined to 4.75% — a level not seen for decades — allowing investors to take P/E multiples higher.

But U.S. interest rates have risen for most of this year — which should lead to lower P/E multiples for equities.

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Year-to-date in the U.S., this hasn't happened, as measured by most major market indices, which have experienced higher, not lower, average P/Es. And since I believe the interest rate increase makes sense for several reasons, I fear that overall equity P/E multiples will have to decline.

The good news? Such lower valuation multiples should make stocks more attractive, thereby allowing us to commit our remaining portfolio reserves.

Why did U.S. interest rates increase? It's very simple....

Russo: U.S.-rate increases reflect several factors.

First, commodity costs have increased as global demand for oil, coal, steel, paper, etc., has increased — especially in developing markets where GDP growth has been restored, following declines that accompanied last year's financial crises. Second, U.S. interest rates will likely increase as political-flight capital — which was directed into our treasury bonds by foreigners seeking protection during last year's crises — returns home. Third, foreigners are becoming increasingly concerned about persistently high U.S.-current-account deficits — thereby forcing the U.S. to pay higher rates to attract the offshore funds required to underwrite our national overconsumption.

Ill wind that's coming stands to fill our companies' sails.

Russo: This rising-rate environment will likely lead to lower P/Es, making new investments for Semper Vic's cash reserves more attractive.

At the same time, I believe our existing investment holdings should withstand the impact of rising rates for several reasons: First, we start with below-market multiples. Second, our companies are less

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dependent on lower interest rates to underwrite their businesses, leading to cash flows and earnings that are less vulnerable to the adverse business impact of rising rates.

Third, the strength of our companies' strong brands should allow them to raise prices to consumers to offset increased commodity prices. Newspapers, for instance, should be able to pass on higher costs for newsprint, ink, labor, etc., through increases in subscriptions and advertising rates, without dampening demand for circulation and ad lineage.

Fourth, our multinational companies should see improved business prospects for both volume growth and improved product mix from developing markets, if economic recoveries overseas remain one of the reasons for higher rates. Better demand from overseas markets should provide investment support for companies with desired brands to sell into these markets. Fifth, the dollar value of our foreign holdings should improve if our currency weakens due to the preceding factors.

Finally, many of our companies have significant liquidity which they will direct to share repurchases if overall market declines negatively impact the share prices of our holdings. Such repurchases will increase the intrinsic value of our remaining shares....

What we own should do well. And so will what we'll buy.

Russo: While nervous with the overall equity markets whose higher P/E multiples stand in contrast to higher interest rates, I feel our holdings are better positioned than the markets overall to withstand the inevitable ill effects of declines in investor enthusiasm. Moreover, I stand ready to commit funds opportunistically into new investments for long-term gains — into markets beset increasingly with short-term swings.

—OID

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S&P 500 CONTRIBUTION & ATTRIBUTE ANALYSIS

	1/1/99 S&P 500 Weight	10/13/99 YTD Performance	Weighted Contribution	Valuation Attributes			
				Price/ Earnings	EV/ EBITDA	Price/ Book	Price/ Sales
Microsoft Corp	3.4%	31.3%	1.1%	99.0	58.9	28.2	30.7
General Electric	3.3%	17.2%	0.6%	42.1	28.5	9.1	3.9
Intel Corp	2.0%	21.7%	0.4%	39.6	29.0	10.6	9.5
IBM	1.7%	14.0%	0.2%	31.2	15.2	9.8	2.3
Cisco Systems	1.4%	51.5%	0.7%	159.8	74.7	31.7	26.8
Wal-Mart Stores	1.8%	26.0%	0.5%	65.8	35.0	11.2	1.9
Lucent Technology	1.4%	13.9%	0.2%	169.3	37.2	34.7	6.4
Exxon Corp	1.8%	0.7%	0.0%	28.2	15.1	3.9	1.8
Merck & Co.	1.7%	-1.7%	0.0%	32.9	22.4	10.3	6.3
Citigroup	1.1%	32.3%	0.4%	26.4	25.0	3.1	1.9
AT&T	1.3%	-9.4%	-0.1%	19.1	12.4	5.7	2.7
Pfizer Inc	1.6%	-8.8%	-0.1%	43.0	36.4	16.7	10.9
AIG	1.0%	10.7%	0.1%	29.8	20.7	4.8	4.0
Bristol-Myers Squibb	1.3%	11.5%	0.2%	47.2	25.7	19.6	8.1
MCI Worldcom	1.6%	4.4%	0.1%	NA	130.8	2.8	7.9
Coca-Cola	1.6%	-25.8%	-0.4%	34.7	22.5	14.6	6.5
Johnson & Johnson	1.1%	13.6%	0.2%	42.0	20.7	9.4	5.4
Procter & Gamble	1.2%	4.2%	0.1%	34.7	17.5	10.3	3.4
Royal Dutch Petroleum	1.3%	23.2%	0.3%	NA	NA	NA	NA
Dell Computer	0.9%	21.4%	0.2%	123.4	81.8	87.7	9.2
Weighted Avg YTD Performance			4.4%	64.2	38.4	17.0	9.8
Overall S&P 500 YTD Performance & Attributes		4.6%		30.0	23.3	4.7	2.0
SemperVic Partners, LP, Attributes				20.5	10.5	4.1	2.2

*Valuation attributes calculated from 1998 data excluding BRKA.

Source: Standard & Poors and Bloomberg

OID MAILBAG: DUNCAN ROSS ASSOCIATES'
ROBERT ROSS & MARK HUGHES
(cont'd from page 1)

DON'T CONFUSE VOLATILITY WITH RISK.
WE KNOW WHY OUR PORTFOLIOS ARE DOWN.

Our portfolio has less risk, but is subject to more volatility.

Before we discuss what has caused our unit value declines, we would like to share with you a quote from our September 30, 1998 quarterly report:

"A portfolio of a dozen stocks, no matter the degree of underlying intrinsic value or the quality of the companies, will fluctuate in price more than an index of several hundred stocks. Despite academics have to say, though, this volatility does not translate into risk. Our companies or 'investees' have low business risk, due to both the nature of their businesses and the quality of the people running them. In several ways, we think our portfolios are less risky than the market. However, that doesn't mean that their prices fluctuate any less."

Never were these words truer than this quarter.

We know exactly why our portfolios are down this year....

Duncan Ross Pooled Trust's unit value decline has been caused primarily by share-price declines in four of our largest holdings as follows:

- Philip Morris Companies Inc. is down 36% this year....
- Berkshire Hathaway Inc. is down 21% this year....
- Fairfax Financial Holdings Ltd. is down 54% this year....
- Freddie Mac is down 22% this year....

Duncan Ross Equity Fund's unit value has been [hurt by the performance of the above four holdings as well as] Great West Life — [which was] down 24% this year....

Lower prices have given us an opportunity to buy more.

Each of these companies had its problems this year — some controllable and some not controllable. Part of our analysis involves assessing how management has responded to these challenges. These assessments then become part of our decision-making process as we decide whether or not to continue owning each.

In some cases, the share-price declines have given us opportunities to buy more of what we believe to be very good companies at very attractive prices. Hopefully, in five years we'll want to kick ourselves for not having bought more.

IT'S BEEN A TOUGH YEAR FOR INSURERS.
THEIR BIGGEST PROBLEM? PRICING.

Insurance area has attracted great investors for a reason.

Over the years, well-run insurance companies have been able to make their owners large amounts of money. That's why the insurance industry has attracted many of the world's great investors. There are drawbacks, though: low barriers to entry, many competitors and an undifferentiated product make it a commodity business.

To be successful long term, an insurance company

must have a competitive advantage.... Some of the factors we look at in determining whether an insurance company has such an advantage are the following: (1) whether the managers are good investors of float, (2) whether the company has extremely low overhead and operating costs, and (3) whether the managers are disciplined underwriters.

Not a good year for North American insurance stocks....

Nineteen ninety-nine has been a tough year for the North American insurance industry. And this has been reflected in the share prices of the major public companies. The chart below illustrates the December 31, 1998 and September 30, 1999 share prices of some of these companies (all prices in U.S. dollars):

	Dec 31, 1998	Sept 30, 1999	% Change	Dec 10, 1999	% Change
American Intl	\$77.30	\$86.94	13%	\$111.69	44%
Allstate	38.50	24.94	-21%	27.00	-30%
CNA Finl	40.25	35.00	-13%	40.00	-1%
Mercury Gen	43.81	27.56	-37%	22.06	-50%
Progressive	169.38	81.69	-52%	76.56	-55%
Safeco	42.94	28.00	-35%	23.44	-45%
Reliance Grp	12.87	4.43	-66%	5.75	-55%
Mutual Risk	39.13	12.25	-69%	14.94	-62%

[Editor's note: We've updated the chart by including the price per share as of 12/10/99 for each company and the corresponding year-to-date percentage change.]

The biggest problem these companies have had? Pricing.

A tough pricing environment, storms in the U.S., a severe hailstorm in Australia, higher losses in the auto area and a declining bond market have all contributed to the industry's problems this year. However, the insurance industry participants who we've spoken with all point their finger at pricing as their biggest problem. Excess capital has led some companies to try to increase their market share by dropping policy prices.

This may lead to increased premiums written in the short run. It doesn't necessarily lead to future profitability, however. And indications are that insurance prices will rise next year — driven by decreased competition, decreased capital and recent losses.

BECAUSE ITS QUARTERLY EARNINGS DISAPPOINTED,
FAIRFAX'S STOCK WAS TAKEN OUT AND SHOT.

Quarterly earnings fell short. So it was taken out and shot.

In its 1998 annual report, Fairfax Financial Chairman and Chief Executive Officer Prem Watsa wrote:

"As emphasized in the past, ad nauseam, our company is run for the long-term benefit of our shareholders while maintaining a very strong financial position which will benefit our bondholders. The emphasis though is long term. Therefore, don't be too concerned about short-term results as we will accept short-term volatility in our earnings for better long-term results.

We've been fortunate not to have had any short-term

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**OID MAILBAG: DUNCAN ROSS ASSOCIATES'
ROBERT ROSS & MARK HUGHES**
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(read quarterly) surprises, but I'm sure they'll come one of these days! And, unlike the prevailing practice in the financial markets, you will not get a 'profits warning' announcement from us."

Well, that short-term earnings surprise came in early August when Fairfax reported its second quarter results. The pricing trends we mentioned earlier and the recognition of costs related to Fairfax's acquisitions of Crum & Forster, Inc. and TIG Holdings, Inc. — i.e., closing branches and cutting staff — reduced quarterly earnings. Brokerage industry analysts who had been expecting quarterly earnings in the range of \$6 to \$8 per share put out sell orders when Fairfax reported a second quarter profit of about \$3 per share. The share price fell from \$385 to \$271 in one day and has since crept down to \$220.

[Editor's note: And as we prepared to go to press,* Fairfax Financial's stock was trading at around \$244.]

But it's not about quarterly earnings...

When evaluating companies, we don't include short-term measures like quarterly earnings as part of our evaluation process. Much more important to us is assessing the long-term drivers of a company's earning power. The growth of float, investments and book value per share, the cost of the float, combined ratios, reserving experience and practices and historical returns on equity are all measures we review when looking at insurance companies.

The following chart shows certain measures of Fairfax's performance over the years:

	Market Price	Book Value	Investments	Earnings	Combined Ratio	Return on Equity
	Per Share					
1999	\$220	\$231	\$1,185	*\$9.19	*113	n/a
1998	540	185	998	32.63	113	20.1%
1997	370	125	520	21.59	104	20.4
1996	290	87	330	15.36	105	21.4
1995	98	53	188	9.79	105	20.1
1994	67	44	173	4.66	104	12.1
1993	61	35	107	5.42	99	20.3
1992	25	24	65	1.76	114	7.7
1991	21	21	62	3.94	94	21.3
1990	11	17	61	2.92	113	23.0
1989	19	12	18	2.25	140	20.3
1988	15	10	19	1.94	92	21.2
1987	12	8	17	2.23	98	31.3
1986	13	6	14	1.35	95	25.4
1985	6	2	7	-1.89	126	n/a

*for six months ended June 30, 1999

All results are as of 12/31 except 1999 which are as of June 30th.

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It's been nearly a decade since Fairfax was this cheap.

Over the 15 years Fairfax has been operating under current management, we estimate its cost of float has been a little over 2% — which has contributed significantly to their profitability. It's interesting to note the last time Fairfax traded at a discount to its book value, as it does now, was in 1990. At that time, it had around \$60 in investments per share as opposed to the approximately \$1,200 per share it had at June 30th, 1999.

Over the years, Fairfax's management has proven to be a good investor of its float, very disciplined in its underwriting and hardworking at getting costs down — all important factors, in our opinion, [in generating] long-term profitability.

**FREDDIE MAC DOES FACE CERTAIN RISKS,
BUT WE STILL SEE QUITE A LOT TO LIKE.**

Freddie Mac is not risk free...

We have owned Freddie Mac (formerly known as Federal Home Loan Mortgage Corporation) for about nine years.... The biggest risk Freddie Mac faces in its mortgage securitization business is that borrowers default and, therefore, it doesn't receive the amounts it's due. On its retained portfolio, the biggest risk exposure Freddie Mac faces is interest rate fluctuations. In a environment of declining rates, mortgage prepayments increase thereby lowering Freddie Mac's income to the extent that those prepaid mortgages are replaced by lower yielding ones.

On the other hand, in an increasing interest-rate environment, Freddie Mac's income will be reduced if borrowers don't prepay their mortgages as quickly as expected and the corresponding debt, used to buy the mortgages in the retained portfolio must be replaced with higher cost debt when it comes due....

Freddie Mac's share-price decline this year has been caused by investor concern about the potential impact of increasing inflation and rising interest rates on the company's growth and profitability.

When we look at Freddie Mac, we see a lot to like.

However, Freddie Mac has a great franchise. It's run by excellent managers. And it's generated, in a variety of interest rate environments, returns on equity greater than 20% for 17 years in a row.

Its 1999 earnings are ahead of its 1998 earnings — which itself was a record year. And finally, if management doesn't see profitable opportunity in the mortgage market, it will, as it has in the past, repurchase its own shares.

**LATEST LEGAL DEVELOPMENTS ARE MISUNDERSTOOD.
WE DON'T THINK THE WORST-CASE IS SO BAD.**

The latest litigation drama for Philip Morris...

The share price of Philip Morris has declined this year primarily because of the uncertainty surrounding its tobacco business and its ongoing litigation problems. The most recent litigation getting headlines relates to a class action lawsuit in Florida.

In phase one of this trial, a jury found Philip Morris and the other major American tobacco companies liable for

(continued on next page)

**OID MAILBAG: DUNCAN ROSS ASSOCIATES'
ROBERT ROSS & MARK HUGHES**
(cont'd from preceding page)

causing a variety of illnesses. In phase two of the trial, jurors were to set the amount of damages payable to the class representatives (nine plaintiffs). Damages for the rest of the class were to be determined in future trials; however, the judge revised the trial plan for phase two to allow for a lump sum award to be determined for all class members, not just the nine representatives.

The tobacco companies appealed this change to the appeal court. The appeals court originally ruled in favor of the tobacco companies — ruling, in effect, that the judge couldn't change the trial plan. However, on October 20th, the appeals court overturned its earlier decision, thereby allowing the revised trial plan to stand....

Investors have misperceived the latest appeals court ruling.

The appeals court did not address the underlying legal dispute as to whether or not damages could still be awarded in a lump sum. They have put off this decision until the second phase of the trial is over. Investors, however, have incorrectly perceived this ruling as an opinion by the court that the lump-sum award was legally correct. The tobacco companies are likely to appeal the outcome of phase one of this trial and the damages awarded against them.

In the event of an appeal, the tobacco companies could be required to post a bond securing the full amount of the award plus interest. This bond posting requirement is what concerns the investment community. It's felt that the tobacco companies may be unable to post such a bond.

Lawyers for the tobacco industry, though, have stated that because of the unusual nature of this case, it is unlikely that a bond would have to be posted before an appeal could occur.

Worst-case scenario is that damages get passed through.

In the past, U.S. juries have awarded damages in smoking liability cases only five times — twice in Florida and once each in New Jersey, Oregon and California. The New Jersey and Florida verdicts were overturned on appeal. The California and Oregon verdicts are currently before the courts of appeal.

When we bought Philip Morris, we were fully aware of the litigation risks and built them into our valuation.... We knew that over the long time period we planned on owning Philip Morris, it would both win and lose cases and that there would be significant volatility in its share price. We still feel any damages the industry is required to pay will be borne by smokers through higher cigarettes prices.

PHILIP MORRIS IS ABOUT MORE THAN TOBACCO.
AND THERE'S LOTS OF OPPORTUNITY THERE.

And don't forget Philip Morris' other assets....

Philip Morris, however, is more than just a tobacco company.... It is also involved in the food, beer and financial services industries. Below is a table showing the source of its 1998 revenues and operating profits:

	Revenues (in millions)	Operating Profits (in millions)
Domestic Tobacco	\$15,310	*\$1,489
International Tobacco	27,390	5,029
North American Food	17,312	3,055
International Food	9,999	1,127
Beer	4,105	451
Financial Services	275	183
Total	\$74,391	\$11,334

*After settlement charges of approximately \$3.4 billion.

Philip Morris' food subsidiary, Kraft Foods, is the second largest food company in the world. Among its brands are Jell-O, Kraft, Oscar Mayer, Maxwell House and Toblerone. Philip Morris' beer subsidiary, Miller Brewing, is the second largest beer company in the U.S. and the third largest in the world. Miller, however, has had problems over the last several years with some extremely unsuccessful marketing campaigns and, as a result, has changed its senior management.

And Philip Morris sees plenty of opportunity in tobacco.

There are about 50 million adult smokers in the U.S. One out of two cigarettes smoked is made and marketed by Philip Morris. The American tobacco market has been shrinking gradually. However, Philip Morris believes it can increase profitability by continuing to increase its market share and selling prices and by effectively controlling costs.

In 1998, worldwide cigarette consumption was about five trillion (yes, *trillion*) cigarettes. And Philip Morris sells only about one in seven cigarettes smoked outside the U.S.... Philip Morris views the international tobacco marketplace as an incredible opportunity.

PERCEIVED AS AN INVESTMENT HOLDING COMPANY,
BERKSHIRE HATHAWAY IS ACTUALLY MUCH MORE.

Berkshire is more than an investment holding company.

For many years, Berkshire Hathaway, with its high-profile portfolio investments in Coca-Cola, Gillette, American Express, Walt Disney, The Washington Post, Freddie Mac and Wells Fargo, has been viewed as a large investment-holding company. However, over time, Berkshire Hathaway's become a major insurance company. It owns General Re, the largest reinsurance company in the U.S., and GEICO, the seventh largest U.S. car insurer. Berkshire Hathaway is also the largest underwriter of super-catastrophe insurance in the U.S.

We plan on owning our Berkshire shares indefinitely.

Berkshire Hathaway's share-price decline this year has been caused by two factors — pricing problems facing [not only Berkshire, but also other North American] insurers and a decline in the prices of its portfolio holdings — [including Coke, Gillette and Disney]....

However, we still think very highly of Berkshire. Besides having a great stable of businesses, it's run by one of the best businessmen in the world. We, therefore, plan on owning it indefinitely.

—OID

VALUE INVESTING PANEL DISCUSSION
 CHUCK ROYCE, CHRIS BROWNE & MARTY WHITMAN
 (cont'd from page 1)

Panel Discussion (which was co-sponsored by their firms) on October 19th in Manhattan. As usual, we found their remarks, assisted by the ever-stimulating challenges of moderator Jason Zweig, to be both meaty and enlightening. We hope that you will, too.

SOMETHING FUNNY HAPPENED TO VALUE INVESTING:
 IT STOPPED WORKING — AND STAYED STOPPED....

Take value investing, please....

Jason Zweig: This is the value managers' panel.... And we're here partly to honor the memory of Ben Graham whose great book, *The Intelligent Investor*, was published 50 years ago and whose landmark textbook, *Security Analysis*, first appeared 65 years ago. But we're also here to talk about the future of value investing — namely whether it has one. Something funny happened to value investing. Right after you put your clients' money into it, it stopped working — and it stayed stopped.

Worse, it's not just the Vanguard Index Fund that's making everybody in this room, including the gentlemen to my left, look kind of stupid. It's also the taxi dispatcher or the shoe salesman who reads that FHX is going to go up like a rocket in some chat room, then buys it at E-Trade and sells it 43 minutes later. Never mind the fact that the guy doesn't know what FHX stands for, what it makes or, for that matter, one single, solitary thing about FHX. Never mind the fact that he actually meant to buy FDX. He's a genius and you're not.

A horde of analysts, academics & pundits couldn't be right.

Zweig: How did we wind up in this mess? I think that it's because about five years ago, there emerged an almost universal consensus among finance professors and financial advisors — even media flunkies like me — that value investing was a clearly superior strategy. Funny, isn't it? That's exactly what happened with small stocks in the early 1980s ... and emerging market stocks in 1993. As soon as they were anointed with holy water, they went right out and started sinning their way right down to hell.

The fault lies not in our stars managers, but in ourselves.

Zweig: Why does this kind of misjudgment occur and recur so often? Personally, I think it has to do with two powerful heuristics (mental rules of thumb) identified 25 years ago by the great psychologists Amos Tversky and Daniel Kahneman — (1) Representativeness: the human tendency to consider short series of data to be typical of long-term trends, and (2) Availability: the natural inclination to let recent, vivid events overwhelm our judgement about normal expected outcomes.

Under representativeness, we conclude too much about the shape of the future from trends of the previous few years. And under availability, we conclude too much based on a single, large, notable number — like, say, the number of people buying belly button lint on eBay.

These two ways of thinking, in my opinion, go a long way toward explaining why investing styles tend to regress to the mean just after investors conclude that they won't. We let the data play tricks on us. And then, instead of getting mad at ourselves, we get mad at the data — or, perhaps, we get mad at the fund manager.

The fundamentals still apply as years go by.

Zweig: You've all been diehard value investors for decades. And we all know everything regresses to the mean, the market's preference for growth and value is cyclical, the infatuation with giant, global tech stocks is just a passing phase and that the four most dangerous words on Wall Street are, "This time it's different."

But Peter Bernstein tells the story about how in 1956 the yield on stocks fell below the yield on bonds for the first time in memory and all of Wall Street's gray beards told Peter that the market was terribly and unsustainably overvalued based on that measure. However, what had never happened before *did* happen — and 43 years later, bond yields *still* exceed stock yields. Isn't it possible that you guys are just flat out wrong — that you're dinosaurs and that this is a new era?

Chuck Royce: I'm glad we're beginning with the easy ones.... It is a fascinating question because it intersects with everything that we do every day. Most of the time, frankly, I don't think about the question because we're focused on buying individual securities. And I think that although there are major demographic and economic shifts — for example, to a service economy — the issue of "New Era or New Errors" is relevant, but less so in individual stocks.

In addition, I think they have *not* changed the rules on valuation. And they haven't changed the rules on what makes a superior company. A superior company is one with sustainably high returns on assets.... The idea that all of us would concur on is that you try to capture that future stream of higher returns at a reasonable price. And I don't think they changed that rule at all.

I think there has been a shift in how markets play out. That's changed. And that will *continue* to change....

SPECULATIVE BUBBLES ARE NOTHING NEW.
 CAN THEY PERSIST? HISTORY SAYS IT'S UNLIKELY.

New Paradigms are nothing new. So hold onto your wallet.

Chris Browne: I've often said that I think somebody should get a master's degree in history before they get an MBA — because it gives you a much more important guide to what's going on in markets than all the fancy stuff that you learn at Harvard Business School or Wharton.

We've had these "New Eras" so many times in the past that it's really nothing new to see that right now we've got "A New Paradigm" in technology stocks or telecommunication stocks. Back in the early 1980s, it was computer stocks. If you'd put \$1 in every computer stock back in 1980, it would have compounded at 4% for the next 20 years. You saw it back in autos at the turn of the century. You saw it in railroads in the late 19th century.

If your results don't vary from the index, you can't beat it.

Browne: Soros Fund Management actually keeps a full-time financial historian on staff to remind them of

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VALUE INVESTING PANEL DISCUSSION
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what's going on — as kind of a reality check. And I think we're in another phase of reality check ... right now.

I recently read Bill Ruane's latest letter to shareholders of Sequoia Fund. He was down about 1% or 1-1/2%. Apparently, some people were sort of grousing at him. And at that time, I think the S&P was up about 12%. However, during the 29-year history of Sequoia Fund, he's returned 12,500% to his shareholders vs. 4,900% for the S&P 500. But in 40% of those 29 years, the index *beat* him.

I've found that if you're going to have results that track the index, then you don't have much of a chance of really *beating* the index at the end of the day. People with outstanding results relative to any kind of benchmark over long periods of time are the same ones who have tremendous variability in their returns relative to an index. And that's just what value is doing right now.

Can the fluff in the market persist? You bet....

Marty Whitman: First, anything is possible. And I think value analysts deal in probabilities. Let me talk briefly about three things that are going on. Two are market phenomena: a "flight to the Nifty Fifty" and a "flight to garbage" — and then I'll talk about value. As for the flight to the Nifty Fifty, we've been through that in the late 1960s and early 1970s. And the probabilities are that that ended in denouement.

In terms of the flight to garbage, I had an epiphany last week. I was playing tennis with a friend of mine — a stock promoter whom I had advised in the early 1990s. He had an Israeli high-tech company that he was promoting back in 1993. And when I was advising him, we'd talk about how we could go public: Could he do D.H. Blair or Oscar Gruss — or, if he were very good, maybe he could go to Alex Brown. Well, that was in 1993. And I said to him, "Bob. My God! If this thing happened today, we'd be going to Morgan Stanley, Goldman Sachs and Merrill Lynch — and they'd be standing in line to do the deal." That's the flight to garbage. It's in existence.

Can it persist? Listen — can the internet persist? You better believe it can — provided these people who have no prospects of earning any profit continue to have access to the equity markets at super-attractive prices. That's the industry they're in and the game they play: Get a vastly, vastly overpriced stock and issue it. Can that persist? I'd say the probabilities are against it. But is it possible? Sure. Anything's possible.

I've seen this play before. And you won't like the ending.

Whitman: I've lived through an infinite number ... of speculative bubbles. All of 'em had elements of reality. And in most of 'em, outside passive investors — retail people such as yourselves — ended up getting wiped out.

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Finally, the third thing: One characteristic of value — a very important characteristic — is if you're doing it right, you don't need the market to bail you out. Regression to the mean will occur in mergers and acquisitions, going privates, recapitalizations, redeployments of assets and other things outside the ordinary course of business. If that doesn't happen after a lengthy period — if you don't get a bail out from the market or a bailout from resource conversion — then you probably weren't buying value in the first place....

WE'VE TAKEN PAGES FROM GRAHAM AND DODD.
 BUT WE'VE CHANGED AND IMPROVED IT, TOO.

Asset orientation? No. Margin of safety? Amen.

Zweig: How do each of you gentlemen define value? Is Ben Graham's philosophy still applicable? And how have each of you expanded on his methods?

Royce: I went to Columbia Business School which has a long tradition of value investing and teaching many of Ben Graham's principles. The one that's stood out the most for me has been the margin of safety aspect. With everything that we do — with everything we look at — we spend [a lot of] time looking at the margin of safety to understand that it's very real and in place — and we spend less time on the dreams and the future part of things. How much money could we lose? What's in place? What are the ingredients in this company that will give us downside protection? That's sort of our version....

The kinds of companies that we look at tend not to be classic Graham and Dodd stocks — they tend not to be low price-to-book value stocks. They tend to be stocks that have higher returns on assets. We use higher returns on assets as our ... central filter....

It's all about private market value.

Browne: Graham said that buying a share of stock is like buying a fractional interest in a business. And that's the way we approach it. When we look at a company, we try to figure out the private market value — in other words, what would the logical buyer be willing to pay for the entire enterprise. That was Graham's definition of intrinsic value — the likely transaction price in a negotiated transaction between a knowledgeable seller and a knowledgeable buyer.

And following that approach enables us to buy all kinds of businesses. We don't just have to buy old, dinosaur metal benders at a discount to book value — which is how a lot of the growth people like to characterize what value is.

One benefit of being a value investor. You can tune out....

Browne: Remember that Warren Buffett is probably considered the best value investor in the world. And I don't think he has a single metal bender in his portfolio. Graham said we could do that. We appraise businesses. We look at what other similar businesses have sold for and who the logical buyers were. It's really no different than putting your house on the market: You call brokers and get a list of all the comparable sales. That's how you arrive at a valuation. We do the same thing with businesses on a day-by-day basis.

The beauty of Graham's approach is you don't have to worry about all the noise and blather on all of these

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financial news talk shows about the market and whether or not the world's going to fall apart if the chairman of the Federal Reserve burps one morning and raises interest rates a quarter of a point. That's totally irrelevant to what we do. And we've found out over the years of doing what we do that it pays off for us to ignore all that blather.

Another benefit: It's light work.

Browne: As Marty said to me earlier, being in the value investing business is very relaxing. You don't have to work very hard. I recently saw the turnover statistics for the average equity mutual fund in Morningstar. And they're approaching 105% a year. I don't know what these people think they're *doing*. I guess they feel that they have to have some value added — so when they come in every morning, they have to rearrange all their portfolios.

However, 105% turnover equates to a holding period of less than one year. So the only people that they're really doing any favors for is the IRS [and their brokers]. We happen to think that if you take the time to figure out what you're doing, it becomes very easy then to construct your portfolio — and you can live with it for a long time and save your shareholders a lot of tax money.

Graham and Dodd had its shortcomings....

Whitman: I just wrote a book with a whole chapter on Graham and Dodd — contrasting it with what I think of as value investing.

[Editor's note: The book is entitled *Value Investing: A Balanced Approach* published by John Wiley & Sons, Inc., New York, NY 1999.]

Whitman: The thing about Graham and Dodd is that many, many people talk about it, but very few people have actually read it. The first thing I should say about Graham and Dodd, just to get it off the table, is that those fellas didn't have a clue about credit analysis. It was badly done. And in equity analysis, they were basically buy and hold, long-term, margin of safety people.

We're very, very different than Graham and Dodd in three respects: First, we emphasize the *quality* of assets, not just the quantity of assets. They were looking more for large amounts of assets rather than quality.

It was a very different era — for example, disclosure-wise....

Whitman: As for the basic work, *Security Analysis*, it was written before 1964. I think the last good edition was published back in 1962. And after 1964, with the Securities Acts Amendment, there's literally been a disclosure explosion. Now, as you can tell from the hostile takeover area, it's possible to have a tremendous amount of information from the public record about a tremendous number of companies.

That was not true in the Graham and Dodd era. So their emphasis on quantity of assets was well placed. They basically stipulated a large number of terrific caveats to compensate for not knowing very much about the company in which you were a passive investor. But now, because disclosure has improved so much, you *can* know about it.

And we have other differences with Graham and Dodd....

Whitman: The second thing where we would differ with Graham and Dodd is that they thought the past earnings record in most cases was the best tool — or even the only tool — for predicting future earnings. I submit that there is no one tool. We think the quantity and quality of resources existing in a business at a moment in time is as good or better a way to predict the future for most businesses than is just relying on the past earnings record — which, again, they relied very heavily upon.

Finally, one very big difference, as best I can tell: The object of a Graham and Dodd analysis, like most passive analysis, is to predict what the stock price may be in the period just ahead — maybe for the next six months or year or two years. By contrast, all control investors and the best value investors have a different focus. They're interested in the underlying value of a business and what its dynamics are rather than predicting market prices. Predicting market prices in the view of control investors — and certainly in our view — is a more appropriate subject for abnormal psychology than finance.

We would be happy to take big market risks — following Chris' example, as he points out Graham and Dodd did — of buying a high quality business with high quality resources at a huge discount from what its common stock would be worth were it a private business or a takeover candidate.

Two key margins of safety — low leverage and high returns.

Attendee: Chuck, you mentioned margin of safety. Could you be specific on some of the things you look for?

Royce: Sure. We look at leverage ratios. We're quite keen on having companies with very low leverage. And we're looking for very high returns on capital — for operating returns on capital in the mid-20s. That's your primary margin of safety. And in terms of free cash flow, we want to own companies that aren't spending more money than they're generating. I would say that those are the three most important things.

Efficient information flow? That's a great, great myth.

Attendee: As businesses become more dependent on knowledge and the flow of information rather than hard assets, how do you find a margin of safety in those things?

Whitman: I don't know what all this nonsense is about the flow of information. The information everybody else seems to be interested in is next quarter's earnings or whether or not the company's going to beat the consensus. That is a great, great myth that information flows efficiently into the market.

In value investing, we tend to look at different types of information. In the case of much of what we look at, it's not very competitive. One of the ways we create our criteria, unfortunately, is that for all the stocks we buy, almost invariably, the near-term outlook sucks. That information is known, but we're looking at something else.

In value investing, it's about business valuation, not assets.

Browne: Again, you have to get out of the mindset that value investing revolves around tangible book value. When I started out back in 1969, I used to have to calculate companies' net current assets per share. Well, we don't find too many net current asset stocks anymore.

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But in the mid-1970s, we discovered something called TV stations. We'd never bought a company that owned TV stations because there was no tangible book value there. Yet it was actually much easier to value a TV station than it was to value a metal bender in Illinois. The reason why was that they sold out consistently. Fifty or sixty stations a year traded at 10 times EBIT. So you just went to the EBIT line, multiplied by 10, subtracted whatever net debt was there or added back the cash and that's what the business was worth.

So what you're doing is appraising the business. When you sell your house, you don't sell it based upon what it would cost you to reproduce it. What it cost to build your house is an accident in history. It's what the neighboring houses sell for.

And it's the same thing with businesses. Their value is what people are paying for similar businesses.

Always ask yourself, "Does it make any sense?"

Attendee: Couldn't you do the same thing for companies in the internet area?

And is it the knowledge of history that keeps you from falling into one extreme or the other? Is it more of an art sometimes than just a pure science?

Browne: We try to understand the qualitative factors of a business and why a business is a better business. Why is GEICO a better business? And why can't Travelers compete with GEICO? It's because they'd have to completely throw out the way they do business currently.

As for internet stocks, yes, there are acquisitions now. But you have to ask yourself, "Do you understand the reality of these things? And does it make any sense?" Does it make sense to pay 10 times cash flow for a TV station? Yeah, that makes sense to me. Does it make sense to pay \$2.7 billion for another internet company that doesn't make any money? No, that doesn't make any sense to me.

So ultimately, you can't say that it's purely science. But if it doesn't make any sense to you, don't go into it. Where we have been suckered in in the past is into things that didn't make any sense to us, but where we could see what others were paying. Usually those were a mistake — because the person who created "the value" by having made the acquisitions was all wrong, too.

ONE OF THE GREAT RETAIL BUSINESSES OF ALL TIME,
 A COMPANY WE KNOW WELL AND A PRICE WE LIKE.

One of the great retailers of all time becomes a sound value.

Zweig: Could each of you name a stock that typifies your research approach, tell us how you found it, where and how you get your research ideas, how you raise your confidence level about the stock and how you keep current? It doesn't have to be a name that you still own, although that would be nice. But make it one that really epitomizes how you research a stock.

Royce: The other day, I was walking around Bloomingdale's. And there's a store right nearby called

Claire's. They go under a variety of names. However, it's basically a teenage accessories business — essentially, an inexpensive jewelry store.

We own the stock. We've owned it on and off for the last 10 years. We have very recently reacquired a position. They made another faux pas in inventory management a few months ago — and the stock fell from \$30 to \$16. But Claire's is earning about \$1.60 per share today. And they've had up earnings most years. They have \$3 or so per share in cash. They have a cap rate — which is operating income divided by enterprise value — of over 20% by our calculation looking out maybe a year. And we think it represents extremely sound value.

We don't particularly like Claire's management. However, we love their business. We think that Claire's has one of the great retail businesses of all time — with extremely high returns on capital.

How do we get our ideas? Here are two or three ways...

Royce: That's a good example of having a history with a stock. That investment was based on familiarity. We have a long history with probably 500 or 1,000 stocks. That's one of the fundamental ways for us to track things — having a history.

And we do other things. Obviously, we do all of the normal things. For example, we're always screening and looking at ideas. And one of our favorite pastimes is tracking IPOs that are three months to two years out after an IPO. You get a tremendous window on companies that were sort of priced to perfection on day one. Then the underwriters move on and they become extremely interesting companies as they go through sort of a reality cycle and the stocks come down a lot. So that's another great source of ideas.

INSIDER BUYING + CAPABLE MANAGEMENT
 + DEEP DISCOUNT = OUR KIND OF BARGAIN.

Insiders can be a great leading indicator. For example...

Browne: We also basically start with screening. In the markets we've had for the last year or two where values aren't screamingly obvious in many cases, we've been using the insider trading data to a great extent. We run it over the Compustat database in the U.S. and try to find patterns of insider accumulation — which is usually a tip-off that something's happening. The combination of that with a stock that may have tanked two years back because there were problems is usually a great leading indicator that something's going on.

One stock we came across in the past year which hasn't worked out so far is Quorum Health Care Group. An operator of community hospitals, they buy hospitals in areas where there are no competing hospitals and where they don't have teaching hospitals. And they're considered to be one of the best hospital operators.

Well, insiders were buying it from about \$14 on down. The chairman is a non-executive chairman — a guy named Russell Carson who I know from sitting on the board of Rockefeller University. He's a principal of Welsh, Carson — one of the leading venture capital outfits in the country.

I happen to sit on another board that I know is just dying to give money to Welsh, Carson — as is every other endowment in this country. But they won't let you in

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because their existing shareholders gobble up every dollar that they're willing to take in. They're in so much demand that they now charge clients 2% plus 30% of the gains....

And he was willing to personally buy \$25 million worth of Quorum Health Group at \$14 down to about \$12. Well, the stock is now at about \$6-1/2 or \$7.

And the price is right.

Browne: When we found it, it was around \$10. They'd had some problem digesting a couple of acquisitions of hospitals. The earnings have been off maybe 10-15%. But going forward, the projections were in the \$1.25 range and climbing thereafter. So you're buying something at less than 9 times earnings.

You can also do a private market valuation using the EBITDA of the hospitals based upon acquisitions — acquisitions that are ongoing incidentally — and come up with a valuation of twice today's market price of the stock.

So we had a situation where something was low P/E. We had a confirmation of smart insiders buying the stock. And we had confirmations of private market valuations that were much higher. So we started to buy it.

A GREAT TRACK RECORD, A LOW EXPENSE RATIO
 AND AN HISTORICALLY HIGH DISCOUNT.

A well managed company with a great track record...

Whitman: Capital Southwest closed yesterday on the New York Stock Exchange, I believe, at \$61. It's a business development company that has a reported net asset value of around \$95 including something like \$20 or \$25 of deferred income taxes which will never become payable.

Capital Southwest is run by Bill Thomas. And I guess over the years since he's been running it, it's had compound annual increases in net asset value of probably close to 25% — certainly at least 20%.

Unlike other business development companies which are registered under the Investment Company Act of 1940, it has a very modest expense ratio — less than 1%. Most business development companies have expense ratios that are up around 10% or thereabouts. [Whitman chuckles.] And when you capitalize those expenses, it really reduces the net asset value.

Why is the stock down? I don't know. It's a well managed, good company.

And the discount today is as great as it's ever been.

Whitman: Oh, yeah. I guess I'm supposed to talk about how I got into Capital Southwest. Many years ago, I was approached by a group — American General — which was then the controlling shareholder and looking to sell. And [they] asked me if I would like to participate in the American General sale and try to take control. However, control didn't look possible. So I went back to the group and said, "Listen, control isn't here. Would you mind if we just bought the stock?"

So we bought out American General. I'd guess that our original cost basis is \$3 or so. And I would say today

the stock sells at as big a discount from net asset value as at any time during the 20 or so years we've been involved with Capital Southwest.

YOU HAVE TO LOOK AT WHAT THE NUMBERS MEAN
 MORE THAN WHAT THE NUMBERS ARE.

Lies, damn lies and Tejon Ranch's fundamentals...

Zweig: The last time I checked the figures on your biggest holding — Tejon Ranch — it looked like it was selling at 74.5 times earnings, 8.3 times book value and 6.3 times sales. Why is that a value stock?

Whitman: Well, you have to look at what the numbers *mean* more than what the numbers *are*. As a matter of fact, that's an example of a stock that proves that luck beats brains. We bought out Times Mirror's 31% control position.

And why did I buy it? It was a debt-free company — and I was paying something under \$650 an acre for the largest contiguous land assembly in California, 90 miles north of Los Angeles, with 32 miles of frontage on I-5 which is their equivalent of the New Jersey Turnpike.

Tejon Ranch is worth an awful lot more than today's price.

Whitman: The book value is derived from a land cost when Tejon Ranch was created back in 1853.

Zweig: Real estate has gone up since then?

Whitman: It looks that way. And I would suppose that the bailout in Tejon Ranch, like in most real estate, won't come from earnings per share. It'll come from converting appreciated land to other things — getting taken over, redevelopment or something of that sort. It's not a business where you look at earnings per share.

I don't know what it's worth per acre. But it's an awful lot more than today's price. The reason I lucked out was that the stock was selling at \$18 and Times Mirror got a new management that just wanted to dump it. So we floated in a bid at \$13. And we bought it at \$13-1/2.

And we just fell into a magnificent management.

Whitman: I then went and visited the management. And this is another place where we got lucky. They brought in new people in 1996. But before we arrived on the scene, this company had been micro-managed by its board which had been controlled by Times Mirror and Ardell. And I'm not much in operations, but in all my years of experience, I've never seen a company worth a damn that was run by its outside board rather than its management. So I said, "Don't you worry. We're the 800-pound gorilla. You just run the company." And I think we just fell into a magnificent management.

So far, their first development along I-5 has been super successful. It's a huge truck stop — 415 parking spaces for trucks. Management also made an outstanding deal on interior land with Enron — which is putting up a 1,000 megawatt facility that will sell electricity to the Los Angeles market. They made a super deal with Quest. They got the two leading housing developers in Los Angeles to start a homesite development of 10,000 homes on 4,000 acres. It looks to me like they're doing the right things and that we're going to realize a lot of long-term value, but probably not in earnings per share.

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VALUE INVESTING PANEL DISCUSSION
 CHUCK ROYCE, CHRIS BROWNE & MARTY WHITMAN
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Real estate securities in general are ultra-depressed.

Attendee: It looks like REITs aren't doing very well, but they appear to offer good value. What's going on?

Whitman: Yeah. They sure do. Traditionally, except for 1998, real estate securities have always been a lot cheaper than real estate. And they *should* be cheaper — for various reasons....

I think that real estate securities in *general* are ultra-depressed right now. As a form, we tend to like other securities — "C" corporations — better than REITs. REITs inherently are unsoundly capitalized because of the requirement that they pay out 95% or more of their net income. But there's no question about it — the REIT group is one of the most depressed groups today.

Another area that's ultra, ultra depressed....

Attendee: Could each of you mention other industries that you regard as having a lot of excellent values today?

Whitman: One industry that's ultra-depressed today — pretty much, I think, as depressed as it's ever been — is the property and casualty insurance industry. However, other than a few catastrophe insurers, we're concentrated on the types of insurers where their financial results are driven by their expense ratios rather than their loss ratios. That includes financial guaranty insurers, title insurers and surety companies — all of which attempt to underwrite to a zero loss. That area is just ultra, ultra depressed.

We're putting our money where Marty's mouth is again.

Browne: I can't think of an industry that we're looking at as an industry with a lot of cheap stocks in it. The stuff that we're looking at today is all over the place. From our perspective, it's a market of individual stocks rather than any "industry that's depressed".

Royce: We would normally say the same thing — that we're just looking at individual stocks. But in truth, once we find a single stock that we like a lot, we look in the neighborhood. And when we wander in the neighborhood, maybe we find something even better.

We've owned some insurance stocks. We're certainly looking at them more aggressively because they're down. Obviously, a very specialized level of knowledge is needed. We're looking at Mutual Assurance — and at Zenith in the

(continued in next column)

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workmen's comp area. We're looking at companies with a history of going through other moments of difficulty.

I believe that it's a very interesting zone today. And we're definitely adding to our positions here.

HOW MUCH DO WE ELECT TO DIVERSIFY?
 THAT DEPENDS ON WHAT WE'RE BUYING.

How much do we diversify? In real estate, not much.

Zweig: Would each of you talk about how diversified you seek to be and why you run your portfolio as you do?

Whitman: ...Diversification is a surrogate — and usually a *poor* surrogate — for knowledge, control and price consciousness.... How much diversification we do depends on what we're doing. For example, if we're in a company which is a real estate investment builder, as we are, we'll bet all our chips on Forest City Enterprises — the biggest company nobody every heard of, a super investment builder and one we're sure we're buying for less than 50% of the appraised value of the income-producing properties alone.

Zweig: What does betting all your chips mean?

Whitman: We would go to 10% in one position. We're constrained by the Investment Company Act of 1940. Every mutual fund per se has to diversify. But real estate would represent one extreme.

But in venture capital-type investments, we better diversify.

Whitman: But let me also go to the other extreme. We have maybe 30% of our fund's assets in semiconductor equipment common stocks. And in each of these companies, by the way, their cash alone exceeds their total liabilities.

We went into these 11-12 semiconductor equipment stocks on the basis that we were getting in at maybe half the price we would have to pay to get in these companies if we were first stage venture capitalists — because I view 'em as venture capital. And I gotta tell you that in doing the semiconductor equipment industry, no matter how fantastic its growth prospects are, not every company will make it. We're going to have quite a number of losers — as if we were venture capitalists. Therefore, you better believe that common sense dictates that we be quite diversified across a broad range of very, very well capitalized companies in that industry....

WHEN WE BUY SMALL CAPS, WE HAVE TO DIVERSIFY.
 BUT WE DON'T MIND. WE WANT A LOT OF ISSUES.

By shopping at a global grocer, we doubled our selection.

Browne: We look at our universe of stocks as sort of our investment grocery store. That's one of the reasons why we went global. You have about 11,000 items to look at in the United States. And if you add the rest of the developed world, you get another 11,000 items. So we have a total of about 22,000 items to look at.

And we don't segment our purchases by market cap. We buy the micro caps and we buy the huge-cap stocks. All we're really looking for is value.

We have to own a lot of names. But that's fine with us....

Browne: In terms of constructing a portfolio, we're

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VALUE INVESTING PANEL DISCUSSION
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highly diversified. We put a cap of no more than 3% in any single issue at cost. And in terms of participating in smaller cap stocks, that means we need to own a lot of names because you can't buy a whole lot of each of those particular securities.

However, we've found that rates of return in an investment portfolio are highly skewed. If you're up 20% one year, it's not as if all of your stocks went up 20%. A handful of issues actually brought you all of your returns. That's consistently happened throughout history. Therefore, if we have diversified portfolios following the same investment strategy, there's a much better chance that we're going to participate in that highly skewed return.

We've thought from time to time, "Well, gee — if we can only pick the ones that are going to be at the high end of those highly skewed returns during the coming year, then we could have just unbelievable rates of return." However, we've found we can't. Whenever we go through the portfolio and pick out the ones we think are going to be the best performers next year, we're invariably wrong. There's a certain randomness to positive event surprises within a portfolio.

Therefore, if you don't have enough issues in there, you may not participate in that randomness in a given time. That's why we diversify as much as we do.

JUST BECAUSE WE'RE VALUE INVESTORS
 DOESN'T MEAN WE SHOULDN'T BUY TECHS.

We actually think the technology area is wonderful...

Zweig: In Royce Opportunity Fund, you have 39% of your assets in a sector that a lot of [value] investors don't think of as much of an opportunity — namely technology. And most of your other funds have a big chunk of change in technology, too.

Also, according to some 13-F filings, you own things like RCN and Network Solutions. And I could've sworn that I saw Yahoo in there. Do you own Yahoo, Chuck?

Royce: I'm in trouble here. One of my partners, Buzz Zaino, runs Royce Opportunity Fund. And Buzz does use a little more technology. But as a firm, we think of the technology area, actually, as a wonderful source of investment ideas. You have a very high rate of change. You have lots of cyclicalities in stock prices. And you can look at stocks in ways that other momentum investors — growth investors — are not looking at them. They're looking at quarter-to-quarter earnings — what you might call the sequential earnings ideal. We're looking at the sustainability of the companies' franchises.

We put our money where Marty's mouth was, too....

Royce: We also took a very big bite of the semiconductor capital equipment apple — for the same reason [as Marty]. These stocks got down to book value and below normalized earnings — *dramatically* below normalized earnings. We believed in the industry and we believed in the sustainability of [their long-term earning power]. We believed in their future. Therefore, we took a

big bite. That would actually be quite typical.

Not all technology companies are high tech....

Royce: In the technology area, though, are lots of lower tech, industrial-type companies that we also find very attractive. And we do those all the time. We like the distributors. Obviously, these aren't high-tech companies. They're sort of marketing enterprises.

And we like the service companies. Right now, we're taking a very strong look at IT [information technology] technical service companies. The companies that we're focused on have had Y2K activity the last couple of years. They're going through a transition and their stocks are down 50-75%. But I believe that they'll be around — because companies use outsourcing now as a permanent feature.... We're still sorting through which IT service companies we want to own, but we're going to have a package approach very similar to what we did in the semiconductor capital equipment area.

EVERYBODY WANTS TO PUT US IN LITTLE BOXES.
 BUT THAT DOES OUR CLIENTS NO FAVORS.

How important is style consistency? I don't have a clue.

Zweig: How important is style consistency to you — specifically Morningstar style boxes and the like?

Whitman: I don't have a clue. I'm with Chris. We buy value. The only style description that I would put on what we do is that we just want to be in businesses that we understand. Our style is that if we're going to buy a common stock, the underlying company is going to be extremely well capitalized or have a franchise or something. We *hope* the company is reasonably managed from the stockholder point of view. I say "hope" because assessing management is the toughest thing we do.

But above all, we want to own businesses that we think we understand. Incidentally, that keeps us out of an awful lot of industries. I think the commonality of understanding is that the company fully complies with SEC disclosure requirements or the equivalent and has had audited financial statements. [And we rely on those statements] not for telling us the truth, but for giving us objective benchmarks.

For credit instruments, our style is that we want the instruments well covenanted. Ninety-eight percent of the credit analysis in the world revolves around trying to figure out whether or not there's going to be a money default. Our credit analysis revolves around the assumption that there *will* be a credit default and how we're going to work out — which normally means that we can be in well covenanted distress, but we have only limited opportunities in subordinated junk.

Style consistency is overrated. What counts is integrity.

Browne: The institutional consulting industry has tried to put people into ever smaller boxes. They constrain you by market capitalization. They constrain you by style. They take the entire universe of securities, draw a line down the center and designate one half growth and the other half value. I don't know what criteria they're using.

I think the key thing to look for in somebody who's managing money is integrity — integrity in their approach.

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Do they have principles that they consistently apply rather than being constrained by being only able to buy stocks that are selling at 1-1/2 times book or less?

You can only buy something that's reasonable. How else could we have in the same portfolio something like Johnson & Johnson and EZ Corp., which operates a chain of pawn shops in Texas? They all fit into a certain value approach that we have. And we stick to those principles. That doesn't mean those principles have to be so narrowly constrained that you can't buy something good just because its market cap is too big.

I think Morningstar's style box does everyone a disservice.

Royce: I have the same problem. And it's somewhat the same issue. According to the Morningstar style boxes, we're in the smaller-cap thing. And we have self-defined ourselves to be in the small-cap world.

But where it gets very blurred and where I do have an objection is in their value, blend and growth boxes. We don't pay any attention to [that] at all.... We do sort of look back and see what our composite P/E and price-to-book ratios are — because that's how they develop the style box. But, in fact, that has *nothing* to do with how we select a stock. [We just try] to buy a dollar bill for 50¢ when we believe conditions are right to double our money with minimum risk. And we look at growth companies all the time — especially if they have a superior franchise.

If it's important to pay attention to book value, we will. But in many companies, we want to pay attention to these other ingredients which are not picked up in the style box. I think in some sense, it's misleading to the investor.... We float between the low left-hand corner to the middle one — back and forth. We read about it when it gets published, but we don't pay attention to it.

It sounds like all of us are "new value" investors.

Attendee: An article in a major financial publication divided value investing into three subcategories — I believe they were value, deep value and new value. And as I recall, Bill Miller at Legg Mason was an example of new value. Do you find these sub-categories helpful to what you do?

Whitman: I do. But first, as long as we're attaching labels, there ought not to be a label called "growth stocks". They ought to be called "generally recognized growth stocks" because it's not necessarily growth.

Like Chris, I think we're very much into new value. For example, we have large positions in money management firms. In today's New York Times, you'll see an article that suggests the normal market for those firms is 3-1/2% of money under management. The truth is that they trade at anywhere from 1-1/2% to 5%. But there's a ready market of new values in all sorts of areas — telecommunications, etc.

Again, let me impress on you that it's not hard assets. As Chris alluded to earlier, it's not about book value. Whatever an accounting figure is, it's not truth. It simply gives you an objective benchmark that the analyst, not the accountant, then uses to determine values. I think all of us at this table — certainly based on what I've heard — are

new value people.

As for the difference between value and deep value, I don't know. I guess the more price conscious you are, the more deep value you are. And the more outlook conscious you are, the less deep value you are....

Growth stock funds w/high turnover aren't growth funds.

Browne: I think it's all just a matter of the reporter's opinion. But I'd like to go back to the statement that Warren Buffett made — which is that value and growth are joined at the hip and that it's merely a function of price. The best growth stock investors, I think, are value people. They buy good businesses at reasonable prices that they can hold onto for a long time.

It's always amazed me to see "growth stock" funds have higher turnover rates. I thought the whole idea of buying a growth stock was that you were buying shares of a business you could hold for a long time — because the intrinsic value is increasing as it sits there in your portfolio.

I concluded that what must really be going on in funds that characterize themselves as growth funds that have high turnover is that they're really momentum people. The stock starts rising and they jump on. And as soon as it stops going up, they get out, etc. That's not growth stock investing. Buffett's a growth stock investor. We do some of that. We also do some of what's called deep value. We've got a lot of flavors on our tree.

If we could have all of our funds only invest on a diversified basis in great businesses that were growing and reasonably priced, we'd do that. But it's not that perfect a world. Warren only finds one stock a year — maybe.

PAST RETURNS ARE ONE IMPORTANT FACTOR.
 BUT QUALITATIVE FACTORS ARE MORE IMPORTANT.

Our benchmark is absolute return....

Zweig: What's the right benchmark? How do you guys think you ought to be measured?

Royce: My preference would be absolute returns over time. But tell that to the SEC, tell it to shareholders and tell it to Morningstar. They want a benchmark reference stick. And we do it. We dance with that. But, personally, I don't think that's the right way to do it at all. I would much prefer to think about risk factors and absolute returns over long periods of time.

Browne: I prefer to think in terms of absolute returns, too. And I'm perfectly happy if I can compound our money at somewhere north of 15% and south of 20% over long periods of time. I find that to be a real wealth builder — especially if I can do it without incurring a whole lot of capital gains taxes along the way.

But that said, ultimately, you have to sort of see how your approach is doing over long periods of time by comparing it to what somebody could have invested in on a passive basis. To our clients who ask us, "What's the appropriate benchmark? Should it be half S&P and half Russell 2000 or this or that?", we say, "It's up to you to pick the benchmark(s) you want to use. And we hope we'll beat it. However, we're not going to sit there and look at it."

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VALUE INVESTING PANEL DISCUSSION
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Qualitative factors are more important than past returns.

Whitman: I think the appropriate benchmarks are long-term past returns appropriately weighted and the composition of the present portfolio appropriately weighted. And I think the latter would tend to deserve big, big weight. Maybe I say that because I think our present portfolio has securities that I haven't seen this attractively priced since 1982 or 1974. But to just concentrate on one factor such as long-term returns ... I don't think [is a good idea].

Again, I think it has to be appropriately weighted. And the other consideration is the quality and the appreciation potential of the present portfolio.

Zweig: How would you suggest that people in this audience get a better handle on how to measure that?

Whitman: Beats me. That's why nobody uses it — because it's strictly qualitative. You can't quantify it.

I have to make a statement. I think that the common stocks we own are very attractive. And since we don't pay much attention to current P/E ratios — which everybody else seems to do — I don't know. I don't know how an outsider does that, but it's very important to do.

[Editor's note: Your editor and more than a few contributors and subscribers believe one of the best ways to help do what Whitman describes is reading *OID*.]

THERE ARE TWO WAYS TO LOSE MONEY.
 THEREFORE, WE JUST DON'T GO THERE.

We've found that there are two ways to lose money.

Zweig: Aside from a broad market crash, could each of you speak very briefly about the other broad risk factors which could severely affect your funds? Where do you think your worst vulnerabilities lie? Are there any risks financial advisors should be aware of that might prevent them from getting some kind of bad surprise one day?

Browne: I've found that there are two ways to permanently lose money: One is to leverage where somebody else can call a halt to the game when it may not be what you want to do. So we don't employ any leverage. And the other is to own what I call "crash and burn stocks" — which are things that are utterly, ridiculously overvalued that given any kind of general, overall market turn down are the things that crash and burn. For example, Avon traded at \$132 in 1973 and \$17 in 1974. It was selling at 68 times earnings. Well, that's crash and burn potential. That money *still* has not been made back, I might add. Therefore, we avoid situations like that.

You have to accept the fact that any portfolio of stocks can drop 25-30% in a really bad market. However, if you're not leveraged and you have the ability to ride it out, you almost always ultimately get your money back.

And government is always a risk. The less of it, the better.

Browne: The other major risk is government. Whenever the economy gets screwed up, it's usually the government's hand involved. So it's a question of who we get in the next election. The current situation is great

because neither Clinton nor Congress can do anything. Therefore, it's as if the government has been on a holiday and the market took over — which is the best thing that could happen. I wish they'd adopt the Texas formula — which is where the legislature only meets every two years. That way, they have less opportunity to cause us damage.

ONE RISK WE *DON'T* WORRY ABOUT: MARKET RISK.
 WE ACTUALLY LOOK *FORWARD* TO LOWER RETURNS.

Market risk is overrated. It's not even on our radar screen.

Whitman: The word "risk" has to have an adjective in front of it. We don't try to guard against *market* risk. Market fluctuations are not our business. What we try to guard against is *investment* risk — which is the risk that the companies we're in have something wrong with 'em. And I'd say that our major risk is lousy analysis — period. I don't think market risk counts for diddly squat, frankly.

I have to make one comment about market crashes: Since the end of World War II, the U.S. economy has been characterized by industry after industry going through depressions as bad as anything that they experienced during the 1930s — whether it's banking, real estate, energy, auto, steel or agriculture. Yet it's happened without a domino effect. And securities in those industries have really crashed and burned.

So everybody looking for the "Big Bang", you may have to wait 50 *more* years — because we get "Little Bangs" almost every day of the week.

We look forward to a more normal (lower return) market.

Royce: I'd like to mention an offbeat risk — a risk that's kind of special to the small-cap world. The small-cap world made a top about a year-and-a-half ago — in April of 1998. It's been in a period of negative and low returns ever since. I think it's entirely possible that that trend will be sustained for some time. So that's the bad news.

However, the good news is that stock selection and active management has a tremendous payoff during periods of low returns. Therefore, in some perverse way, we're kind of looking forward to the return of a more normalized return market — a lower return market — where the kinds of things we do every day will have a greater payoff....

NO MATTER HOW SMART YOU ARE, STUFF HAPPENS.
 HOWEVER, SOMETIMES YOU DIG YOUR OWN HOLES.

Our toughest mistakes — ones that neither succeed nor fail.

Zweig: Might each of you talk very briefly about a particularly memorable mistake — something you bought wrong or you sold too soon or you just completely blew it. What was it — and what did you learn from it?

Royce: The most interesting mistake isn't the one where it goes wrong right away. The really *tough* mistake is the one that compounds very slowly, say at 3% — and you never have a sufficiently good reason to sell it because you still have hope about its future value. And yet it doesn't have a sufficient problem to justify a sell decision....

We've had plenty of those over the years. That's the worst part of a portfolio process — the stock that neither

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VALUE INVESTING PANEL DISCUSSION
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(cont'd from preceding page)

fails nor succeeds. One that comes to mind right now that we've owned for years that hasn't helped our performance is ENESCO. It's a collectibles business. And we've owned it on and off for a long time. It has neither failed nor succeeded.

No matter how smart you are, stuff happens.

Browne: The worst stock that we owned last year was Sun Health Care Group — a nursing home operator. And we bought it because based on EBIT valuations of other nursing home acquisitions, it was cheap. And there was heavy insider buying in the stock which confirmed that. But bingo, along comes a change in the nursing home reimbursement schedule — and the thing goes in the tank.

What we learned from that is our inability to predict what's going to happen in the world. What do we do about it? That leads us to want to be diversified because you get negative event surprises sometimes that you can't predict. And it doesn't matter how smart you are. For example, Warren bought an encyclopedia company that used to sell these things for \$1,600 a set. And now you can buy 'em for \$10 on a CD-ROM. This stuff just happens.

How do you avoid getting hurt too much by that? Well, don't put too many of your eggs in any one basket.

With hindsight, we were just stupid...

Whitman: The worst thing we did was Long Term Credit Bank of Japan in 1998. In the early 1990s, we had cleaned up buying U.S. regional community banks at pricing that was never as much as 80% of book value in companies that were extremely well capitalized — for BIS [Bank for International Settlements] and all regulatory purposes.

In Japan, where we have a lot of interest, we went into Long Term Credit Bank because it seemed to me to be well capitalized. We were getting in at maybe half of book. Above all, we had Swiss Bank — who had just become a joint venturer with Long Term Credit Bank — as a partner. And we were getting in at some huge discount from what Swiss Bank had paid.

With hindsight, we were just stupid. Why I would have thought that things in Japan in the banking system were anything like the United States escapes me.

Buy what you understand and pay attention to asset quality.

Zweig: What did you learn?

Whitman: I learned that Japanese banks are in deep doo doo — and that they're going to *stay* in deep doo doo. And we're only going to invest — we'd *better* only invest — where we understand...

Above all, what I learned goes back to the same thing: Pay attention to the quality of resources. The quality of resources was really very bad here. And I had no way of knowing.... It was a sort of stupid due diligence that I did. I spoke with their bank officers in New York. I asked 'em, "Did Swiss Bank do a thorough review of your bad loan portfolio?" And they said, "Oh, yes. They did everything." So I thought I was backing into it — which was stupid.

Browne: That sounds sort of like it was the inmates doing a review of the asylum, wasn't it?

Whitman: Yeah. It sure was.

WE HAD NO IDEA WHEN JAPAN WOULD TURN.
WE JUST FIGURED THEY'D WORK IT OUT SOMEHOW.

In Japan, we had to cover our ears and scoop up bargains.

Attendee: Are you more sensitive to the market and its dynamics in your participation in Japan than you are in the U.S. where you say you ignore the market?

Browne: No. We invested in Japan because things were just screaming bargains. For example, you could buy a Coca-Cola bottling franchise for less than book value — where half the book value consisted of government bonds and cash. And if you used the same depreciation schedule as U.S. bottlers, it was trading at about 7 times earnings. If that were a private business, a private equity group would *jump* at buying that. It's a screaming bargain.

So we ignored what was going on in Japan. The only thing, I think, that probably affected us is that we tried to avoid companies where their business was based upon some kind of trade barriers that kept the competition out. We tried to only invest in companies that were already competing on a worldwide basis....

We were buying stocks at less than net cash! You just had to ignore the fact that nobody had a nice thing to say about Japan.

[Editor's note: Outside of *OID*. As you may recall, at least three of our contributors pounded the table.]

We figured they'd work it out somehow — like New York....

Browne: But I guess our feeling was that here were 125 million people who only 20 years ago said they were going to rule the *world*. We figured that somehow they'll figure it out. One reason they hadn't done anything was that the pain wasn't bad enough.

But I go back to the mid-1970s here in New York City. You could buy Park Avenue apartments for \$20 per square foot that now sell for \$3,000 per square foot. And nobody had the nerve to do it except for somebody who said, "Gee, I work here. I *can't* leave." So they bought 'em anyway.

One guy said, "There are 8 million people in New York. Those people aren't going to move away. And there are tremendous assets here. Somehow they'll figure it out. And even if the City does wind up going bankrupt, the State will pay for police and fire — and that's all I *need*."

Value guys go in early. But sometimes that's the only way.

Browne: That was sort of our approach in Japan. We couldn't tell you *when* they were going to do it. However, the growth investor wants to see tangible signs that Japan is turning and that everything's happening. And meanwhile, the value guy goes in too early.

The Japanese stocks we bought just kept going down and down and down and down. And we kept buying more and buying more trying to hold our Japanese stake at 15%. And then *bingo* — with no warning whatsoever, it turned. If we'd tried to get into Japan after it turned, we could never have established the positions that we did. We had to buy it *before* it turned.

—OID

TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from page 1)

who bought the bulk of his shares of Berkshire Hathaway through Howard Browne. And we could go on and on.

Of course, the firm hasn't exactly been a slouch at money management either. Since January 1, 1959, its private investment partnership, TBK Partners, has earned a compound annual return before all fees and expenses of approximately 19.7% versus 12.0% for the S&P 500.

The modern-day partners have done their part to carry on the Tweedy tradition. Since January 1, 1975 (by which time two of the firm's three portfolio managers were in place,) the firm's composite equity accounts earned a total return before fees of 21.5% vs. 17.1% and 9.6% for the S&P 500 and the Value Line Composite, respectively.

And they achieved those returns, incidentally, despite carrying around significant cash balances for much of the period. Their total compound annual return net of fees on the common stock portion of their portfolio alone was actually 21.9%. (All figures provided by Tweedy, Browne.)

During the most recent 10-calendar-year period, a time which has been relatively unpleasant for any manager who hasn't been concentrated in the S&P 500, the compound return of the firm's composite equity accounts lagged those of the S&P 500 — 17.6% per year before fees versus more than 19.2% per year for the streaking index.

However, it's worth noting that its 17.6% return was nearly double that of the Value Line Composite over the comparable period. And Tweedy Browne's six-year-old domestic flagship fund — Tweedy, Browne American Value — performed well enough to rank among the top five funds (the top 7%, incidentally) in its category according to Morningstar for the five years ended October 31, 1999.

When we heard value investing had stopped working at the recent Value Investing Panel Discussion — and that it might even be an open question whether the style had a future at all — we figured the time was right to give the guys at Tweedy, Browne a call.

The following excerpts were selected from a series of in-depth conversations with Tweedy's portfolio managers/general partners, John Spears and Chris and Will Browne, and its director of marketing, Bob Wyckoff, which occurred from November 5th right up to press time. We always enjoy our conversations with the folks at Tweedy, Browne and find them both stimulating and rewarding — both for perspective on the current financial scene and, invariably, for some specific, intriguing investment ideas. We found these to be no exception and hope you'll agree.

LARGE CAP GROWTH STOCKS HAVE SKYROCKETED
WHILE SMALL-CAP VALUE STOCKS HAVE LANGUISHED.

OID: I gather from remarks at your Value Conference that value investing has stopped working...

John Spears: In U.S. stocks, that's right. Internationally, the value investing style has been just fine.

But it's been terrible in the U.S., all right.

Will Browne: But there's a misperception out there. Not too long ago, I was shooting the breeze at a party and it came out that I was in the investment advisory business. They asked, "What's your approach?" And I said, "Value." And they said, "Oh, my God! Do you still have clients!?! You're not out of business!?!"

OID: That was my next question.

Spears: The implication of that person's reaction is also that our returns must have been awful.

Will Browne: Exactly. As value investors, we must have suffered horrible returns for an extended period. And that's simply not the case. If you look at the results of our accounts right through 1997, you'll see that we were handily exceeding just about any index you might pick. We were doing *extraordinarily* well. We haven't been sitting around licking our wounds for the past nine years or whatever. Far from it.

Bob Wyckoff: No. It's been *great*...

Chris Browne: Tweedy, Browne American Value Fund, for example, over the past five years ended November 30th has compounded right at 21% per year — which is less than the S&P's 27% per year return over that same period. But I'm perfectly happy with a 20%+ compound return.

Spears: Yeah. The lousy relative returns have only been for the last year-and-a-half.

OID: So value investors recently became dinosaurs.

Spears: Tweedy, Browne American Value Fund had a total return after all fees and expenses of 9.6% for 1998 — versus 28.6% for the S&P 500. And through November 30th of this year, the fund was trailing the S&P 500 with a return of 2.95% versus 14.3% for the same index.

Will Browne: But if you strip it all away, you see that a lot of that differential is from the enormous returns generated by the technology and communication components of the indexes.

Wyckoff: There's been just *huge* dispersion — well over 30 percentage points, or 3,000 basis points, between the returns of small-cap value and large-cap growth. Returns have basically been concentrated in 20-30 stocks.

OID: Which is what FPA Capital's Bob Rodriguez told us last year. So that's continued. And presumably, the worst group of all remains small-cap value...

Wyckoff: No question about it. Listen to these figures: For the one-year period ended September 30th, the Russell 2000 Value Index, a proxy for small-cap value, was down a little over 1% — 1.43% to be more exact. The Russell 1000 Growth Index, meanwhile, was up 31.5%. That's a difference of nearly 33 percentage points — or 3,300 basis points.

OID: That's an amazing difference, all right.

Wyckoff: It's been *enormous*. And if you go out further, say three years, it's been the same story. For the three years ended November 30, 1999, the Russell 2000 Value Index has compounded at 6.75% per year versus 28.88% for the Russell 1000 Growth Index. It's really been a large-cap growth stock market over the last three years.

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

OID: Wow.

Wyckoff: And it's been the same thing over five years — 30.25% per year for growth vs. 13.12% per year for value. So we've been in a period of *enormous* dispersion between so-called broad value and concentrated, large-cap growth.

Chris Browne: And the NASDAQ has become a totally irrelevant index. When an index of 4,400 stocks has five stocks account for 50% of the index, it's irrelevant.

Will Browne: Similar to most European indexes now.

Chris Browne: It's not really relevant to a portfolio — because nobody constructs a portfolio where five stocks account for half of the portfolio and the other half is in 4,395 other stocks.

IS IT A NEW ERA? HAVE THE RULES CHANGED? *
NAHH. HUMANS ARE JUST WIRED TO THINK THAT WAY.

OID: But some suggest large-caps have outperformed for good reasons — in particular, because they enjoy the economies of scale necessary to take advantage of huge new markets around the globe.

Wyckoff: Maybe so. But there's *always* a reason. Whenever there's a two-tiered market, people wonder, "Have we entered a new era? Have the rules changed? Etc." For example, in terms of mutual fund flows today, virtually all of the money is going two places — into index funds and into focused technology funds. And there's this trend toward focused portfolios — more concentrated portfolios — like the Janus 20. I think that trend is partly due to Buffett's success running a pretty concentrated approach and hammering away about putting all of your eggs into one basket and watching that basket very carefully.

OID: You call what Buffett's done "success"?

Wyckoff: These firms running focused portfolios watch where the returns have been in the stock market and then create portfolios of 10-20 technology stocks in order to capture that return. *Huge* amounts of money are flowing into those portfolios. And the S&P is dominated by those same 10-20 stocks. So there's a lot of money flowing into a very high risk part of the market right now.

[Editor's note: Shortly before we went to press, we heard commentators on a leading financial network talk about Janus's success in this area. They pointed out that the firm had raised more than \$30 billion this year — or roughly triple what they raised last year — and, we believe they said, a record amount of money in November, eclipsing the prior record which had been set in October. Furthermore, its best-performing fund, Global Technology, was up 172% year-to-date.

As we listened to that report, our first thoughts were, "With all of that money chasing a relatively limited number of stocks, it's certainly no wonder that they're up so much! Here's a very bad accident waiting to happen."

So we found it fascinating when, following the piece, one commentator expressed precisely the *opposite* view.

Said that commentator: "Up 172%! That is tempting."

Chris Browne: If that's what the public wants, they'll create a product for 'em — irrespective of whether or not they think it's good for people to be doing that or not.

OID: You're not suggesting that money managers and brokers don't put their clients' interests first?!

Spears: It's the behavioral emphasis on the near term. Humans are just wired that way. It's called "the hot hands theory" — where one basketball team gets a few baskets in a row and observers extrapolate it.

Chris Browne: And it's the same after a plane crash — people don't want to fly. And it's totally illogical — because it's far safer than traveling by car. You should never waste your money on flight insurance. Statistically, you're much better off buying a lottery ticket. However, people buy it all the time.

Spears: The human mind is not programmed to think about base rates — about long run averages and statistics.

OID: That's what Charlie Munger says — if you rely on your standard wiring, you're like a one-legged man in an ass kicking contest.

Spears: Exactly.

Chris Browne: Therefore, money gravitates to what has performed best recently. For example, over the last three years, the earnings of the so-called Magnificent Seven (coined by Edward Yardeni) — Microsoft, Lucent, Intel, IBM, Cisco, AOL and Dell — are up 157% as a group. Well, that's terrific. But those stocks are up 314% — which means that their P/E has doubled.

OID: Maybe they deserved to have their P/Es double. After all, as you point out, their earnings have been growing quite rapidly.

Spears: Other things being equal, we prefer to own stocks that are increasing in value rapidly year after year. We like the idea of tax efficiency.

But we recently completed a study of how companies with great 10-year track records — those with the highest return on equity and the highest earnings per share growth as of December 31, 1990 — did during the subsequent seven years. Going in, those companies had an average historical return on equity of 29.1% and average historical earnings growth of 18.5%. And yet, less than 20% of those companies had earnings per share growth during the subsequent seven years of more than 15%.

OID: Interesting.

Spears: In fact, those companies with the *lowest* historical return on equity from 1980 to 1990 actually had a similar distribution of subsequent seven-year returns. There seems to be a reversion to the mean.

WE'VE SEEN INVESTORS GET CARRIED AWAY BEFORE
WE'LL NO DOUBT WATCH 'EM BE CARRIED AWAY AGAIN.

Chris Browne: And that's been true in our experience. We were value guys back in the 1970s. Back then, we were eccentrics off in a corner doing something really weird.

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

OID: Let's leave your personal lives out of it.

Chris Browne: But most people were market timers and growth investors...

Spears: It was the era of the Nifty Fifty.

Chris Browne: Yeah. And that's what the world did. We were these green eyeshade people off in the corner.

OID: You were value investors before value investing was cool.

Chris Browne: Yeah. That was back before the academic studies showed the efficacy of value investing. So we've seen it all before.

It's nonsensical. Byron Wein of Morgan Stanley presented a list of 21 glamour stocks of the 1967-68 period. The average P/E at their highs was 103. But if you knocked out a couple of 'em like Mohawk Data at 285, Levin Townsend at 352 and Fairchild Camera at 443, the average P/E of the group was probably around 65. Of course, everyone thought every one of these companies was a great company — that nothing could go wrong. Why else would they be valued at such ridiculous prices?

But poof — today, only one of 'em is still in existence. The average decline for the group by 1970 was 88%. The best performer — the one that declined the least — fell 80%. And the greatest decline was 96%.

OID: Ouch.

Chris Browne: And for whatever it may be worth, the P/E of the Magnificent Seven is roughly 65 today as well. So are we dinosaurs? I don't think so. To the contrary, we've seen these periods before — and we'll see 'em again.

Spears: Yeah. And we know that stinko periods have tended to be followed by periods of substantial success. Underperforming the S&P 500 30-40% of the time is normal for people who've generated substantial wealth in excess of the Index. For example, that was the case with Buffett's "Super Investors of Graham and Doddsville". That's just another way of saying that indexes lag very successful investors 60-70% of the time.

OID: That glass isn't 30-40% empty; it's 60-70% full.

Spears: Exactly. But nobody uses Tweedy, Browne as the benchmark for the S&P. It's the other way around. Nobody says, "Gee, the S&P really stinks because it's underperforming these value guys 60-70% of the time." It's just a given. Nobody questions it.

Chris Browne: And you can't beat the index if your returns don't vary from the index — by definition.

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

THERE'S ACTUALLY BEEN A BEAR MARKET ALREADY.
IT'S JUST BEEN HIDDEN BY THE RESULTS OF A FEW.

Chris Browne: What the consultants want to do is take the universe of stocks, draw a line down the middle and call half "value" and half "growth". But that's not the

way it works.

If you imagine stocks arrayed along a bell curve, where the value thing works is way out at the ends — at the extremes of valuation. That's where you have to concentrate your money because that's where the real future outperformance lies.

OID: Speaking of valuation extremes, how does the availability of real values compare with other times we've spoken?

Chris Browne: Increasing. [He chuckles.]

OID: So you're not finding any shortage of ideas.

Spears: Not at all.

Will Browne: Over the last six months, over half of the industry groups in the S&P 500 have declined between 18% and 34%.

Spears: Financial stocks have been one of those groups. They've done lousy.

Will Browne: And health care — you name it. Many, many stocks have been absolutely obliterated.

OID: So, in effect, there's been a bear market. It's just been hidden by the appreciation of a narrower and narrower group of stocks dominating the indices.

Will Browne: Exactly. There's been a bear market, but it's been hidden by the performance of a handful of securities which have done extraordinarily well.

Wyckoff: A narrow part of the market, which is predominantly large-cap in nature, has masked the mediocre results elsewhere.

Will Browne: So are more names popping up that we'd like to buy? Absolutely.

OID: Might we trouble you to share a few with us — and the more extreme the better.

Will Browne: Sure. There's a misperception out there that what value investors own is the dead and dying of corporate America — the one-puffers — companies on the brink of disappearing. And that's simply wrong.

OID: Yeah. That sounds like our portfolio.

Will Browne: For example, if you look at the 20 largest holdings in Tweedy, Browne American Value Fund, you'll see there are many, many good companies. They're the kinds of companies you can sleep comfortably owning — whose intrinsic values are likely to grow over time — where the clock is working for you. And these companies probably comprise half the portfolio.

And I think we're implementing, to the point of crossing our "t"s and dotting our "i"s, the value approach. But that doesn't necessarily lead you to buying a bunch of dying businesses.

QUORUM'S NOT EXACTLY A LUMP OF COAL.
IT HAS MORE IN COMMON WITH WAL-MART.

OID: At the Value Conference, you mentioned beginning to buy Quorum Health Group at or above today's price.

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

Do you still consider it to be a bargain today?

Chris Browne: Definitely. But equally important, the insiders are telling us that they consider it to be a bargain — by voting with their dollars.

OID: Then by all means...

Chris Browne: Quorum [QHGI/NASDAQ] is in two businesses. First, it owns hospitals. Currently, Quorum owns 22 hospitals directly. Plus, it owns a stake in two joint ventures. Second, it's the largest manager of not-for-profit hospitals in the country. It has contracts with 230 hospitals. And management revenue accounts for about 10% of revenues, with the balance coming from their owned hospitals.

[Editor's note: According to its 10-K, as of June 30th, Quorum provided management services to 223 hospitals. Most interesting, according to that same 10-K, it's believed (according to industry studies) that the #2 and #3 players managed only 51 and 19 hospitals, respectively.]

Spears: Quorum's management business gives them a first look at not-for-profit hospitals that are for sale. And those not-for-profit hospitals, incidentally, make up approximately 85% of our country's hospitals. They're similar to a management firm that manages hotels, only they manage not-for-profit hospitals.

OID: And didn't you say they're considered to be one of the best operators in the country?

Chris Browne: That's right.

Spears: They're definitely one of the best. They have one of the best track records — and they've achieved some of the best margins in the business.

OID: And they've done it without throwing people out in the snow or anything like that.

Chris Browne: That's right. And that's easier to do because they're not dealing in big-city, inner city hospitals. The company targets markets with a population of 50,000 to 500,000 with pretty good projected population growth — 8% versus 4.2% on average according to estimates by William Blair — where it can be a dominant or sole provider. And it is the #1 or sole provider in many of its markets.

OID: It sounds like Quorum is following a strategy sorta like the one Wal-Mart followed for many years — invest where the competition ain't.

Spears: That's right. And they're noted for excellence. They have an excellent reputation and the trust of many players in that industry.

OID: It sounds like it might give 'em quite a leg up.

Spears: It's definitely helped. It's given 'em insights into hospitals that are for sale — most, of which, are non-profits. So it's aided them in making investments in hospitals and in buying hospitals outright — by knowing more about the business, by being in a better position to know about available opportunities and by having an excellent reputation and the trust of so many players in

that industry.

Plus, after they acquire hospitals, they can utilize their expertise and their advantages of scale — both to achieve purchasing economies and acquire cost-effective management resources.

OID: Sounds impressive so far.

Spears: There's a lot to like — including the fact that the hospital management business doesn't really require any capital.

YOU CAN BUY QUORUM AT A HUGE DISCOUNT
— AND EVEN AVOID THE LINES AT THE DOOR.

Chris Browne: We originally found Quorum on the insider buying list. You found that one, John, didn't you?

Spears: Yeah. And there's *very* big insider buying — huge insider buying.

Chris Browne: Yeah. Quorum is basically a partner with Welsh, Carson, Anderson & Stowe — which is a highly respected venture capital firm that bought Quorum in an LBO [leveraged buyout] from Columbia when it was primarily a contract hospital management company.

And Russell Carson, the principal of Welsh, Carson, Anderson & Stowe who specializes in the health care area, is Quorum's chairman and largest individual shareholder.

OID: That sounds like a great combination, all right.

Spears: We think so. And Carson has been chairman of Quorum since his venture firm first acquired it. Well, we couldn't help but notice that Russell Carson, among others, began actively buying Quorum shares.

Chris Browne: Yeah. I believe Carson alone bought more than \$25 million worth.

Spears: Back in December of '98, Carson bought 590,000 shares at \$11-12 per share. He also bought another 2,450,000 shares in February between \$8 and \$9. And another officer bought 100,000 shares at an average price of \$8.80.

Chris Browne: And there'd been an earnings glitch because some of its hospitals weren't meeting year-to-year patient increases or something like that. Plus, there were some acquisitions that they hadn't straightened out yet.

But long term, they've been one of the best operators of hospitals in the country. And on a normalized basis, when we found it at \$10 or \$11, it was probably trading at about 10 times earnings. And then you could estimate the private market value of their hospitals using their EBITDA — which we did.

Will Browne: And we also used a per bedpan basis.

OID: Let's come back to that analysis later — because it sounds like it might be all wet...

Chris Browne: We came up with a value that way — using EBITDA — of about \$17 per share.

Spears: Something like that, yeah — with the stock at \$10 or \$11. So we started buying it. I think we paid up to \$12 or so and kept buying all the way down to \$6. And it's trading around \$8.50 today.

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

OID: *And it looks like Quorum's stock traded north of \$30 as recently as last year.*

Chris Browne: Yeah. And as you know, I'm on a board with the chairman. So at one meeting, I said to him, "Well, we started buying Quorum. It's nice that you bought some." He said, "You'll make money someday."

Then, when the stock was bouncing around somewhere down in the high \$5s, I saw him again. And I said, "Russ, we share your pain."

OID: *What did he say?*

Chris Browne: He smiled and laughed.

OID: *The heartless bastard.*

Chris Browne: Then when I saw him most recently, he said, "I hope you kept your Quorum stock." Of course, we did.

OID: *And he wasn't wishing you harm...*

Chris Browne: No, he wasn't. Russell Carson is one of the nicest human beings I've ever met. He's the kind of person who wishes everybody well.

And what's funny is that every endowment in the country wants to get into their LBO limited partnerships — to have the privilege of paying them a 1% annual fee plus 30% of their gains.

OID: *At the conference, you said 2% plus 30% of the gains. But who's counting...*

Chris Browne: I think it is 2%...

Will Browne: Wow.

Chris Browne: The firm has a fabulous record. And one of its specialties happens to be health care. Russell Carson is Welsh, Carson's expert on health care.

And here, you can buy one of Welsh, Carson, Anderson & Stowe's investments — basically at the same time that they're buying more of it — without paying 30% of the gain or a 2% annual fee.

OID: *His fund is buying it, too?*

Chris Browne: It is. Since the insider purchases that we mentioned, Welsh, Carson, Anderson & Stowe and Russell Carson individually purchased additional shares, in effect, by purchasing \$150 million worth of convertible subordinated debentures.

[Editor's note: According to Quorum's latest proxy (dated September 30th, 1999), including the convertible issue mentioned above, Welsh, Carson, Anderson & Stowe VIII, L.P. owns slightly more than 19-1/2 million shares — or about 23% of Quorum's outstanding shares. And Russell Carson owns just over 21.4 million shares — or slightly in excess of 25% of Quorum's outstanding shares.]

Chris Browne: So if you really think that these guys are so brilliant (and their track record would seem to suggest that they are) then why wouldn't you buy this one — as part of a diversified portfolio, of course?

And one nice thing about the ownership structure is that LBO funds have a finite life. The Welsh, Carson fund

that owns the Quorum shares probably has no more than seven years of life remaining — and they may wind it up earlier. So they have to realize on their investment to capture their 30% of the gain.

OID: *So there are serious incentives in place for the movers and shakers here to make it work.*

Chris Browne: Yeah.

Spears: Very serious. You have really shareholder-oriented, wealth-creation-oriented partners.

OID: *If the price is right, I'll put my broker on hold.*

Spears: We think the price is right, too.

OID: *What's your sense of their normalized earnings?*

Chris Browne: In the prior year, Quorum earned \$1.42 per share.

Spears: Adding back goodwill, that's right.

OID: *And that \$1.42 wasn't inflated — or well above normalized earnings for any reason?*

Chris Browne: No. It wasn't an abnormal year.

Spears: It was pretty much normal.

OID: *So we're talking about a single-digit P/E. So far, so good.*

Spears: Plus, it's trading at around 1 times book and at a nice discount to our estimate of private market value.

OID: *We can't argue with you so far.*

THERE'S A STORM IN HEALTH CARE TODAY,
BUT THE SKIPPER AND THE SHIP ARE RIGHT.

OID: *But you're not worried about these guys taking advantage of the company in any way?*

Chris Browne: Russell Carson has more integrity than almost anyone that I've ever met. He's really an outstanding individual. He gives away huge sums of money very quietly....

OID: *And the reason why it's so cheap?*

Spears: Because he's giving away too much money. He's gotta get it from somewhere.... Sorry, Chris.

Chris Browne: Why is it so cheap? Because it's a health care stock. All the health care stocks got slammed.

Spears: Yeah. They have been slammed.

Chris Browne: There's concern about whether or not they're going to cut back Medicare reimbursement.

OID: *Not exactly a small point when it represents 54% of your revenue.*

Spears: No. Who knows? It's happened before.

Chris Browne: However, it's one thing to hurt Granny's nursing home. It's another thing to shut down your neighborhood hospital.

Spears: That's for sure.

OID: *How so?*

Chris Browne: When we originally looked at Quorum,

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

Will didn't like it because of the experience we had with Sun Health Care — which is a nursing home operator. And the analyst and I argued that Quorum is different.

Again, for the most part, Quorum owns hospitals — mostly community hospitals — that are the only game in town. So they usually don't have to compete with other hospitals for patients. And of course, that makes it easier.

By comparison, the University of Pennsylvania Health Services Division lost \$198 million last year. They're just gushing red ink. And that's because Philadelphia is the most overbedded city in the country. Also, something like two thirds of its patients are accounted for by two HMOs. So you can imagine what kind of pricing power they have in Philadelphia.

OID: Therefore, those HMOs can drive hard bargains with the hospitals on rates, etc.

Will Browne: Exactly.

Chris Browne: And as if that weren't enough, Philadelphia has no municipal hospital. They had one — Philadelphia General. However, they were smart — and they shut it down. So where do the indigents go? To everybody else's hospitals. Therefore, it has one of the highest indigent patient counts of any city in the country.

OID: I think I get the picture.

Chris Browne: It's a disaster. The only way that they're ever going to get the supply and demand in synch is for somebody to go out of business. And who's going to go first? Well, the University of Pennsylvania can't go first. It's got a medical school.

Quorum is out in places like Eau Claire, Wisconsin. They have the only hospital in town.

Will Brown: And places like Biloxi — in communities that basically can't have their hospitals shut down. Therefore, it's much more difficult for the government to cut back Medicare reimbursements in order to save money if the possible result is that hospitals go bankrupt.

OID: Why do you say that?

Chris Browne: If you're in a place like Eau Claire, Wisconsin and you have one hospital and it shuts down, people go crazy.

OID: Wouldn't it simply operate in bankruptcy — with new owners?

Chris Browne: That would imply they have cash flow. And bankrupt hospitals don't have cash flow.

OID: So it would interfere with its ability to continue operating and deliver a reasonable quality of care.

Chris Browne: Exactly. Quality and availability. And who's always on the hospital boards in those towns? It's the leading citizens of the community. So while the government could go and slash the reimbursement rates on nursing homes and no one would care all that much, they can't do it on hospitals — because of that political clout.

OID: Why not? The clout you describe is local. Aren't

medicare reimbursement rates set nationally?

Chris Browne: They are. But as the old saying goes, all politics is local. Meanwhile, Quorum has the second best profit margins in the industry. Therefore, those community not-for-profits are going to go out of business — or, at least, begin to gush red ink — first. And who are they going to complain to? Their congressmen.

THE PENDULUM'S ALREADY SWUNG TOO FAR.
SO BETTER WEATHER MAY BE ON THE WAY.

OID: Meanwhile, Quorum's earnings get squeezed — by HMOs and managed care companies and by reduced Medicare payments resulting from the so-called 1997 Balanced Budget Amendment.

Chris Browne: Not so much. There's not much of a large managed care presence in most of Quorum's markets.

OID: What about the impact of Medicare cuts?

Chris Browne: I don't think that there's really been such significant cuts in Medicare reimbursement rates.

OID: Then why are their earnings depressed?

Chris Browne: Quorum typically acquires hospitals with much lower EBITDA margins, say 8%, and through operating savvy and building new specialties — especially in the cardiac and ob/gyn areas — boosts their margins quite dramatically over the subsequent three years. To give you some idea of just how much, I believe their average EBITDA margin the past five years has been north of 18%.

However, for the latest acquisitions, it's taken them longer to improve those profit margins than anticipated. So it's sort of an indigestion problem — they're having trouble digesting an acquisition.

OID: Value Line seems to disagree. They suggest that higher managed care discounts and governmental payor pressures will keep Quorum from returning to its historical profitability.

Spears: Yeah. They've told us that a more realistic EBITDA margin going forward is probably 16% — at least in the context of today's environment. And for a lot of reasons, we don't think it's unreasonable for them to eventually get their EBITDA margin back up to at least 16%.

OID: On the other hand, it sounds like you guys believe that the pricing pendulum has swung too far.

Spears: Yeah. So there could be upside revisions as a result of changes in Medicare reimbursement rates. In fact, there have been some releases indicating that Medicare has saved more than they planned to save. They're surprised by how much money has been saved. And that makes some people think they went a little too far in their Medicare rate cuts.

OID: In which case, a 16% EBITDA margin guesstimate may be lowballing Quorum's future profitability.

Spears: We're just not sure. That 16% is really an echo of what management is saying they think. And here's another case where insider buying comes into play in dealing with the typical murkiness of information and the difficulty of making decisions about investments. People with much more information about all of this stuff than we

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**TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS**
(cont'd from preceding page)

have as outside analysts are betting millions and millions of dollars of their own money that the stock's a good value. So that tips the decision scale for us. It's an example of just how useful that tool is.

When you get into things like the future of an industry and a specific company's margins in an environment that's been undergoing dramatic change, it's very nice to have the crutch of people who are right there, parking their cars in the company's lot, going to work each day in that business betting their dough. End of speech.

OID: It makes sense.

Spears: Yeah. We saw an article in the newspaper that mentioned that Columbia/HCA had successfully imposed a nice price increase in its hospitals in Florida, but that Humana had basically blinked in the negotiation. And after reading that article, we decided that we should undertake some discussions with people in the health care business.

Well, it just so happens that I live on a street that you could almost call health care row — because probably 60% of the people who live on it are employed by Merck, an HMO, Johnson and Johnson or they're doctors...

OID: It could always be worse. They could be lawyers.

Spears: And I was talking with a bunch of these folks and their friends. And there was a sense that the balance of power was shifting — that doctors and hospitals were having an easier time getting price increases from HMOs.

There was also the sense that the decrease in Medicare rates had gone too far...

OID: Given the audience, that's not surprising.

Spears: No. But you're seeing it especially with the teaching hospitals in the big cities. Again, they're just losing buckets of money.

And there was the thought that there could very well be political pressure placed on Congress by leading citizens of these towns who are on the boards of directors of these little non-profit hospitals to raise the Medicare rate.

[Editor's note: A Tweedy, Browne research report on Quorum sounded a similar note:

"There is mounting political pressure against any further reimbursement cuts or other quick fixes; S&P says a record number of not-for-profits will go bankrupt this year, and a proposed new set of cuts has been shelved. If proposals floated by the recently disbanded Medicare panel get revived, these will likely entail a premium-based plan with a variety of options for the beneficiaries rather than another round of cuts to hospitals."

OID: Again suggesting a swing away from further cuts.

Spears: But only time will tell. Ultimately, revenues from the government are very important in this business.

Chris Browne: But what I fall back on there again is Russell Carson's \$25 million purchase of stock. He's intimately aware of all of these issues. And maybe Quorum won't get back to the 18%+ EBITDA margin that

they've managed historically. But he's clearly concluded that it's dirt cheap at these prices.

OID: And you think he should know.

Chris Browne: Oh, yeah. He's one of the top guys in the health care venture capital area in the entire country. Welsh, Carson is really well respected in health care. And he's their health care guru.

OID: Let me read you another excerpt from Value Line:

"The company is involved in a [whistle-blower] lawsuit with the government that alleges Quorum prepared fraudulent cost reports for Medicare and other federal programs from 1984 through 1997.... The worst case scenario would preclude Quorum from participating in Medicare and other government programs in the future...."

OID: That obviously doesn't worry you.

Chris Browne: No — because it's a stupid statement. Again, if you're the only hospital in town and people who are going there are having it paid by Medicare — and now they can't have it paid for... That's just not something that's going to happen.

OID: Couldn't such sanctions just force ownership of the hospitals out of Quorum's hands — in effect, force them to sell all of their properties — if they are found guilty of wrongdoing?

Chris Browne: That would be great. We'd love them to do that.

OID: Because Quorum's trading at a healthy discount to liquidation value.

Chris Browne: Exactly. So that would be a wonderful outcome.

OID: But you don't think it's likely.

Chris Browne: No. And neither does Carson.

OID: How do you know that? Has he said as much?

Chris Browne: Only by writing a check for more than \$25 million. That means a lot more to me than it would were he to make the statement in words.

Also, we understand that Quorum is embroiled in the government investigation of Columbia/HCA because it was once a unit of that company. The government claims overcharging for the period prior to '93 equaled \$70 million. But I suspect that Columbia is the first line of defense. If there was any wrongdoing, then it sounds like Columbia was the one doing it.

[Editor's note: We should also not fail to mention that Value Line suggests the worst-case scenario is unlikely and says "a couple of non-profit health care organizations have filed friend of the court briefs in favor of Quorum with regard to the pending whistle-blower lawsuit".

Also, in Quorum's most recent annual report, its CEO, James Dalton, Jr., points out that "Despite the negative publicity associated with the lawsuit, the boards of our client hospitals have demonstrated belief in us. Our new contract rate met expectations, as did our renewals.... Perhaps the most gratifying vote of confidence we received over the past year was the renewal of our contract for

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TWEEDY, BROWNE'S
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(cont'd from preceding page)

seven years with the hospital in Whitefish, Montana where the ... lawsuit originated.”]

Spears: Meanwhile, here we have heavy insider buying in combination with low P/E, low price-to-book, low price to private market value and share buybacks. So Quorum has a multitude of the elements that we look for.

OID: It works for us.

HOLLINGER MAY HAVE NO FRIENDS ON THE STREET,
BUT WE AGREE WITH THE INSIDERS — WE LOVE IT.

OID: That one sounds like a very hard act to follow. But I hope that won't stop you from trying.

Will Browne: What else do we think represents extreme value today? I think Hollinger's [HLR/NYSE] sort of interesting. Of course, Hollinger is Conrad Black's newspaper chain.

OID: Sure. But even died-in-the-wool value investors like Ruane, Cunniff appear to be losing patience with that one.

Will Browne: I don't know who's lost patience. But Hollinger's stock has come way down in price — from a high up around \$20 to a low just under \$10. It's trading around \$12-1/2 today — and we've been buying it.

[Editor's note: According to *Portfolio Reports*, so has David M. Knott, Ltd.]

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

Spears: Basically, we've paid as little as \$10 — maybe \$9-7/8. And we're paying the current price.

Chris Browne: To give you some idea of just how out of favor this company is, the gentleman who runs Hollinger's investor relations office in New York called us when we filed our 13-D recently [on November 2nd] all thrilled and excited. Why? Because our filing gives them credibility. And they have very little credibility otherwise at this point. Our liking it enough to buy 5% of the company

(continued in next column)

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makes his job a lot easier.

Will Browne: Our biggest competitor, incidentally, in buying stock is the company itself.

OID: They're buying back shares, too?

Will Browne: Absolutely. Every day, we're competing with them for stock. They're in there each day purchasing stock. They're undertaking an *enormous* stock buyback.

Spears: Hollinger's been buying back a lot of stock. And given the large insider ownership, that's equivalent to Conrad Black buying his own checking account at a discount. It's very similar to an insider purchase. In fact, given his very large ownership position, in effect, it is an insider buy.

Will Browne: And if you listen to Conrad Black talk, you understand quickly he's not in Hollinger for the salary. This is an important part of Conrad Black. He's going to make money in it. He's *determined* to make money in it.

Spears: His pride is committed, too.

Will Browne: He's on the line.

OID: None of those things ever helped us.

Will Browne: And we think Hollinger makes *enormous* sense at these prices. Even when we use the most conservative assumptions imaginable, we figure that it's *got* to be worth \$18-20 — and probably much more.

OID: Having looked at Hollinger and Southam briefly a couple of years ago, we agree with the much more. But why, then, has the stock gone nowhere but down?

Will Browne: There are three or four different reasons. First of all, Black has always been somewhat controversial — to say the least. And as you might expect, the company hasn't been meeting expectations.

Also, there are probably, as I recall, some hard feelings on the part of analysts toward Hollinger. It's interesting — rather than arriving at their conclusions independently based on analysis, today analysts get guided to things by the companies.

Chris Browne: Didn't the company make a mistake in amortization or depreciation at one point?

Spears: Yeah. Hollinger's had some reporting snafus.

Chris Browne: Yeah. And Wall Street doesn't like that kind of thing. It gets 'em all excited.

Will Browne: When the analysts find out that they've been misguided, their sense of injustice and outrage knows no bounds. There is no redemption. They just say, “Out!” And I think that's what's happened here.

OID: Hell hath no fury like an analyst scorned.

Will Browne: I think that pretty much sums it up. And until recently, its structure was quite complicated and difficult to understand — with a lot of minority pieces, etc. But they've cleaned it up.

OID: So investors understand the company better — and they don't like what they see?!

Will Browne: No. But because the company just changed its financial structure so dramatically, it doesn't have a particularly robust shareholder constituency.

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

Chris Browne: However, the biggest reason why Hollinger's earnings are depressed is that it's invested enormous money into this newspaper start-up in Canada — the *National Post*. And Hollinger is expensing all of it.

Spears: Right.

Chris Browne: The launch of their national daily has resulted in nothing but Hollinger bleeding red ink so far. And that hasn't helped matters in terms of its stock any.

OID: It sounds a bit like Gannett with its USA Today operation — where it lost money for a long time.

Will Browne: In that way, it is — although a lot of Hollinger's assets aren't located in Canada. It has major assets located in the U.S. and the U.K. — and assets all over the world.

And you can look at the company in one of two ways: One way to look at it would be to factor in something for what its national daily newspaper might be worth. And we haven't done that. Alternatively, you can look at what the company's earning ex the money it's spending to develop its national newspaper by simply adding it back. And that's what we've done. That way, we're not relying on the success of Hollinger's Canadian national newspaper.

OID: I should say not. It sounds like you're valuing it at zero. And that's unlikely — at least outside of investment publishing...

Will Browne: We think it's very unlikely given that their effort to build it so far has been very, very successful. In fact, there was a big article in *The Financial Times* about the new newspaper and its reception in the marketplace.

But before people start to advertise, they wait to see the circulation. However, he's been very successful building the circulation on a national basis. It's apparently becoming an extremely well read newspaper.

HOWEVER CONSERVATIVE OUR ASSUMPTIONS,
WE CONCLUDE THAT HOLLINGER'S A BARGAIN.

Chris Browne: And setting the *National Post* aside, Hollinger has some pretty good assets. We all know that. It's got the newspaper in the U.K. It's got the regional newspapers here. It has the *Chicago Sun-Times*.

[Editor's note: According to its annual report, besides the *Chicago Sun-Times*' 1.7 million readers (and 71 newspapers in the Chicago area), Hollinger's other newspaper properties include *The Daily Telegraph* and *The Sunday Telegraph* in London, *The Jerusalem Post*, and more than 43% of the Canadian daily newspaper market.]

Will Browne: And based on their operating income, Hollinger looks to us like it's probably trading at about half of what its assets would bring were they put up for auction. And that's assuming they shut down the new national newspaper that they're launching in Canada tomorrow and auctioned off the assets.

All we're doing is adding back the losses associated with that entity. People who want earnings momentum

don't seem to go through that little exercise. They just say, "Well, earnings are down a couple of cents. They should've been up a couple of cents. Therefore, it doesn't have earnings momentum. So we'll sell."

OID: Having looked into Hollinger before, albeit never having written it up, we don't disagree with you. But would you walk us through your analysis?

Will Browne: We calculate Hollinger's EBITDA today, add back what they're spending on the *National Post* and apply a multiple of 10. And when we do that we come up with a value, as we mentioned earlier, of between \$18 to \$20 per share.

And besides excluding any value for the *National Post*, we think that figure is conservative for several reasons.

Spears: Yeah. We could come up with a *much* higher valuation for Hollinger depending on the EBITDA multiple.

Will Browne: That's exactly right. And I don't think that we're stretching it one *bit* in terms of the multiple — at all — given what people are paying for these things.

OID: We'll bite. What are people paying?

Will Browne: Well, not all of Hollinger's newspapers are dailies. And many of them are community newspapers. And our analyst estimates that when Hollinger sold limited partnership units in its Canadian community newspapers earlier this year, it sold them at about 10-11 times EBITDA, net of taxes.

But we don't think we're being aggressive using 10 times. An EBITDA multiple of 10 seems to be very much on the low end in terms of deal multiples for newspapers. In fact, a recent article in the *Wall Street Journal* mentioned some deals that occurred between 12 and 13 times EBITDA. And our in-house analyst on Hollinger tells us that they sold a package of mature U.S. community newspapers in January for around 12-1/2 times EBITDA — and another newspaper, the *Minneapolis Star Tribune*, sold for 16 times EBITDA. I'd say that the private market value for a daily newspaper probably tends to range somewhere between 12 and 14 times EBITDA.

Spears: Yeah. I think the *San Francisco Examiner* just traded at something like 14 times EBITDA. And various articles about that transaction mention deals occurring at 12-14 times EBITDA. However, to be really detailed in doing comparable sales, you should know the margins among other things. But again, we just use 10.

Will Browne: Although deal prices have been higher. Some pretty fancy prices have been paid for these things.

People will often pay a higher multiple of EBITDA, too, if they believe that they can improve a property's margins with cost savings, price increases or what have you.

Spears: That's right. An EBITDA multiple of 10 would be *extremely* low end for a newspaper property that hasn't optimized its margins.

OID: And is that the case here?

Will Browne: Oh, yeah.

Spears: Hollinger definitely believes it has room to go raising its margins. Their EBITDA margin is below 20% — and some of its newspapers have EBITDA margins of 30%. That's not to say they'll get their overall margin to 30%, but

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
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we definitely believe it's very improvable. They talk about margin improvement opportunities. For example, they're putting color presses in the *Chicago Sun Times* and expect margin improvement there and in some of their other papers.

Chris Browne: All told, the new facility in Chicago is expected to cost about \$120 million. However, they expect to recoup \$60-70 million from the sale of the old plant. So their net cost should be \$50-60 million.

But those new color presses will increase their EBITDA by \$12 million per year from cost savings alone. It's the most state-of-the-art printing plant in the country. Black says they expect to cut their headcount in the plant by more than half. Plus, they believe those color presses will enable them to further increase EBITDA by \$17 million by raising the newsstand price of the *Chicago Sun Times* from 35¢ to 50¢ — which, by the way, would only match the price of the *Chicago Tribune*.

OID: *It doesn't sound like you're factoring in the impact of a price increase into your estimate of private market value. So we'll let you ride. However, they are in a dogfight in that market, aren't they?*

Chris Browne: They don't have a monopoly in that market by any means. But our analyst suggests that the limits on cover pricing seem to have as much to do with convenience as they do with price. For example, for a newspaper like the *Chicago Sun-Times*, 70% of whose sales are at the newsstand, the reader will not pay something that takes more than two coins. So the natural price hike is from its current 35¢, consisting of a dime and a quarter, to 50¢, consisting of two quarters.

And as further evidence of her thesis, she points out that the company says that it's achieved cover price hikes on between 50% and 60% of its circulation over the past few years — and achieved a steady upward trend in circulation during that period in spite of the upward creep in cover price.

OID: *Very interesting.*

Chris Browne: But like you say, we're ignoring it. We're also ignoring the fact that color advertising commands a 25% premium to black and white ads.

Also, they plan to centralize their newsprint buying. And although that won't happen until next year — given the complexity of figuring out how to buy, hedge, etc. — once it does, they expect \$30 million per year of savings. (Hollinger buys 600 million tons of newsprint per year.)

So there's a laundry list of things that stand to increase Hollinger's margins. There's the savings from the new printing plant, the higher newsstand price once they have the color presses, the higher ad rates from color ads and the centralized buying, etc. There's lots of margin upside.

[Editor's note: It sounds like Conrad Black agrees. Here's an excerpt from his letter to shareholders in Hollinger's latest annual report:

"Approximately \$38 million of EBITDA was sold in the U.S. community newspapers for a little over 10 times EBITDA net of capital gains taxes. For about the same amount, or

a few million more ... we bought the Southam minority which last year represented US\$59 million of EBITDA.... And growth prospects for Southam, which had a '98 EBITDA to total revenue margin of 22% (over '97 — 21%) are considerably greater than the prospects for the Community Group which had a corresponding margin of about 28%.

Southam, like Hollinger, had the greatest year in its history, but as with Hollinger, the best is yet to come....

The projections for declining newsprint prices, which appear to be well founded, provide another encouraging sign for 1999. Every \$10 drop in the cost of a metric ton of newsprint, and several such declines seem likely, produces \$5 million of pre-tax income."]

Chris Browne: But again, we haven't paid for it. None of that's in the current calculation.

Spears: Yeah. We've just used run rate numbers and backed out Hollinger's losses on the *National Post*.

Will Browne: We assume it's shut down.

Spears: That's right. We're ascribing no value — none whatsoever — to the *National Post*. And even then, we've slapped on a low-end EBITDA multiple.

OID: *What exactly are we talking about in terms of current EBITDA per share?*

Spears: Hollinger has about \$3.35 per share of core EBITDA — and about \$11.70 per share of net debt.

OID: *And that's historical EBITDA — in other words, before adding any of the sources of additional income you've talked about.*

Spears: Correct. That's adding back only the losses associated with the *National Post* start-up.

OID: *Thus, using an EBITDA multiple of 11 or 12 instead of 10 would add between \$3.35 and \$6.70 per share to your estimate of private market value — which would bring it up to \$22 to \$26 per share.*

Will Browne: Correct. And in Hollinger's latest annual report, Conrad Black makes it very clear that he thinks the company is worth more than \$18-20. He sure wouldn't sell it at that price — or at anything close to it.

BLACK'S TRACK RECORD IS QUITE GOOD —
AND HE'S NOT IN HOLLINGER FOR THE PENSION.

OID: *You said that the company has no credibility with the financial community because they feel like they were misled. What is your assessment of Black as a manager?*

Spears: He's been a long-run money maker.

Chris Browne: Yeah.

Will Browne: From a social point of view, he's been willing to stick his finger in people's eyes quite frequently. And most people find that unpleasant.

Chris Browne: I think he may not cater to the financial community as much as they like to be catered to.

Spears: But he's been very open.

Chris Browne: Yeah.

Spears: The annual report is amusing and refreshing

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

to read — the comments about the value of the stock. And he does talk to you sort of like a partner.

Chris Browne: These guys are *capitalists*.

Spears: We understand that the company had bought back nearly \$100 million worth of stock through August.

He's very disappointed in the stock price. He's always talking about how low it is — and frequently with humor.

Chris Browne: Yeah. He really wants this to succeed.

Spears: His shareholder orientation is unusual...

OID: *And intense. I think he, in effect, says that unless their shares more closely reflect their value, he'll buy back shares until they're a private company.*

Spears: To get the stock up — exactly. It's refreshing and different.

[Editor's note: Here's another sample from Black's letter to shareholders in Hollinger's latest annual report:

ON THE NON-RECOGNITION OF HOLLINGER'S VALUE:

Conrad Black: "*Business Week* magazine's Investment Outlook scorecard, which should be read with some caution given that publication's frequent unreliability, summarized our problem more or less accurately at the end of last year. (Their Hollinger earnings growth figure, however, was completely inaccurate because of their inability to distinguish ordinary from unusual income.)

In a survey of prominent U.S. publishing companies, they had Hollinger in the middle ground on return on equity, tied with the Tribune Company. [Stock valuation-wise,] we had the lowest price as percentage of book value except for A.H. Belo; the lowest P/E ratio; the lowest price-sales ratio; the lowest P/E to growth rate; and the highest yield. Changing this status has become management's first priority.

ON HIS STRATEGY TO CLOSE THE VALUATION GAP:

Black: But as the Hollinger share price has not responded to positive results, opportune dispositions of secondary assets or a significant diminution in the number of outstanding shares, we have, on behalf of all the shareholders, rateably, devised a further strategy to seek an appropriate market valuation.

First, we have secured a variance of the covenants attached to our outstanding long-term debt issues, releasing a large amount of resources for share repurchases, should we judge it prudent to proceed with such a step.... [Ed. note: Which, apparently, they have.]

The second element of this strategy is the sale, which has been authorized, of partnership units totaling up to 25% of the vehicle which has been established to hold all the non-metropolitan Canadian newspapers (i.e. excluding Toronto, Montreal, Vancouver, Ottawa, Calgary, Edmonton and a couple others)... Hollinger will continue to hold 100% of these properties. By reconstructing these non-metropolitan newspapers on the basis of partnership units, soft costs will be reduced to capital expenditures and after an appropriate management fee, cash will be distributed from the operations and taxed in the hands of the unit-

holders rather than the issuer.

It is expected that these units will be sold at 11 times EBITDA. The sale has been structured such that there will be no capital gains taxes. Hollinger stock is now trading at under 7 times EBITDA after deducting net debt....

ASSESSING THE STRATEGY'S POTENTIAL IMPACT:

Black: The entire proceeds of the sale of partnership units, an excellent instrument with a high yield and considerable growth potential, which is expected to find a willing market, would go initially to debt reduction. A large part of those proceeds, as non-taxable capital gains, will go directly to shareholders' equity. Such an issue will reduce our concentration in Canada and have a very benign impact on our balance sheet. The realization of this cash, (up to about US\$300 million) will, coupled with the covenant variance, give the management all the resources and flexibility it is likely to need to secure a more realistic appreciation of the value of our Company and its shares....

We will be able to sell an interest in one part of our company at almost or about 11 times EBITDA and buy in and effectively distribute among continuing shareholders an interest in the entire Company at or under 7 times EBITDA while reducing debt and building shareholders' equity. Few activities could more obviously serve the shareholders' interest; it is as close as we are likely to come to buying dimes for nickels on a grand scale.

If the entire proceeds of this transaction are applied to debt reduction, the result will be a modest improvement in net income at current interest rates. If the proceeds are applied entirely to the cancellation of shares at current prices, we would have sold about 9% of last year's net income (and likely a smaller percentage in future years), but eliminated almost 20% of the outstanding shares, thus increasing earnings per share by approximately 13%.

WHAT HE'LL DO IF THE GAP DOESN'T CLOSE:

Black: In the unlikely event that this strategy does not produce recognition of real value in the shares, we will propose sequential transactions and proceed determinedly toward the partial or entire privatization of most of the business. If value can only be realized in asset sales, which has been the case, but which we believe is a temporary condition, the stock market can, over time, be dispensed with altogether. Our British and Canadian privatizations were very satisfactory.

The controlling shareholder will do whatever is appropriate and necessary to achieve realistic value for the interests of all persevering stockholders. (At current prices, \$850 million, a reasonably accessible sum, is all that would be required to take the company private and even with some accompanying asset sales, earnings per share would double."

FYI, the letter from which these comments were excerpted is dated March 9th at which time Hollinger's stock was trading around \$12-1/2 — give or take four bits.]

Will Browne: It's very simple: His salary is cab fare in relation to his equity ownership. It's his business — and his wealth.

Chris Browne: Yeah. That's always nice.

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

Will Browne: He's not in it for a pension.

Spears: And he's been quite successful — Hollinger's got quite a good track record — buying newspapers and improving them. Their performance with the U.K. paper — the *Telegraph* — has apparently been very, very good.

OID: How far back does their track record go?

Spears: That's how Conrad Black made his fortune. We can't tell you exactly how long he's been doing it, but he started buying newspapers at a pretty young age.

WE'RE NOT SAYING HOLLINGER FACES NO RISKS,
BUT ONE WE DON'T WORRY ABOUT IS THE INTERNET.

OID: You're not worried about Gannett launching a Canadian version of USA Today.

Chris Browne: They can't.

Spears: Because of the culture rule. Right, Chris?

Chris Browne: That's right. There are restrictions on U.S. media in Canada.

OID: So aside from the National Post continuing to be a black hole, Canada going further left and civil war, what could turn Hollinger into a mistake?

Chris Browne: People stop reading.

OID: That may not be so far fetched, I understand.

Spears: Yeah. Readership, long run, is declining.

Will Browne: You could get a terrible stock market, the stock could fall to \$5 or \$6 — and the company could tender for all of its shares at \$8 and take it away from you.

OID: Another not-so-far-fetched risk.

Spears: No. And there are cyclical and secular aspects of the newspaper business that could be negative. For example, besides fewer and fewer people reading newspapers, some observers fear that newspapers' classified ad revenues will be cannibalized by new media — especially the internet.

OID: Three for three.

Spears: We think that risk is offset in part by the stock price. But the advent of the new media have to hurt newspapers in the long run — at least a little bit.

OID: By making it less unique — the way Buffett describes TV as being less unique today than it was when it had only three lanes...

Spears: Right, exactly — the three networks. Plus, there are disadvantages to the classifieds in a paper form. For example, you can't perform an automated search.

OID: On the other hand, in Richard Siklos' book about Conrad Black, Shades of Black, he quotes Black as saying that the asset in the newspaper business isn't the physical paper, but rather its content. In which case the internet represents another distribution

medium for papers' content — where you can perform automated searches and everything else.

Spears: That's true. And that's, in fact, what I did the last time I was looking for real estate. The newspaper's real estate website was just richer and better generally than the realtors' site — realtor.com.

Chris Browne: And despite all of the competing media these days for advertising, newspapers are booming. Believe it or not, the *Wall Street Journal* is sold out through the end of the year.

OID: Sold out?!

Chris Browne: For advertising. And I'm not kidding. There's no advertising available in the *Wall Street Journal* through the end of the year.

Will Browne: Why not just put more pages in it?

Chris Browne: It already weighs 10 pounds.

Will Browne: If I ran it, I'd let 'em carry 11.

Chris Browne: And you know what's spawning a lot of the ads? It's internet advertising.

Spears: That's right.

Chris Browne: Because it becomes very difficult to establish your presence on the internet without advertising in other media.

Will Browne: That's all there is on the radio it seems — at least in the morning.

Chris Browne: And they can get plenty of capital for their advertising budgets without making any money. All they have to do is say they're establishing their franchise.

In fact, I very recently met with Conrad Black at Hollinger's office here in New York. And what I found most interesting was his comments about the dynamics of the internet and its impact on newspapers — you know, whether people will get their news from the internet and stop reading newspapers, etc.

Well, they found that it's actually quite the opposite.

OID: He didn't say they own a bunch of dinosaurs?!

Chris Browne: No. In fact, they found that people who look up things from the newspaper on the internet are *more* likely to actually buy the physical paper or subscribe to it. They say that their e-commerce ventures have been additive of audience in every market where they've looked. For example, in Chicago, a market where the *Sun-Times* is the scrappy tabloid competitor to the *Tribune*, Hollinger's website outguns the *Trib's* — and with a much smaller investment to boot.

Spears: We get the impression that their internet joint ventures to date have been pretty successful. For example, isn't one of their sites the leading Canadian site for jobs?

Chris Browne: I think that's right. And internet sites tend to be category-specific, not geographically specific, unlike newspapers. And so far, Hollinger representatives claim that they've lost none of what many view as their most vulnerable business — i.e., classified advertising. Instead, their own websites offer classified advertisers extra reach for an additional cost.

Also, lots of internet ventures have to spend enormous amounts of money on advertising in order to

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**TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS**
(cont'd from preceding page)

create awareness in the mind of the consumer.

OID: Which will probably continue, as Marty Whitman alluded to at the Value Conference, as long as those companies have access to capital dirt cheap.

Chris Browne: Hollinger and other newspapers have the further advantage that they can advertise their website for free in its own newspaper.

And they're using the internet to create additional ad revenue opportunities. For example, they have one program with the Chicago area home builders. On the *Chicago Sun-Times* web page, you can check out the different home builders and their developments right there. They're charging the home builders for that. And they're very happy to pay it because they can actually get a count of how many hits they have — so they can tell how effective it is.

The problem that's developing with the internet other than the fact that it's not that easy to use is where do you go to find information. What the *Chicago Sun-Times* has is a brand. And if it can let the world know that it's a resource on the internet for lots of different information, it'll get a lot of internet traffic.

We're told that they're thinking about spinning out their internet assets — which would potentially add tremendous additional value. They're no money makers yet, but of course that only means it's worth more.

OID: Maybe we should change our name to OID.com...

Chris Browne: Actually, I think it does already make a little bit of money. But it's minuscule in relation to Hollinger's total earnings.

OID: So Hollinger is an internet play.

Chris Browne: At least they *have* an internet strategy.

OID: There's no need to get personal.

Chris Browne: They aren't worried about cannibalizing themselves. They've learned that it's actually quite the opposite. It enhances the basic product while creating a new income stream. And if it turns out to be something one day, they're there.

The beauty of Amazon.com by becoming a mall now is that they've created a brand. But if you do a search on home builders, you might have 8,600 things to look at. If you want a new home in the Chicago area, you don't want that. But you can do it through the *Chicago Sun-Times*. So they've managed to create a different advertising category through the internet.

OUR WORST CASE SCENARIO AIN'T SO BAD.
THE ONLY ISSUE IS HOW BIG WE WIN.

OID: You paint a pretty picture. But isn't it possible that you're being optimistic. Isn't it possible that the National Post may turn into a permanent black hole — at least until they put it out of its misery?

Will Browne: Look. Anything can happen. But...

Chris Browne: But you tell us. Here's an excerpt

from the article in *The Financial Times*:

"Only one year after its launch, Conrad Black's new national newspaper in Canada, the *National Post*, is staking a claim as the most successful broadsheet newspaper launch in the past 50 years anywhere in the English-speaking world...."

In 16 major cities nationally, the *Post* can claim about 810,000 daily readers, only slightly behind the *Globe's* 844,000. In Toronto, the *Post* appears to have taken away about 140,000 daily readers from the *Globe*, a 28% drop, and ... 110,000 from the *Toronto Star*, the city's largest newspaper. In several cities, including Vancouver and Ottawa, the *Post* has already overtaken the *Globe*...."

Spears: It sounds like it has great demographics — and lots of potential.

Chris Browne: It has the second greatest circulation in Canada. Why would he shut it down? He'll sell it. Somebody will buy it. They'll ride it out until it gets the advertising.

[Editor's note: Conrad Black apparently agrees. Here's what he had to say about the *National Post* in his latest letter to shareholders of Hollinger:

"The *National Post*, Canada's new national newspaper, serving a countrywide market of 25 million English-reading people, had one of the most successful launches in modern newspaper history in the last two months of the year. It quickly achieved a size and quality of readership fully competitive with the only other claimant to the status of a national newspaper and incites well-founded expectations of dividing that very lucrative market with its competitor.

The *National Post* is printed in nine plants from Nova Scotia to British Columbia, is a well-received, high quality product, and if management chose to cease promoting circulation, which continues to rise toward 300,000, it would reach the break-even operating threshold within a few months. As we continue to build the *National Post* from its strong initial base, we are confident that the costs of fully launching the newspaper will prove modest compared to the demonstrable value of the franchise.]"

Spears: And I like the idea of Conrad Black investing some of Hollinger's money on a pretax basis in something like this that he thinks has good prospects. After all, he's made great strides with that newspaper. And long run, he's been a money maker. If he thinks that it's a good odds play to invest the company's pretax dollars in a newspaper that he obviously believes will be a winner, I'm not going to second guess him. I like that exposure.

There's almost a freebie venture capital aspect to owning Hollinger. You get a free option on the upside potential of the *National Post* and all of the internet ventures. And certainly, it clearly seems cheap given today's private market values for newspapers.

[Editor's note: The same *Financial Times* article mentioned earlier also referenced several negatives:

[1] The president of Canada's largest media buyer, Ann Boden, said she wasn't expecting any major moves in ad buying practices because the numbers weren't "significant enough". "[I]n Toronto, the country's largest market and by far the most attractive market for large advertisers ... 'the *Post* is still number four in a four-paper market'."

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TWEEDY, BROWNE'S
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[2] "[The] publisher of [one of the *Post's* competitors] ... refuses to accept the veracity of the ... numbers calling them 'the reflection of a freakish market' in which all the papers have been offering substantial promotions to attract or retain readers...."

[3] "Perhaps the most surprising result of the survey is that, in the middle of the most intense newspaper war in modern Canadian history, total readership has actually fallen about 4% in the Toronto market.... [That's] not welcome news for any of the combatants. [Says Ms. Boden,] 'You're giving away all three newspapers and still can't get the readership up. It certainly doesn't say good things for newspapers.'"]

Will Browne: Again, we're not attributing any value to the *National Post*. It's an expense. So if he were to shut it down, we'll still wind up with \$19 or \$20 or more. So we've got a big gain in Hollinger whether he shuts it down or not. And the early evidence suggests that it is going to become worth a fair amount of money.

Spears: Yeah. It could add nicely to the upside. Either way — whether the newspaper is successful or whether it doesn't work — the losses will stop and Hollinger's reported numbers will start to sparkle.

Will Browne: But we're not relying on it.

Chris Browne: So it can *only* have upside. Either it succeeds and becomes valuable or they shut it down and the losses stop.

Spears: Meanwhile, Hollinger just continues to take advantage of its mispriced stock by buying back shares. For example, we use 118.4 million shares in our figures — which was our estimate of their fully diluted shares outstanding as of June 30th.

However, it's somewhat lower — 4 million shares lower as of September 30th according to their 10-Q. And we know they've been actively buying back shares since.

OID: So the actual shares outstanding are probably closer to 5 or 6 million less — say 113 million...

Spears: Yeah. And in terms of getting conviction, Hollinger really is shrinking its share base. Many companies have buyback plans that are largely offset by option exercise. Therefore, there's no real reduction in their shares outstanding. But at Hollinger, it's a shrink. These shares are going down. When a company buys back 8-9% of its shares during a nine-month period — well, that's not insignificant. If it can do that for five years in a row, it reduces its shares outstanding by 40%.

And with Conrad Black owning so much stock, to us that's equivalent to insider buying.

[Editor's note: According to Hollinger's proxy, as of March 19th, Black owned nearly 52.6 million shares of Hollinger's Class A Common (47.35% of the class), slightly less than 15 million shares of its Class B Common (100% of the class) and more than 800,000 shares of its Series C Preferred (100% of the class).]

MBIA: EPS GROWTH OF 14-15% PER YEAR,
A P/E BELOW 10 AND HEAVY INSIDER BUYING.

OID: Any others like those two you can tell us about?

Spears: I don't know. You're pretty tough to please. But we think MBIA [MBI/NYSE] is an absolute bargain today.

Chris Browne: Yeah.

OID: Then fire away.

Chris Browne: MBIA first came to our attention when we noticed its CEO, Joseph Brown, buying up millions and millions of dollars worth of its stock. Brown is an informed individual — an actuary by training — with a good reputation as an insurance person. He used to be CEO of Fireman's Fund Insurance Company — which was one of MBIA's founding investors along with Aetna and some other large insurers. He's long been on MBIA's board — almost without interruption — since it went public in 1986.

And when MBIA's previous CEO retired, Brown became CEO and continued buying MBIA's stock. And he's kept on buying and buying and buying.

OID: We won't ask where he came up with that kind of money. He doesn't have sticky fingers, does he?

Chris Browne: Brown has an excellent reputation. And he's paid up to as much as \$75 per share — and MBIA's selling at around \$52 today.

OID: So far, so good.

Spears: And MBIA actually has a terrific record. Over the past 10 years, its earnings have compounded at between 14% and 15% per year. And it's been very steady. So when we compare it to the S&P at 25 times earnings, we don't think it's a close call.

Some people may think 14-15% earnings growth doesn't sound like a very high growth rate. But long run, it's *very* hard for companies to maintain that kind of growth. Only 5% of the companies in the S&P 500 were able to do 15% or better compounded earnings growth over the last 18 years. And MBIA looks like it may be one of the few that may be able to manage that kind of growth for a long time.

OID: And the current valuation?

Spears: It's selling at less than 10 times earnings.

Will Browne: Yeah. Earnings are expected to be somewhere in the \$5.25 to \$5.50 area. And, again, MBIA's stock is trading around \$52.

OID: May we ask what you've paid?

Spears: As little as \$45 and as much as \$65...

OID: So you've put your money where your mouth is.

Spears: Oh, absolutely.

Chris Browne: Remember when growth stock guys used to say that they buy growth stocks at a P/E less than a company's growth rate? Have you heard that one lately?

OID: You're right. We haven't.

Chris Browne: Well, this one fits that description.

Spears: And other people at MBIA have been buying

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**TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS**
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the company's stock besides its CEO. And they think that its future growth prospects remain 14-15% per year.

And it looks like they have excellent growth prospects both domestically and internationally. Within the U.S., while the proportion of muni bonds that are insured has stabilized at approximately 50% of those issued, the amount issued has been steadily trending up — and is expected to rise between 10% and 20% per year over the next 3-4 years. And outside the U.S., the prospects are even better.

OID: What sort of return on equity does MBIA earn?

Spears: It's had about a 15-16% return on equity.

OID: So they've been retaining the lion's share of their earnings.

Spears: That's right. It's a high retention business. And they recently cut the dividend — which we were pleased to see because it means that they're retaining and reinvesting more of their earnings.

LOW COST PRODUCER + PRICE PROTECTION
= UNUSUALLY GOOD EARNINGS PREDICTABILITY.

Spears: The letters in MBIA's name stand for the Municipal Bond Insurance Association. MBIA pretty much invented the field. They insure municipal bonds. And a municipality that wants to issue bonds will be able to sell 'em at a lower yield if they get municipal bond insurance — because once someone like MBIA insures a muni bond, the rating agencies will give the bond a AAA rating. Therefore, the municipality has a lower interest cost.

Chris Browne: And the municipality uses part of that interest savings to buy the insurance.

Spears: Exactly. And there's some split where MBIA gets some percentage of the interest savings.

OID: It sounds very much like the insurance segment of Fannie Mae and Freddie Mac.

Spears: It is. And like Fannie Mae and Freddie Mac, MBIA's business is pretty darned steady because it gets paid up front to insure a bond for 30 years. So they'll take in, let's say, a \$1 million premium. But they'll recognize it into income over a 30-year period. As a result, they have a very, very steady revenue stream. And when they open their doors on January 1st, 80-90% of their revenues for that year are basically known based on their existing book of business.

Chris Browne: And MBIA's huge book of business not only provides a base of earnings for many years hence, but it insulates the company's income statement somewhat from the vagaries of price competition — because the prices on its huge book of business are locked in. The company has well over \$2 billion worth of unearned premium reserve that will be recognized into income over the outstanding life of the bonds insured. And we value that future stream of income alone at around \$15 per share net of expenses and taxes.

Also, the barrier to entry is high because of statutory losses related to setting up reserves for a young company.

Spears: MBIA has three competitors. But it was the first player in the business and it has the largest amount of capital — 75% more than its largest competitor — and the lowest level of expenses as a percentage of revenues.

Including MBIA, there are four players in the business rated AAA. And last year — 1998 — was an atypical year. However, let me give you some figures for 1997:

MBIA's expense ratio was 16.7% versus 21.6%, 37.8% and 27.6% for its competitors. MBIA's return on equity according to the way that Fitch calculates it was 13.5% versus 12.8%, 9.6% and 11.9%.

Chris Browne: And if you're the low-cost producer, nobody can really undercut you on price.

[Editor's note: According to their most recent 10-K, MBIA had a 36% market share of new issue, long-term municipal bonds in 1998.]

Chris Browne: And they enjoy pricing protection, too.

OID: Pricing protection?

Chris Browne: Because they're rated by the insurance rating agencies. So if somebody tries to take business away by insuring municipal bonds for too little, then the insurance rating agencies will lower their rating because they're taking on too much risk.

OID: Very interesting.

Spears: The discipline imposed on companies by the rating agencies keeps the business from getting too crazy. In effect, it forces all of the participants to price in what you might call a statesmanlike way.

OID: Then what is market share based on — marketing ability or what?

Spears: To some extent, market share may be based on availability of capital. So MBIA with the largest amount of capital can insure the largest amount of bond offerings and the largest bond deals.

Chris Browne: Yeah. At the same price, would you rather have a policy issued by AIG or Podunk Insurance Associates, Ltd.?

Spears: Exactly. The capital has to be a plus — because it would tend to equate to staying power during hard times. And that would have to be a selling point for investors who buy muni bonds.

Will Browne: And MBIA and the other bond insurers are providing the marketplace with a necessary service. The world perceives the need, too. And that also contributes to making MBIA's results fairly predictable.

Spears: Yeah. MBIA has much greater earnings predictability than most companies. For example, during the past nine years, we estimated that MBIA's average return on beginning of year equity was 16.1% and that it was never once below 14.4%.

OID: And adding to that predictability, no doubt, is the fact that municipal borrowers have taxing authority.

Spears: Absolutely.

OID: Plus a serious incentive to avoid doing anything

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

that would tarnish their credit rating and, therefore, cause their borrowing costs to soar.

Chris Browne: That's right.

Spears: Exactly. And given all of those virtues and given what financial businesses have sold for, MBIA probably has a private market value up around \$100.

OID: How do you figure?

Spears: Well, banks and insurance companies have sold at 16-20 times earnings. And MBIA is pretty unique in its combination of virtues — between its earnings stability, its growth prospects domestically and internationally and the fact that 80-90% of its revenues are basically locked in even before they open their doors each year. If we simply assign a P/E of 20, we arrive at a value of \$100.

OID: Actually \$105 to \$110. But who's counting? *

DEFAULTS HAVE BEEN INFINITESIMAL
AND LOSSES VIRTUALLY NON-EXISTENT.

OID: What then is the perceived risk here? Why does something with so much in the way of apparent predictability, attractive growth prospects, etc. trade at less than 10 times earnings?

Chris Browne: I don't think it's very well understood. It's really a unique animal.

Spears: Yeah, it is different.

Will Browne: And haven't they talked about doing the same thing outside the U.S. Maybe there's some skepticism about their ability to do that.

OID: You're not skeptical there?

Spears: Well, first of all, their rates of growth overseas have been very high. And there's another thing about their expansion overseas that is neat from a competitive standpoint: Again, within the U.S., including MBIA, there are four primary players. But MBIA has teamed with the #2 U.S. bond insurer, AMBAC, in a joint venture to take advantage of international opportunities. We believe that joint venture may result in more statesmanlike pricing. And it appears to us that the competitor market shares in the international business are more concentrated to begin with.

(continued in next column)

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OID: Speaking of international business, did we read that MBIA had entered into a strategic alliance with two Japanese property and casualty companies — Mitsui and Yasuda?

Spears: That's right. And those are big companies and two great companies to be aligned with in Japan.

OID: And did we also read something about MBIA entering the asset-backed bond area?

Spears: That's right. They bought Cap Mac, which is an insurer of structured finance bonds — also known as asset-backed bonds. Incidentally, structured finance and international bonds (primarily in Western Europe and Japan) today account for just over 20% each of MBIA's new premiums written. But we understand that MBIA's management hopes that each of those areas will represent one-third of their business within five years. So there's further opportunity for growth.

OID: And profits?

Spears: There are higher delinquencies in that business, but pricing is higher, too. And MBIA's optimistic that the returns in both of those businesses, on balance, will be higher than the returns on their existing business.

Chris Browne: Another reason MBIA is so cheap is that it had a default recently — Allegheny Hospital System — where Tenet Healthcare came in and took over.

Spears: Yeah. Therefore, there's a little cloud. And that default put a smudge on their otherwise pristine underwriting record.

OID: And that smudge doesn't worry you.

Spears: No.

OID: Why doesn't it? And how would you assess MBIA's default risk looking forward?

Spears: Well, when you come right down to it, it's depression insurance basically. They have stress tests — statistical-type of things — that actuaries would love based on looking back at what happened during the Depression. But their actual losses have been minuscule. Since they've been in business — for 20 years or whatever it may be — they've experienced *very* few defaults.

Chris Browne: Yeah. Defaults in the muni business have been very infrequent. And losses — after asset sales, recoveries, additional financings, etc. — have been nothing short of infinitesimal. Their statutory combined ratio is less than 27%.

OID: Of course, losses in junk bonds were minuscule at one point, too.

Spears: Their whole pricing and rating premise and framework is based on a time when there were earthquakes in their business. Statistically, using that as an analogy, they underwrite and set their rates based on that expectation.

OID: But in a depression scenario, how badly do you think they stand to get hurt? How badly were similar companies hurt in the Great Depression?

Chris Browne: I don't know. The closest we got was

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New York in the mid-1970s. That was pretty close to a bankruptcy.

Spears: We've let the actuaries handle that question.

OID: *But you feel comfortable living with that risk.*

Chris Browne: Yes, we do.

Spears: But we feel comfortable in the context of owning a lot of stocks in a portfolio. We don't have our entire net worth invested in this one stock.

Chris Browne: But you can't invest on the theory that we're going to have a repeat of the Great Depression.

WITH FINANCIAL COMPANIES, YOU CAN NEVER KNOW.
BUT WE KNOW WHAT THE IN-HOUSE ACTUARIES THINK.

OID: *Maybe not. But given the Allegheny default and what sounds like the fragile state of hospital systems around the country, perhaps another Great Depression isn't needed. And maybe that's especially worrisome given that MBIA has 10 times as much in health care loans outstanding as it has in shareholders equity — \$38.9 billion versus \$3.9 billion.*

Spears: We're not looking at the portfolio. We don't believe we can assess it in any kind of detail. However, again, MBIA's CEO is an actuary by training. He's a numbers guy. And he's been a director of MBIA almost the whole time since it went public in 1986. And we know that he's been buying millions and millions of dollars worth of stock.

MBIA's former CEO has also been buying stock. And another director — a gentleman who headed up Goldman's municipal bond area — has been both a significant and a persistent buyer. And some other directors and officers have also been buying it. So MBIA insiders are certainly betting that there's not a disaster looming here.

Chris Browne: In effect, these underwriters who are buying the stock are better underwriters than we are. They understand the portfolio much more intimately than we ever will. And their way of reporting back to us that they think it's OK is by buying the stock.

OID: *But the Allegheny Health Care System loan...*

Chris Browne: That's not typical of what's going on.

OID: *And it's not typical of their health care loans?*

Chris Browne: In a way, it's even better that Allegheny *did* blow up — because then you know that those three guys *did* focus on the health care loans.

Spears: Absolutely. I think that's a great point.

OID: *Similar to what Munger said about Freddie Mac — that their prior problems educated them to the risk and made such problems less likely going forward.*

Chris Browne: The Allegheny default was a red flag. So they probably thought, "Let's go look at the rest of it." And they seem to have concluded, "It's not a problem."

Spears: Yeah. Their actions with their own wallets

answer the uncertainty that arises as a result of that flub.

Chris Browne: It's a much more convincing opinion than if they told us it was OK, but didn't buy any stock.

Spears: Also, the rating agencies go over these companies with a fine-tooth comb. And they're not talking about downgrading MBIA.

OID: *Plus, I gather that another response to the default has been for MBIA to raise rates dramatically. According to Moody's, they increased rates on their new premiums written by 30-50% or more — and that other insurers followed suit.*

Spears: They've successfully initiated price increases. And pricing is apparently pretty strong.

OID: *On the other hand, Moody's says that "MBIA's first half municipal market share fell to 22.6% from 40-43% over the past few years reflecting its emphasis on value pricing". That doesn't concern you?*

Spears: No, it doesn't. What MBIA has been doing through its behavior is leading pricing. And they've been strategically allowing their competitors to take lower-priced business and fill up their capacity. They're all writing at or near their capacity. So if someone's got a \$100 million net worth and that allows them to write \$100 million of total volume, MBIA has made a strategic decision to let 'em fill up with \$20 million of lower-priced business. And once they're full, then MBIA will start increasing their volumes. However, meanwhile let 'em load up.

Chris Browne: Yeah. When all is said and done, we're anticipating that MBIA will wind up with roughly 40% of the market total.

OID: *Good answer. But let me read you an excerpt from one of your in-house reports:*

"Reinsurers have been willing to provide capacity on favorable terms which will be helpful to MBIA. When faced with a \$170 million loss in the bankruptcy of a Pennsylvania not-for-profit hospital, MBIA was able to reinsure the full amount in exchange for ceding premiums to those reinsurers in the future."

Spears: Yeah. You're referring to the special reinsurance transaction related to the loss that they had for the Philadelphia hospital.

OID: *That's right. Couldn't they use that ploy to paper over a loss and, in effect, cover up past mistakes at the expense of future profits?*

Spears: They could. An insurer can use reinsurance to move a liability on policies it's written to another insurance company. But, of course, they have to pay somebody to accept that loss.

OID: *And it sounds like papering over past losses at the expense of future profitability is exactly what's happening here.*

Spears: It does...

OID: *However, once again, I get the feeling that you take comfort in the fact that insiders are buying shares out the wazoo.*

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TWEEDY, BROWNE'S
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Spears: It gives you comfort, doesn't it? In effect, those insiders are comfortable with the entity in its entirety. That's *exactly* how our judgement works.

OID: And it's clear why. Absent the judgement of the insiders, it sounds like it would be totally impossible to know the depth of the liability, etc.

Spears: That's right. Ultimately, I think that's true of any financial service company that takes on risk. I'd say that would be true of insurers, reinsurers, banks — I could go on and on. After MBIA's loss on the Allegheny bond, a very important question is, "What else is out there? What else have they insured at too low a rate? What other losses are lurking within their existing book of business?"

You can never get a definitive answer to that question. But you do have the long run data for their losses. And their average yearly losses have been minuscule. But clearly, writing municipal bond insurance on bonds issued by hospitals is not the same thing as insuring that Rye is going to pay off its bond or that some school district will pay off its bond — that kind of thing. Especially given all of the changes going on in Medicare reimbursement, you could very well think, "Geez! This is a different kind of risk. The history we've seen in MBIA is not related to this kind of a risk. And maybe there are a lot more losses waiting to pop up."

But as you say, we answer that uncertainty with the insider buying — at least to some extent. That's not to say that insider buying is some silver bullet — that it's perfect. On a group basis, it's terrific. But the dispersion is great. There are a lot of situations with heavy insider buying that just poop out — that do *terrible*.

OID: Speaking of poop, insider buying sounds sorta like a flea collar. You know that it's not going to eliminate 100% of your pet's fleas, but you know that it's going to cut 'em way back.

Spears: That's exactly right. You'll have fewer fleas. We'll have fewer crack-ups, we hope. It improves our odds by giving us a statistical edge.

OID: And, I gather, a relatively powerful edge...

Spears: Yeah. There's a terrific book entitled *Investment Intelligence From Insider Trading* by Nejat Seyhun — the head of the finance department at the University of Michigan. And basically, he determined that the advantage achieved simply by buying low P/E and low price-to-book stocks was not that robust — only about 2% per year. But when he combined low P/E or low price-to-book with significant insider buying by the top executives (the CEO, the chief financial officer, the chairman of the board, the treasurer, etc.) he found that the combination beat the market by 10-11% per year — or five times the excess return achieved by valuation alone.

OID: Very interesting.

Spears: So we make a point of shopping in that area. Mind you that we're still using judgement and selecting from a vast number of companies. Every month, there are hundreds of stocks with insider buying and that qualify as

low P/E or low price-to-book. However, by using that as a first cut, we feel like we're tilting the odds in our favor — by, in effect, buying stocks with robust characteristics.

OID: Sounds like it.

Spears: There are lots of value stocks out there. However, what we want are value stocks that are going to generate good returns. It's not that hard to find a stock that's selling at a low P/E or a low price-to-book or one that's selling at less than private market value.

OID: Remind us to delete this part...

Spears: What we want isn't value — we want *returns*. And the value strategy is the best way that we know to get the returns. After all, we're in it for the money.

HEAVY INSIDER BUYING AND HUGE SHARE BUYBACKS
AT 40% OF PMV FOR THE MOST PROFITABLE PLAYER?!

OID: What about International Specialty Products?

Spears: International Specialty Products [ISP/NYSE] is a specialty chemicals business. We originally got interested in it based on the insider buying. There's been quite a bit of insider buying.

OID: And according to Value Line, insiders own about 78% of its common shares outstanding.

Spears: Yeah. And that percentage is increasing because the company is buying in its own stock.

OID: I'd say so. Shares outstanding have shrunk from nearly 96 million at year end 1997 to slightly over 63 million in July.

Spears: It's controlled by a guy named Sam Heyman. He owns approximately 76% of the shares outstanding. Therefore, when the company's buying back its own stock, it's really more or less a proxy for insider buying.

OID: Where have we heard that name?

Chris Browne: He was a raider during the 1980s.

Spears: He was a wheeler dealer. He used to be involved with GAF. That probably goes back 15 years. Anyway, International Specialty Products currently sells at around \$8.50 per share. We began buying it at \$9. And we've probably paid as little as \$7. Meanwhile, insiders have paid as much as \$16 per share in the last 18 months.

Something else we like — we understand that company insiders have also been electing to buy the stock in their 401-K plans. And that's in addition to the significant insider buying that you see reported publicly.

OID: A super start.

Spears: And International Specialty Products' stock is selling at a low P/E, a low price-to-book, a low multiple of EBITDA and a high discount to private market value.

OID: Could we deal with each of those one by one?

Spears: Sure. First, book value is just over \$8.25. So it trades at a very small premium to book. And it's selling at about 8 times earnings.

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

[Editor's note: When we annualize the company's results for the third quarter of 1999 by adding back goodwill amortization and non-recurring charges and multiplying by four, we guesstimate that the stock trades at closer to 6-3/4 times earnings.]

OID: Not a double-digit P/E. That's a good start.

Chris Browne: On a P/E basis, it's probably cheaper than 92% of the companies out there.

Spears: Oh, yeah. A P/E of 8 is *extreme*. It's definitely bottom of the pile — in the cheapest 5% of companies — ranked by that measure.

And we estimate that ISP's private market value is at least \$20 per share. We arrive at that figure, incidentally, using an EBITDA multiple of 9. And we think, if anything, that our multiple is low. ISP's investor relations person tells us that other specialty chemical companies they look at as potential acquisitions generally tend to sell at closer to 10 times EBITDA.

[Editor's note: Using their figures and substituting an EBITDA multiple of 10 would increase their estimate of private market value to something north of \$23 per share.]

OID: It's sounding better and better.

Spears: And the last time we ran the numbers on International Specialty Products, it had the highest EBITDA margin and was trading at the lowest multiple of EBITDA. These figures go back to May. However, you may find them interesting nonetheless:

Company	Mkt Cap + Net Debt ÷ EBITDA	EBITDA Margin
Great Lakes	10.9	19.6%
Millenium	8.7	19.2%
Engelhard	9.2	9.8%
Morton Int'l	12.6	19.0%
Sigma-Aldrich	10.5	26.3%
Eastman	6.9	18.7%
Praxair	8.8	27.1%
ISP	5.8	26.8%

[Editor's note: Updating their analysis by utilizing third quarter results, excluding non-recurring items, annualizing the results by multiplying them by four and adjusting the enterprise value for the current stock price, we guesstimate that International Specialty Products currently sells at closer to 4-1/2 times EBITDA (with the usual caveat about our lack of skill in security analysis).]

WALL STREET DOESN'T LIKE THE THIN FLOAT
AND THE HUGE BUYBACKS. WE LOVE 'EM.

OID: Before I call my broker, is there any reason why this stock should be so cheap?

Spears: Not in our view. I would guess that the reason why International Specialty Products is so cheap is that 76% of its stock is owned by Mr. Heyman and he runs an arbitrage portfolio within the company. In other words,

he'll buy into takeovers.

OID: That isn't necessarily a negative, is it?

Spears: No, it isn't. I understand he's done well. And don't ask me how well — because I don't know. But overall, he's been enough of a money maker to build up substantial wealth. However, I don't think it's appreciated by Street analysts who specialize in specialty chemicals. It's just unusual. He's managing his own money and he likes doing arbitrage. But having arbitrage results mixed in with the reported earnings figures creates volatility. That's my guess why ISP's cheaper than its peers. Plus, ISP has a smaller float because of his 76% stake.

But again, those are just guesses. We *never* know why something sells as cheap as it does.

OID: But there are no fundamental reasons that you're aware of why it should be cheaper.

Spears: Only one. The company does have a lot of debt — over \$15 per share in total debt and over \$9 per share in net debt as of March 30th.

[Editor's note: We guesstimate closer to \$16 per share in total debt and \$8 per share in net debt at September 30th (including deferred taxes and other liabilities in our calculation of net debt).]

OID: That's a negative, all right. But nothing else?

Spears: Nope. Not at all. Actually, something else the analysts don't like is the share buybacks. They don't like the company's thin float. So they're upset that the company is buying in stock. Of course, we love it.

OID: Allow us to second your emotion. And to the naive observer, based on a casual perusal of their annual report, the company appears to be reasonably well managed and well positioned for growth.

Spears: Again, Sam Heyman's a wealth builder — a money maker. And the products ISP's specialty chemicals are used in appear to us to be relatively stable in terms of primary demand — you know, cosmetics, hair sprays, detergents. They're not durable goods, but consumables.

OID: Yeah. Plus, nearly 50% of its sales are outside the U.S. And it's hard to imagine the demand for the end products its specialty chemicals are in not rising with standards of living around the world.

Spears: That makes sense.

[Editor's note: FYI, from *Value Line*: "The firm has announced that it will acquire Monsanto's algin operation, which has annual sales of around \$70 million. (Algins are a derivative of seaweed used for their thickening and stabilizing properties in food, beverage and pharmaceutical applications)... We think the acquisition, which marks ISP's first step in the algins business, augurs well for its long-term results, as suppliers of food ingredients have historically been quite profitable."]

OID: Aside from a very harsh business environment causing the company to collapse under a huge burden of debt, Heyman flushing its investment portfolio down the toilet or yours truly buying a few shares, what could make this one a mistake?

Spears: [chuckles] There's always that hunk of

(continued on next page)

TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

information out there that you don't know about that can come out of nowhere and bite you.

OID: Let's leave my portfolio out of this.

Spears: But in the context of a diversified portfolio, International Specialty Products seems like a good bet. We'd love to own 100 companies like it.

WHO CARES ABOUT DOMESTIC TOBACCO?
PHILIP MORRIS IS A BARGAIN WITHOUT IT.

OID: With apologies in advance, do you have any thoughts on Philip Morris — aside from wishing that you'd never heard of the company, of course?

Chris Browne: Our thoughts on Philip Morris? Well, the company's international tobacco and food segments alone are worth more than its implied valuation given today's stock price.

Spears: That's right. Even when we assign no value whatsoever to Philip Morris' [MO/NYSE] domestic tobacco operations, we figure the company is worth between \$42 and \$46.

OID: How do you figure?

Spears: Well, Philip Morris' food operation, Kraft, had EBITA — earnings before interest, taxes and amortization, but after depreciation — of \$1.85 in 1998. And we value that segment at 12-14 times EBITA — which would imply a value of between \$22 and \$26. Philip Morris' international tobacco EBITA was \$2.10. And we've slapped on a multiple of 10. That gets us to \$21. Finally, Miller Beer and Philip Morris' other businesses have EBITA of only about 31¢. And we assign them a multiple of 10 — which would imply a value of \$3.10.

When we total those three figures, we come up with a gross value of between \$46 and \$50 per share. And when we net out its \$4 per share of net debt, we come up with a total value for Philip Morris excluding its domestic tobacco segment of between \$42 and \$46 per share.

OID: And that's using 1998 earnings.

Spears: That's right. That's not including anything for earnings growth. And the Kraft segment is probably a 5% per year grower. Philip Morris' international tobacco segment is probably growing more than 10% per year — and it could be way over. In many years, that segment's had 10% unit volume growth — before factoring in the impact of price increases or anything else.

OID: So that if you factor in growth, you wind up with a total value of more like \$45-50 per share.

Spears: Yeah. But \$42 to \$46 is close enough — because, again, that's assigning no value whatsoever to domestic tobacco. It shows that with the stock trading in the \$20s, Philip Morris' stock is selling at a large discount to its underlying value even if you assume that its entire

domestic tobacco business is nationalized.

Chris Browne: Exactly.

Spears: Also, even though it's not obvious — it doesn't show up in most of the insider tracking services — seven Philip Morris insiders have been buying the stock. They've been exercising options, buying the stock and then selling a lesser number of shares to pay for those shares. Basically, they're selling off stock and using the proceeds to pay for the options that they're exercising and the taxes that they incur from their exercise. In effect, they're adding to their holdings via option exercise.

For example, Philip Morris' chairman, Geoffrey Bible, bought 376,000 shares in August and then immediately sold 265,000 shares. So his net shares increased by 111,000 shares. And six other insiders, including the controller, the treasurer, the chief operating officer and, probably significantly, the in-house lawyer who serves as the secretary of the corporation, were all increasing their holdings in the company at much higher prices — at between \$35 and \$38 per share.

OID: Very interesting.

Spears: Also, according to one analyst's report, the company intends to buy back \$3 billion worth of stock in the next 12 months — which would represent about 5% of its outstanding shares. And if Philip Morris were in fact to buy back 5% of its outstanding shares each year over the next five years, they'd reduce their outstanding shares by nearly 25%. That would boost earnings by nearly a third — simply by virtue of shrinking their shares outstanding. And the company's goal for earnings growth independent of share buybacks is 13% per year.

OID: Sure. And our goal is to break even...

Spears: Philip Morris has a talented management.

OID: There's no need to get personal.

Spears: And that management is optimistic about its growth prospects in the international tobacco business. For example, they point out that currently only one out of every seven cigarettes sold outside the U.S. is produced by Philip Morris. In the U.S., they have a 50% market share in tobacco — and they've been great at increasing their share outside the U.S. So there's a lot of room for growth.

And the company earns a lot more per cigarette in the United States than it does outside the United States — which strikes us as a terrific pricing opportunity long run. Within the U.S., Philip Morris earns 2.28¢ per cigarette versus only 7/10s of 1¢ outside the U.S. So the company makes over three times as much profit inside the U.S.

And the company's been great at increasing earnings by raising cigarette prices. They're masters at doing that. That's where a lot of their earnings growth within the U.S. has come from.

OID: Along with smoking their competitors and gaining market share year after year.

Spears: That's right. Therefore, it seems to us that the much lower profitability per cigarette outside the U.S. represents a huge opportunity for them to increase their profits for years and years to come.

OID: As standards of living outside the U.S. rise —

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

although, of course, how much they're likely to close that gap is pretty much unknowable, isn't it?

Spears: It is. But listen to these figures. In the U.S., they sell 228 billion cigarettes. Outside the U.S., they sell more than three times as many cigarettes — 717 billion. So the potential effect of even partially closing that gap is absolutely enormous.

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

IT'S HARD TO IMAGINE LAWYERS DESTROYING MO,
BUT I WOULDN'T PUT 100% OF MY NET WORTH IN IT.

OID: On the other hand, some suggest the company's ultimate liability could dwarf any reasonable estimate of the value of its domestic tobacco segment and that claimants may be able to pierce the corporate veil — in which case all bets would be off.

Spears: I don't think it's likely. It's hard to imagine society taking over the entire U.S. tobacco industry.

OID: Society? No. But attorneys? Who knows? And lumping attorneys in with society seems unfair to society. And couldn't you have said the same thing about asbestos or breast implants?

Spears: Well, what's the result been so far? Basically, the only result has been price increases. Smokers have borne the expenses. And as long as it is across the board, Philip Morris is not competitively disadvantaged versus Brown & Williamson or Lorillard or R.J. Reynolds.

On the other hand, that's just my personal view. It could happen. Obviously, there's a lot of disagreement. However, the people who are probably the least diversified holders of the company's shares — Philip Morris' insiders — appear to be betting on an optimistic outcome. And analysts who've undertaken intensive legal reviews are betting optimistically.

However, it's probably best to diversify the holding — because I don't think that *any* of our ideas are bulletproof.

Chris Browne: We believe the *portfolio* is bulletproof, but the individual stocks aren't.

Spears: Exactly.

Chris Browne: We would never recommend that anyone have his or her entire net worth in Philip Morris — or in any *other* single stock for that matter. If my entire net worth were in Philip Morris, I wouldn't take the chance. I'd move on. But it's not. It's a 1-1/2% position.

OID: Nonetheless, you sound awfully confident.

Chris Browne: Yeah. Just about everybody we know who's looked at it closely has come to the same conclusion: that the lawyers aren't going to put the company out of business, that the Florida cases will be decertified and lose their class action status on appeal and that the claimants won't be able to pierce the corporate veil.

Spears: As I recall, the Sanford Bernstein report assessed the odds of the case being decertified at 70/30 or

something like that. And the analysts point out that all of the recent cases, with the exception of the ones in Florida, have gone well for the tobacco industry.

OID: Of course, except for the Great Depression, things were probably going well for most U.S. banks. And except for publishing, we might be solvent...

Spears: That's right. And if you've ever been involved with litigation, you know that it's always something of a crap shoot.

OID: And hasn't the game changed in Florida with comparative liability or whatever it's called — where a defendant can be partially responsible for a tort and still be assessed huge damages?

Spears: I'm not a lawyer.

OID: Only one of your many virtues. However, as we understand it, by Florida's legal standard, not only can tobacco companies be successfully sued, but so can every beverage producer, every fast food company and just about everybody else.

Spears: I don't think I can add value by expressing a legal opinion on that issue.

Will Browne: Neither can I.

OID: And didn't the litigation just travel overseas?

Spears: That's right. I noticed that.

Chris Browne: Yeah — in France. And only the foreign tobacco companies were found guilty apparently.

OID: Sounds like a stereotype of the French.

Will Browne: It does. But there's no such thing as a class action lawsuit in the French legal system. Also, there's no "pain and suffering" in the equation for damages.

Spears: Right. So it doesn't look like there's the huge punitive damage liability potential that there is in the U.S. Therefore, any awards appear likely to be much less.

Will Browne: That's right. The most significant thing about the lawsuit is that it happened at *all*. France is one of the last places where anyone expected that kind of thing to pop up. The French love their cigarettes. They smoke in restaurants and everywhere else. And I believe the government owned part of the French tobacco industry. So it was curious that it showed up at all.

OID: Does that suggest that it could start popping up everywhere and that tobacco companies could wind up being like an elephant that gets eaten by army ants?

Will Browne: I have no ability to render an opinion on that one. But I believe the government saves money as a result of people smoking and dying early.

OID: It's very hard to imagine otherwise.

Will Browne: And if the politicians just admitted that what they're doing is grabbing money, I could accept what they're doing morally. But they're being dishonest.

OID: Politicians being dishonest? How can that be?

Will Browne: To me, it's another form of corruption. However, I'm not an expert on that. I would have thought it was over with that big settlement. But given that it's a

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

political issue and a place where money can be extorted...

Spears: Thank God for diversification.

Chris Browne: I wish they'd just *shoot* the lawyers.

OID: Not exactly a contrary opinion...

Chris Browne: It just goes on and on and on and on. But they can't put 'em out of business. There are still tobacco states with senators and representatives who have a say in the final outcome, too.

I guess they can't make a deal until after the election. But ultimately they're going to have to figure out a way to resolve this thing — because the government is dying to get its hands on the money as are the lawyers. And you watch — as soon as they reach a global settlement, Philip Morris' stock will double.

OUR DEBATE HASN'T BEEN ABOUT LEGAL DAMAGES
OR EVEN VALUE, BUT WHETHER TO TAKE A TAX LOSS.

OID: Might we ask you if you've taken advantage of the recent steep decline in Philip Morris' stock price?

Chris Browne: We're full up in that one already.

Spears: For *new* accounts, we buy it. But we were *already* fully invested in Philip Morris before it went down more recently.

Chris Browne: Yeah. The debate in our office isn't over the values. And I don't think there's even much of a debate about whether or not Philip Morris will prevail and survive, etc. The debate here is whether we're talking about dead money for the next several years because this cloud is just going to keep hanging over it with one suit after another after another.

Spears: And then the benefit of taking a tax loss on our shares was another part of our debate.

Chris Browne: Some of us are willing to get out of it and get into something that's also cheap, but that can still go up.

Spears: Yeah — like Hollinger.

Chris Browne: Or Quorum, etc.

Spears: And actually, I'm starting to change my mind about this one — about 30 days out...

OID: Thirty days out?

Spears: Yeah. Let's say that you invested \$100,000 in this thing — and that now it's only worth \$50,000, but you still like it long run. Well, initially, I was against selling our shares in order to capture the tax loss — because I am ambivalent about what's going to happen in the next 30 days. You never know what kind of lightning can strike.

OID: Or death and devastation — if we own it.

Spears: Whereas I believe that Chris has an opinion. I think he believes it's dead money.

Chris Browne: That's right. I do.

Spears: And he could very well be right. But if you're a New York City resident in the highest tax bracket, basically, your all-in marginal tax rate on long-term capital gains, including state and local taxes, is 33%.

OID: A mighty painful thought.

Spears: So just from a tax benefit standpoint, if you've got a cost of \$50 per share and you sell it at \$25, you take a \$25 per share loss. That loss would be worth more than \$8 per share after tax. And that's sort of a locked-in gain that you get in 30 days — \$8 per share of after-tax benefit in tax savings. On the remaining \$25, that's nearly a 33% return in 30 days. That's not too bad.

OID: And worst case scenario, it skyrockets while you're out and you buy something else.

Chris Browne: Exactly.

Spears: So I hadn't really done the math on taking the loss and what it means in terms of after-tax money in your pocket for a 30-day bet. And it's pretty damned good. So I've changed my mind.

OID: When did you experience that epiphany?

Spears: Actually, I woke up last night thinking about it. It just struck me, "Geez! Look at that math! Look at the tax savings you can capture. And you can buy it back in 30 days. If you have 2% of your portfolio in that thing, then you just sit with a little bit more cash for 30 days until you can buy it back without disallowing the loss for tax purposes. And if you want to buy the shares back, you've increased your wealth." That really hit me.

Chris Browne: Exactly. Very simply, the way I look at it is that if I want to buy it back, it would have to go up more than 33% before I'm worse off.

OAKWOOD LOOKS LIKE MINDLESS TAX SELLING
AND A GREAT SPECULATION, BUT WE DON'T KNOW.

OID: What about Oakwood Homes?

Chris Browne: We're selling it.

Spears: Yeah. We're taking a tax loss on it.

Chris Browne: So we'd rather take our tax loss in Oakwood [OH/NYSE] and move the money into Hollinger.

OID: What would it take to make you buy it back?

Chris Browne: I don't know. Oakwood's debt just got a junk rating. It may be in trouble. Who knows?

Spears: Sometimes when a company surprises you, you have an information vacuum. You don't really know what's going on.

OID: Sometimes?!

Spears: And with 100 stocks in the portfolio, you don't necessarily want to spend all your time on the losers which become a smaller percentage of the portfolio as a result of their decline. It's not what everybody wants to hear, I know. However, there we are.

They've had some problems with their earnings. There's an oversupply so they have too much inventory.

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TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE & JOHN SPEARS
(cont'd from preceding page)

OID: It sounds like they're in one rough business.

Spears: It's been a terrific business for 'em in the past. But now they've gotten slammed.

OID: It sounds like they've done a great job with it. But inherently, it sounds like a horrible business.

Will Browne: They're housing builders. Just look at the chart on *Bloomberg*.

Chris Browne: Yeah. The industry looks like a roller coaster. It has to be the most classically cyclical business in the world — *ever*.

Spears: I would buy it myself if I could — if it weren't for the rules restricting me from doing so here at *Tweedy*.

OID: Why? You don't look like the suicidal type...

Spears: No, I don't think I am. But book value is up around \$10 or \$11. Insiders bought it recently at \$6. And the stock's at \$3. I think it's a case of mindless tax selling right now. And if it only gets back up to book, you make three or four times your money.

And the company's 10-year average return on equity was 17%. So with the stock trading at 32% of book, the implied P/E on its average historical earning power is only about 2.

OID: In that case, why not double up on the position and wait awhile and then do the tax selling?

Chris Browne: Because there's not enough stock out there for us to double up. We'd have to tender.

OID: Good answer.

YOU'RE A LOUSY SECURITY ANALYST? NO BIG DEAL.
HARDEST (& MOST CRITICAL) IS COMPETITIVE ANALYSIS.

OID: Given your minuscule turnover, I'm surprised to hear you think about things like tax selling. After all, your turnover in *Tweedy, Browne American Value Fund* has only averaged about 10% per year.

Chris Browne: Yeah. One thing I find very interesting is *Charlie Munger's* theory of the institutional imperative — the need for people to look like they're doing something. It's the reason why bank loan officers have to be making loans even though it may not be such a good idea at times and the reason why CEOs have to be making acquisitions that the evidence suggests they'd be better off, on average, not making.

It's the same thing with portfolio managers. They're always buying and selling stuff. And they're doing it because they think they're making intelligent decisions. But the data suggests that maybe it *isn't* so intelligent.

OID: But they have to justify their existence.

Will Browne: They should force all the analysts to nap between 9:30 and 4:00.

Chris Browne: We view our job here as sort of being like the Maytag repairman.

OID: There seems to be a common theme in several of your investments — in *Hollinger*, *Quorum* and *International Specialty Products*, anyway — where management is not only adding value to its existing asset base, but constantly redeploying those assets.

Spears: Oh, sure — all the time. We have a lot of investments with people who are considered in the business community to be pretty darned smart operators. We're kind of betting on entrepreneurial management in addition to betting on cheapness. And besides the ones you mentioned, we could name others that fit that mold.

OID: Unfortunately, we're out of time and pages. However, save 'em for next time, please.

Spears: As you wish. By the way, you always kid around about not being a very good security analyst.

OID: What makes you think we're kidding?

Spears: Well, I just wanted to let you know that security analysis doesn't do most people any good. Really.

OID: What do you mean?

Spears: Well, the empirical data on analyst estimates varying as dramatically as they do from actual earnings and money managers failing so horribly at beating indices like the S&P 500 says something about the efficacy of security analysis as practiced by most of our brethren.

The hardest part, I think, is competitive analysis. There's a terrific book, by the way, on that subject called *The Innovator's Dilemma* [by Clayton M. Christensen]. But that's the toughie.

OID: Including the people assessment part of it.

Spears: Absolutely. I walk into most meetings and think the people are nice enough.

OID: Same here. I don't think we can distinguish the next Sam Walton from the next moron — except when it comes to money managers, where I think we do a pretty fair job of culling out the wheat from the chaff.

Spears: I won't ask which of the two we are.

OID: You've always been whole wheat in our book. Thanks for so being so generous and spreading a few crumbs our way.

Chris Browne: Our pleasure.

Spears: We always enjoy it.

Will Browne: Yeah. It's been fun. We hope to see you next year. But now it's time for my nap.

—OID

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

As *OID* subscribers well know, the manner in which Buffett and super-investor sidekick Charlie Munger have achieved those returns is no less remarkable. (However, we won't utilize scarce space to re-tell you about it here.)

We would, however, like to thank them for their assistance in preparing this feature and their cooperation, in graciously allowing us to share it with you. As always, we highly recommend that you read it (and re-read it, etc.).

RICH MARKET PROGNOSTICATORS? WE KNOW NONE.
BUT WE KNOW *LOTS* OF RICH BUSINESS APPRAISERS.

Currently, we're having great trouble finding bargains.

Shareholder: What do you think of the market today?

Buffett: Charlie and I don't *think* about the market — and Ben didn't very much either. He made a mistake, I think, to occasionally try and place a value on it.

We look at individual businesses. And we don't think of stocks as little items that wiggle around in the paper and that have shorts attached to them. We think of them as parts of businesses.

It is true that currently we have great trouble finding businesses we like, where we like the managements at an attractive price. So we aren't finding bargains in this market among the larger companies that are our universe.

But we leave market predictions to others.

Buffett: That is not a stock market forecast in any way, shape or form. We have no idea whether the market's going to go up today or next week or next month or next year. We *do* know that we'll only buy things that we think make sense in terms of the value that we receive for Berkshire. And when we can't find things, the money piles up. And when we *do* find things, we pile *in*...

I know of no one that has been successful and really made a lot of money predicting the actions of the market itself. I know a *lot* of people who have done well picking businesses and buying them at sensible prices. And that's what we're hoping to do. Charlie?

Munger: How could you say it any better?

Buffett: The question's whether *you* can say it better, Charlie.... That may be all you hear from him today. So get used to it.

The way I learned was just to go out and read everything....

Shareholder: I have no formal education in accounting and finance. I'd just like some advice regarding your approach to educate myself and a reading list of basic texts — obviously starting with Berkshire's annual reports.

Buffett: The question you ask is a very good one in terms of accounting and finance: What's the best way to teach yourself?

I was so interested in it from such a young age that my approach originally was just to go to the Omaha Public

Library and take out every book it had on the subject. And I learned a lot. [Chuckles] I learned a lot that *wasn't* true in the process, *too*. I got very interested in charting and all of that sort of thing for buying stocks. But I did it by just a tremendous amount of reading. But it was easy for me — because it was like going to baseball games or something of that sort.

To become a great investor, you must do massive reading.

Buffett: As regards specific texts in accounting...

You may want to read some of the better magazine or newspaper articles. There's been some good commentary about accounting there. But I don't have...

Charlie, can you think of any specific texts or anything that we could recommend?

Munger: I think both Warren and I learn more from the great business magazines than we do anywhere else. It's such an easy, shorthand way of getting a vast variety of business experience just to riffle through issue after issue after issue covering a great variety of businesses. And if you get the mental habit of relating what you're reading to the basic structure of the underlying ideas being demonstrated, you gradually accumulate some wisdom about investing.

I don't think you can get to be a really good investor over a broad range without doing a *massive* amount of reading. I don't think any one book will do it for you.

Immerse yourself and ask, "What else do I need to know?"

Buffett: You might think about picking out five or 10 companies where you feel quite familiar with their products, but not necessarily so familiar with their financials and all of that. If you understand their products, you know what's going on in the business. Then get lots of annual reports and all of the articles that have been written on those companies for 5 or 10 years. Just sort of immerse yourself as if you were either going to work for the company or they'd hired you as the CEO or you were going to buy the whole business. You can look at it in any of those ways.

And when you get all through, ask yourself, "What do I not know that I *need* to know?"

AND IF YOU REALLY WANT TO GET SMART,
THEN YOU MUST KEEP ASKING, "WHY?"

You can learn a lot by just asking (and asking and asking).

Buffett: Many years ago, I would go around and talk to competitors, always, and employees. And I'd ask those kinds of questions. In effect, that's what I did with my friend, Lorimer Davidson, when I first met him at GEICO — except I began at ground zero. But I just kept asking questions. That's what it's really all about.

And if I were interested in the ABC company, I would go to the XYZ company and try to learn a lot about it. Now, of course, there's spin on what you get, but you learn to discern that. Essentially, you're being a reporter. It's very much like journalism. If you ask enough questions...

And one of the questions that I'd ask... In his book, Andy Grove talks about the "Silver Bullet". You ask the competitor, "If you had a single silver bullet and you could only put it through the head of one of your competitors, which of your competitors would you use it on and why?"

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

You'll learn a *lot* by asking questions like that over time.

Ask somebody in the XYZ industry, "If you were going to go away for 10 years and you had to put all of your money into the stock of one competitor — not your own — which one would it be and why?"

Just keep asking and asking and asking. And you'll have to discount the answers that you get in certain ways. But you will be getting things poured into your head that then you can use to reformulate and do your *own* thinking about why you evaluate this business at this or that.

As for the accounting, you just sort of have to labor your way through that. You may even want to take some courses there. But the *biggest* thing is to find out how businesses operate. Who should I be afraid of? At GEICO, who do we worry about? Why? Who would we like to put that silver bullet through? And I'm not going to tell you. But you should keep asking those questions.

And then you go to the guy who they want to put the silver bullet through and find out who *he* wants to put the silver bullet through — like [the army recruit who wants to murder the reveille bugler] in the Irving Berlin song.

It's a journalistic pursuit. But we look for the *easy* stories.

Buffett: That's the way to approach it. And you'll be learning all the time. You can talk to current employees, ex-employees, vendors, suppliers, distributors, retailers, customers — all *kinds* of people. And you'll learn.

It's an investigative process — a journalistic process. And in the end, you want to write the story. Six months later, you want to be able to say, "The XYZ company is worth this amount because..." Then you just start in and write the story. Some companies are *easy* to write stories about and other companies are much tougher to write stories about. We try to look for the ones that are easy. Charlie?

You're trying to print out the next 10 years of *Value Line*....

Munger: For the histories of the 1,700 biggest corporations laid out in digest form, I think *Value Line* is in a class by itself. That one volume really tells you a lot about the histories of our best companies.

Buffett: There's 1,700 of 'em. Look at each page and what's happened in terms of return on equity, sales growth, profit margins — all kinds of things. And say, "Why did this happen? Who let it happen? And what's that chart (not the price chart, but the chart about the business operation) going to look like in the *next* 10 years?" — because *that's* what you're really trying to figure out. You're trying to print out the next 10 years of *Value Line* in your head.

If you want to get smart, you must keep asking, "Why?"

Buffett: Some companies you can do a reasonable job with whereas others are just too tough. But that's what the game is about. And ... if you have some predilection toward it, it can be a lot of fun. In fact, the process itself is as much fun as the conclusion you come to.

Munger: When he talks about "Why?", well that's the most important question of *all*. And it doesn't apply just to investing. It applies to the entire human experience.

If you want to get smart, the question you have to keep asking is "Why — why, why why?" And you have to relate the answers to a structure of deep theory. You've got to know the main theories. And it's mildly laborious, but it's also a lot of fun.

VALUATION 101: FIRST, UNDERSTAND THE BUSINESS
BUT MOST IMPORTANTLY, AVOID DOING DUMB THINGS.

The art of valuation involves sizing up the moat and more.

Shareholder: Anyone who's read your writings knows that you look for great managements and economic moats, as you call them, that enable companies to raise prices and margins. In your view, what are the signs of great managements and great moats? Furthermore, do you try to put a dollar value on those managements, moats and other intangibles when you value companies? And if so, can you guide us through your thinking there?

Buffett: The moat and the management are part of the valuation process in that they enter into our thinking as to the degree of *certainty* that we attribute to the stream of cash we expect in the future and its *amount*. However, valuing businesses in an art. The underlying formulas get simple at the end.

If you and I were looking at the chewing gum business (and we own no Wrigley's, so I use it fairly often in class), you'd pick a figure that you would expect unit volumes of chewing gum to grow in the next 10-20 years and you'd give me your expectations about how much pricing flexibility Wrigley's has and how much danger there is that Wrigley's market share might be dramatically reduced — you'd go through all of that.

Well, that's what we go through. We're evaluating the moat, the price elasticity that interacts with the moat in certain ways, the likelihood of unit demand changing in the future or management being either very bright with the cash that they develop or very stupid with it. All of that goes into our evaluation of what that stream of money is likely to look like over the years.

But ... how the investment works out depends on how that stream develops over the next 10 or 20 years.

And if the moat is good enough, management matters less.

Buffett: And the moat enters into that formulation. If you have a big enough moat, you don't need as much management. It gets back to Peter Lynch's remark that he likes to buy a business so good that an idiot can run it — because sooner or later, one will. He was saying the same thing. He was saying what he really likes is a business with a terrific moat where nothing can happen to the moat.

And there *aren't* very many businesses like that. So you get involved in evaluating all these shadings.

Coca-Cola: a great moat, a great mgm't and a great future.

Buffett: This [he holds up a can of Cherry Coke] — not the cherry version, but the regular version — has a *terrific* moat around it. There's a moat even in the *container*. There was some study made as to what percentage of people could identify blindfolded what product they were holding just by holding the container. And there aren't many that could score like Coca-Cola in that respect.

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

So here's a product with a share of mind. There are six billion people in the world. And I don't know what percentage of them have something in their mind that's favorable about Coca-Cola, but it would be a huge number. The question is 10 years from now will that number be even larger and will the impression be just a slight bit more favorable on average for the billions of people that have it? And that's what the business is all about. If it develops in that manner, you've got a great business.

Well, I think it's very likely to develop in that manner. But that's my own judgement. I think it is a *huge* moat at Coca-Cola, although I think it varies in different parts of the world and all of that. Then on top of everything else, Coca-Cola has a terrific management.

No higher math is involved — which the academics hate.

Buffett: But there's no formula that gives you that* precisely — that, in effect, says the moat is 28 feet wide and 16 feet deep or anything of the sort. You just have to understand the business.

And that's what drives the academics crazy — because they know how to calculate standard deviations and all kinds of things. But that doesn't *tell* 'em anything. What really tells you something is if you know how to figure out how wide the moat is and whether it's likely to widen further or shrink on you. Charlie?

Our success has been based mostly on avoiding stupidity.

Munger: Well, you aren't sufficiently critical of the academic approach. [**Buffett** chuckles.] The academic approach to portfolio management, corporate finance, etc., is very interesting. Like Long-Term Capital Management, it begs the very same question: How can people so smart do such silly things? And yet, that's the way it is.

Buffett: The great book that needs to be written really is, "Why Do Smart People Do Dumb Things?" And it's terribly important — because we've got a lot of smart people working with us. If we can just exorcise all the dumb things, it's just *amazing* what'll happen.

And to some extent, the record of Berkshire — to the extent it's been good — has not occurred because we've done brilliant things, but because we've probably done fewer *dumb* things than most. Why smart people do things that are against their self interest is really puzzling. Charlie, tell me why.

We actually pay money to send our kids to these schools....

Munger: You could argue that the very *worst* of the academic inanity is in the liberal arts departments of the great universities. And there, if you ask the question, "What one frame of mind is likely to do an individual the most damage to his happiness, to his contribution to others, etc. — what one frame of mind will be the worst?" The answer would be some sort of paranoid self pity. I couldn't *imagine* a more destructive frame of mind. Whole departments want everyone to feel like a victim. And you pay money to send your children to these places. This is what they teach 'em.

It's *amazing* how these pockets of irrationality creep

into these eminent places. One of the reasons I like the Berkshire meetings is that I find fewer of those silly people.

Buffett: He excluded the head table from that, incidentally.

EFFICIENT MARKET THEORY IS LESS HOLY WRIT,
BUT OLD ASININITIES FADE AWAY SLOWLY.

The market is fairly efficient. But that's not enough....

Shareholder: Mr. Buffett, many in the academic community either call you lucky or a statistical outlier. Mr. Munger, I'm not sure *what* they call you.

Buffett: [**Buffett** laughs.] You're free to *speculate* on what they call him.

Shareholder: I know why you don't like to forecast the equity markets. But maybe you'd dare to forecast the evolution of the debate between proponents of the efficient market theory and value investors. Do you think there'll ever be a reconciliation ... [between the two]? And as an addendum, are your designated successors outliers, too?

Buffett: Well, we like to *think* they are. And they may be more outliers than *we* are....

To me it's almost self-evident if you've been around markets for any length of time that the market is generally fairly efficient. It's hard to find inefficiently priced securities. There are times when it's relatively easy. But right now it's difficult. So the market is fairly efficient in its pricing between asset classes — and it's fairly efficient in terms of evaluating specific businesses.

But being *fairly* efficient does not suffice to support an efficient market theory approach to investing or all of the offshoots that have come off of that in the academic world.

It became a cherished belief — really a foundation stone.

Buffett: So if you'd been taught efficient market theory and adopted it for your own 20 or 30 years ago — or even 10 years ago (it probably hit its peak about 20 years ago) — then it would have been a terrible, terrible mistake. It would have been kind of like learning that the earth is flat. You would have had the wrong start in life.

Nevertheless, it became terribly popular in academia. It almost became a required belief in order to hold a position. It was what was taught in all of the advanced courses. And a mathematical theory that involved other investment questions was built around it — so that if you went to the center of it and destroyed that part of it, it really meant that people who'd spent years and years and years getting Ph.D.s found their whole world crashing around them.

Efficient market theory proponents in less demand today.

Buffett: It's been discredited in a fairly significant way over the last decade or two. You don't hear people talking about it the same way you did 15 or 20 years ago. I don't know exactly how much it's holy writ still. I certainly get the impression as I go around talking to business schools that it's far less regarded as unquestioned dogma than it was 15-20 years ago.

The University of Florida now has some courses in valuing businesses. The University of Missouri is putting one in. And the high priests of efficient market theory probably aren't in as much demand for seminars, speaking

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BERKSHIRE HATHAWAY'S
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engagements and all of that as they used to be.

Old guard fades away clinging to asinities of the past.

Buffett: But it's very interesting. It's hard to dislodge a belief that becomes the dogma of a finance department. It's so *challenging* to them. At age 30 or 40, they have to go back and say, "What I've learned up to this point and what I've been teaching students and all of that is silly." That doesn't come easy to people. Charlie?

Munger: Well, Max Planck, the great physicist, said that even in physics the old guard really didn't accept the new ideas. New ideas prevail in due course because the old guard fades away clinging to asinities of the past. And that's what's happened to the hard-core efficient market theorists. They're an embarrassment to the scene — and they will soon be gone.

People who think the market is *reasonably* efficient — or *roughly* efficient — of course, are absolutely correct. And that will stay with us for the long pull.

Buffett: However, thinking it's roughly efficient does nothing for you in academia. You can't *build* anything around it. What people want are elegant theories. And roughly efficient just doesn't work.

It's certainly easier to teach the efficient market theory.

Buffett: Investment is about valuing businesses.... That is all there is to investment. You sit around and try to figure out what a business is worth. And if it's selling below that figure, then you buy it. But you virtually can't find a course in the country on how to value businesses. You find all kinds of courses on how to compute beta or whatever it may be because that's something instructors know how to do. But they don't know how to value a business. So the important subject doesn't get taught.

And it's *tough* to teach. I think Ben Graham did a good job of teaching it at Columbia — and I was very fortunate to run into him many decades ago. But if you ask the average Ph.D. in finance to value a business, he's got a problem. And if he can't value it, I don't know how he can invest in it.

But one thing always puzzled me...

Buffett: Therefore, it's much easier to take up efficient market theory and say there's no sense in *trying* to think about valuing businesses because everybody knows everything about them anyway. If the market's efficient, it's valued them all perfectly anyway.

But I've never known what you talk about on the second day in that course. You walk in and you say, "Everything's valued perfectly" — and "Class dismissed." So it puzzles me. But I encourage you to look for the inefficiently priced.

Berkshire, incidentally, was inefficiently priced for a long time. It wasn't on the radar screen.... If you'd asked an academic how to value it, they wouldn't have known what to look at exactly.

LARGE SUMS OF MONEY ARE A HEAVY ANCHOR.
AND THE CURRENTS ARE MUCH ROUGHER, TOO.

As money under mgn't grows, expected returns fall fast.

Shareholder: Recently, at Wharton, Mr. Buffett, you talked about the problems of compounding large ... [sums of money].... You were quoted in the local paper as saying that you're confident that if you were working with a sum closer to \$1 million, you could compound it at a 50% rate. For those of us not saddled with a \$100 billion problem, could you talk about what types of investments you'd be looking at and where in today's market you think significant inefficiencies exist?

Buffett: I may have been very *slightly* misquoted, but I certainly said something to the effect.... I talked about how I poll this group of 60 or so people I get together with every couple of years as to what rate they think they could compound money at [if they were investing different sums:] \$100,000, \$1 million, \$100 million, \$1 billion, etc. And I pointed out how the return expectations of the members of this group go very rapidly down this slope.

But it's true. I could name a half a dozen people that I think could compound \$1 million at 50% per year — at least they'd have that return expectation — if they needed it. They'd have to give that \$1 million their full attention. But they couldn't compound \$100 million or \$1 billion at anything *remotely* like that rate.

There are a lot more small inefficiencies than big ones.

Buffett: There are little tiny areas, as I said ... in that Adam Smith interview a few years ago, [where] if you start with A and you go through and look at everything — and look for small securities in your area of competence where you can understand the business and occasionally find little arbitrage situations or little wrinkles here and there in the market — I think working with a very small sum, there's an opportunity to earn very high returns.

But that advantage disappears very rapidly as the money compounds. As the money goes from \$1 million to \$10 million, I'd say it would fall off *dramatically* in terms of the expected return — because you find very, very small things you're almost certain to make high returns on. But you don't find very *big* things in that category today.

Oh, it was so much simpler then — and easier, too.

Buffett: And I'll leave the fun of finding them to you. It'd be terrible to spoil your treasure hunt. And the truth is I really don't *look* for 'em any more. Every now and then I'll stumble into something just by accident. But I'm not in the business of looking for them. I'm looking for things that Berkshire can put its money in. And that rules out all of that sort of thing. Charlie?

Munger: Well, I agree. But I'd also say that what we did 40 or so years ago was in some respects more simple than what you're going to have to do.

Buffett: Right.

Munger: We had it very easy compared to you. It can still be done, but it's harder now. You have to know more. Just sifting through the manuals until you find something that's selling at 2 times earnings won't work for you.

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

Buffett: It'll *work*. It's just that you won't *find* any.

Munger: Yep.

YOU CAN'T EXPECT ANYBODY TO DO IT FOR YOU.
THAT'S NOT THE WAY THE BUSINESS IS SET UP.

If I were back at go, I'd probably focus on small companies.

Shareholder: You've acknowledged that it's a more difficult investment and business environment today than it was when you first started out. If you were starting out again today in your early thirties, what would you do differently or the same in today's environment to replicate your success? In short, how can I make \$30 billion?

Buffett: Start young. As Charlie's always said, the big thing about it is we started building this little snowball on top of a very long hill. We started at a very early age in rolling the snowball down. And of course, the nature of compound interest is that it behaves like a snowball in sticky snow. The trick is to have a very long hill — which means either starting very young or living to be very old.

If I were doing it in the investment world, I would do it exactly the same way. If I were getting out of school today and I had \$10,000 to invest, I'd start with the A's.... [The companies whose names begin with the letter "A."] And I probably would focus on smaller companies — because I'd be working with smaller sums and there would be a greater chance that something would be overlooked in that arena.

People will not tell you about wonderful, little investments.

Buffett: As Charlie said earlier, it won't be like doing that in 1951 when you could leaf through and find all kinds of things that just leapt off the page at you. But that's the only way to do it. You have to buy businesses — or little pieces of businesses called stocks. You have to buy 'em at attractive prices. And you have to buy into good businesses. That advice will be the same 100 years from now. That's what investing is all about.

And you can't expect anybody else to do it for you. People will not tell you about wonderful, little investments. It's not the way the investment business is set up.

You can't look around for people to agree with you....

Buffett: When I first visited GEICO back in January of 1951, I went back to Columbia the rest of that year; but I subsequently went down to Blythe & Company, and actually to one other firm ... that was a leading analyst of insurance. I thought I'd discovered this wonderful thing — so I'd see what these great investment houses that specialized in insurance stocks said. And they said I didn't know what I was talking about. It wasn't of any interest to them.

You've got to follow your own ideas — with the caveat that you've got to learn what you know and what you don't know. And within the arena of what you know, you have to pursue it very vigorously and act on it when you find it. You can't look around for people to agree with you. You can't look around for people to even know what you're *talking* about. You have to think for yourself. If you do, you'll find things. Charlie?

It helps to be passionately rational, aggressive and frugal.

Munger: The hard part of the process for most people is the first \$100,000. If you have a standing start at zero, getting together \$100,000 is a long struggle for most people. I'd argue that the people who get there relatively quickly are helped if they're passionate about being rational, very eager and opportunistic, and steadily underspend their income grossly. I think those three factors are very helpful.

WE SHOULD ALL HAVE LOWER EXPECTATIONS —
IN FACT, MAKE THAT *DRAMATICALLY* LOWER....

We don't have any great answers for passive investors.

Shareholder: My husband and I will have some new money in our early 80s.... We have a 50-year old daughter who will inherit anything we have. We also have shares in a mutual fund that pays us 4% tax free. Are there any better ways to invest our money?

Buffett: Well, those are tough questions. I run into friends of mine all the time who come into a lump sum at a given time. Charlie and I do not have great answers about investing sums of money for people who aren't really active in the process.

As we said, if we were working with small sums now, we'd start looking at a whole bunch of very small situations and some things we might know how to do on a small scale. But for the average investor who wants to own equities over a 20 or 30 year period, we think regular investment in some kind of very low cost pool of money — which might well be an index fund — probably makes as much sense as anything. But it's important to keep the costs down.

I have close to 100% of my net worth in Berkshire. I'm comfortable with it because I like the businesses that we own. But I didn't buy it at this price either. So I ... never recommend anybody buy or sell it.

We find ourselves sitting and waiting for something to do.

Buffett: Do you recommend anything, Charlie?

Munger: If there's anybody in the room today who thinks it would be very easy to come up with a one liner for a great, no-brainer investment tomorrow with a great slug of new money, I wish they'd come up and tell me what it is. We don't have any solution to that one. It's harder for us now than it has been at other times.

Buffett: Yeah, there have been a couple of times [when it was much easier] — in 1974, for example — and the reverse of that situation in '69. I wrote an article for *Forbes* [in 1974], I believe, ... about how equities almost had to be more attractive than bonds at that time — and bonds weren't that *unattractive*. Every now and then, you get a great deal for your money in equities — and at times, you get a great deal in fixed-income investments. However, you *can't* say that now.

So what do you do? Well, in terms of new money, we find ourselves sitting and waiting for something — and we continue to look. But we are forced to look at bigger ideas. So if we were working with smaller sums, we would be *much* more likely to find something than we are in our present situation. As Charlie says, we really don't have any great one-line advice on it. I wish we did.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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We should have lower expectations — dramatically lower.

Munger: The real, long-term rate of return from saving money and investing it *has* to go down from the recent experience in America — particularly *equity*-related, recent experience. The world's wealth simply can't increase at the kind of rates that people have gotten used to in the American equity markets. And the equity markets can't *hugely* outperform the growth [of the rest of] the world forever. We ought to have reduced investment expectations in general.

Buffett: Yeah, and *dramatically* reduced — because ... 53% of the world's stock market value is in the U.S. Well, if U.S. GDP [gross domestic product] grows at 4-5% a year with 1-2% inflation — which would be a pretty good, in fact it would be a *very* good result — then I think it's very unlikely that corporate profits are going to grow at a greater rate than that. Corporate profits as a percent of GDP are on the high side already — and corporate profits can't constantly grow at a faster rate than GDP. Obviously, in the end, they'd be greater than GDP.

It's like somebody said about New York — that it has more lawyers than people. You run into certain conflicts as you go along if you say profits can get bigger than GDP. So if you have a situation where the best you can hope for in corporate profit growth over the years is 4-5%, how can it be reasonable to think that equities — which, after all, are a capitalization of those corporate profits — can grow at 15% a year? It's *nonsense*, frankly.

People aren't going to average 15% or anything like it in equities. I almost *defy* them to show me mathematically how it can be done in aggregate.

At 30+ times earnings, the Fortune 500 is no great bargain.

Buffett: The other day, I looked at the *Fortune* 500. And the companies on that list earned \$334 billion and had a market capitalization of \$9.9 trillion at year end — which would probably be up to at least \$10.5 trillion now.

Well, the only money investors are going to make in the long run is what the businesses make. There's nothing added. The government doesn't throw in anything. Nobody's adding to the pot. People take *out* from the pot in terms of frictional costs — investment management fees, brokerage commissions and all of that. But \$334 billion is all that the investment earns.

If you own a farm, what the farm produces is all you're going to get from the farm. If it produces \$50 an acre of net profit, you'll get \$50 an acre of net profit. And there's nothing about it that transforms that in some miraculous form. If you owned all of the *Fortune* 500 — if you owned 100% of it — you'd be making \$334 billion. And if you paid \$10.5 trillion for that, well, that's not a great return on investment.

And don't count on growth to bail you out. It can't happen.

Buffett: Then, you might say, "Can that \$334 billion double in five years?" Well, it *can't* double in five years with GDP growing at 4% a year or some number like that. It would just produce things so out of whack in terms of

experience in the American economy that it won't happen.

Any time you get involved in these things where if you trace out the mathematics of it, you bump into absurdities, then you better change your expectations somewhat.

Charlie?

Munger: Well, that brings to mind two great sayings: The first goes "If a thing can't go on forever, it will eventually stop." And the second I borrow from my friend, Fred Stanback, who I think is here. As he likes to say, "People who expect perpetual growth in real wealth in a finite earth are either madmen or economists."

WHILE I HAVE NO GREAT RECORD ON THE MACRO SIDE,
DEFLATION WOULDN'T BE SO BAD FOR INVESTORS.

I have no great record in macro forecasting...

Shareholder: Can you comment on the threat of deflation — and what its likely impact would be on the economy, Berkshire and personal investment decisions?

Buffett: Well, I think deflation is very, very unlikely. But I've been wrong consistently now for a decade or more about the degree to which inflation has at least been tamed for that period. If you'd shown me all the other things that were going to happen in the world over the last 10-15 years — if I'd seen that ahead of time — I'd have thought that we would have had more inflation. So I have trouble envisioning a world where the U.S. experiences deflation. But my record is not great on that.

But we do not spend a lot of time thinking about macro factors. If we were to run into deflation, that would mean that capital would be *appreciating*. So you need much lower nominal rates of return on capital to be in the same place under deflation as would be the case if you had inflationary conditions.

So deflation, everything else being equal — and it *isn't* equal — is *good* for investors because the value of money (its buying power) appreciates. However, it would have other consequences, too.

I don't think it's likely, but I have no great record at all in macro forecasting. And if it does happen, the truth is that I don't know what its effects would be. Charlie?

Holders of long bonds might do very well during deflation.

Munger: You've seen what deflation's doing in Japan. It's been quite unpleasant for the people there. On the other hand, it hasn't been a catastrophe — *nothing* like the 1930s in the United States.

Buffett: No. And, actually, in Japan if you'd owned long bonds, you would have enjoyed a tremendous *bonanza* from deflation — because the value of your bonds would have gone up dramatically as interest rates came down and then that money in turn would *buy* more. So if you owned longer bonds issued at higher coupons some years back, that's worked to your advantage.

And presumably that would work in this country, too. If we actually ran into consistent deflation, my guess is that people who own long bonds — even bought at 5-1/2% — would find their position in the world *dramatically* improve relative to people who own most other assets.

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

IF THE BUSINESS IS RIGHT, MACRO WON'T MATTER.
IF IT ISN'T, MACRO FACTORS WON'T BAIL US OUT.

Charlie and I are no good on those macro questions.

Shareholder: How is continuing economic turmoil in Japan likely to effect the global economy and the U.S. stock market over the next 5-10 years?

Buffett: Charlie and I are no good on those macro questions. But that problem has been around in financial markets, banking systems and so on for some time now. So I see no reason why it should have more impact on the rest of the world now than it's had in the last few years. And it's had certainly very little effect on the U.S. in the last few years.

It's no factor in our thinking at *all* in terms of what we would buy or sell tomorrow morning. If we got offered a good business tomorrow, unless it was directly involved — for example, if its primary business were in Japan, but if it were a business in this country — that's not something that we would be thinking about. We would be thinking about the specifics of that business.

We don't want to think about the wrong things...

Buffett: We don't really get too concerned about the things that come and go. In the end, if we're right about a business over a 10 or 20 year period... Take See's Candy. We bought it in 1972. Look what happened in 1973-74 — [with] all of the oil shocks and what this country was going through in inflation and all of that sort of thing. And let's say in 1972 somebody laid out a road map from 1972-1982 — with the prime rate going to 21-1/2%, long-term rates going to 15% and all of the other things happening like the Dow going to 560 or 570 or whatever.

That wasn't the important thing. The important thing was that this peanut brittle tastes like it does, which is terrific, and that over time we could get a little more money for it. So See's made \$4 million pre-tax in 1972 when we bought it and it made \$62 million last year.

We don't want to be thinking about the wrong things when we're buying businesses. And that applies to marketable securities just as much as it does when we buy 100% of a business. If we're right about the business, the macro factors aren't going to make any difference. And if we're wrong about the business, macro factors aren't going to bail us out. Charlie?

Japan presents an interesting lesson about creeping slop.

Munger: What's interesting in Japan is interesting to one as a citizen. Here you have a major industrial country. They understand all about Keynesian economics and everything else. And when it starts to slide down into a big recession, it just keeps going [down] and going [down] and floundering — and stays down year after year. Meanwhile, they take interest rates down to practically zero and run a big budget deficit — and yet the economy *still* stays down. This has been very interesting to economists of the world. None of them would have predicted, I think, that as modern

a country as Japan could contract for as long as it did.

And I think the cause is related to how extreme the moves in its land prices and its security prices have been, the corruption in its accounting practices and in the regulation of its financial system, including its banks.

I think it's an interesting lesson for the world of just how important it is not to allow slop to get into the accounting and regulatory systems. And of course, a lot of folly in markets doesn't help either.

So much for Keynes. On the other hand, the wealth effect...

Buffett: It is fascinating. People keep saying, "Why doesn't Japan stimulate?" Well, they got short-term rates down to zero and long-term rates at 2%. Well, that would stimulate *me*. But as Charlie says, it's defied a little bit of classical Keynesian theory. However, in the '30s, we had the same problem in this country. We drove interest rates way down toward the latter half of the '30s....

Munger: And I would argue that probably the extreme prosperity in *America* is related to this so-called "wealth effect" — with the stock markets going up and up. I think people thought that was a smaller factor than maybe it is.

WE HAVEN'T BEEN ACTIVE IN OTHER MARKETS,
BUT WE'RE NOT RULING THEM OUT EITHER.

Our minimum investment size rules out many markets.

Shareholder: If you were directly investing in equities outside the U.S., what would be your requirements for the market as a whole — such as the transparency of the accounting system, the breadth and liquidity of the market, the rights of shareholders and the stability of the currency?

And ... for companies in these countries, how relevant do you believe the reconciliation to U.S. GAAP contained in Form 20-F really is?

Buffett: Well, most of those points you mentioned would be of interest to us. We'd have to rule out anything where the markets aren't big enough. We're looking to put hundreds of millions of dollars in any single investment at a minimum. Certainly, we think in terms of \$500 million as a minimum — [even though] we do make exceptions to that. And that's going to rule out a great many companies.

We can adjust for other differences if we understand 'em.

Buffett: We care about accounting transparency and accounting rules, but we can make adjustments mentally. In some respects, we may think the accounting's better in certain countries than here. So as long as we *understand* the accounting system, we will be looking toward the same kind of a discount model in our mind of how much cash the business is going to generate over the years and how much is going to have to be put into it. It's the same sort of calculation that goes into our thinking here. And we don't follow strictly GAAP accounting in our thinking even here. So accounting differences would not bother us as long as we *understood* those accounting differences.

The nuances of taxes and corporate governance, which you mentioned, could make a difference. If we thought corporate governance was far inferior to here, we'd

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

have to make an adjustment for that fact.

We aren't ruling out any of the major markets.

Buffett: But in most of the major countries — at least in the countries that have stock markets big enough where we can take a real position — it's a possibility that we would invest in any of them. We wouldn't rule out Japan, Germany, France or England — major markets.

Now it's important to recognize that in all the world's stock markets, something like 53% of the value is in the U.S. market. We have 4-1/2% of the world's population, but 53% of the value of all publicly-held companies in the world.... So we are a big part of the pie.

But we're very willing to look at almost all of the rest of the pie as long as we're talking about markets that are big enough to let us put real money into them. Charlie?

Munger: Well, so far we haven't done much — as Warren has said. But we don't have a rule against it. What more can we say?

If the business and the price are right, you should do well.

Shareholder: Twenty years ago, China unleashed capitalism within its borders. Since then, I believe it has benefited more from that economic system than any major country in history. I also believe that this momentum combined with China's size and demographics will make it the most fertile economic environment in the world during the next few decades.

Nonetheless, there are many Chinese companies with easy-to-understand businesses and 20% per annum sales growth this decade trading at 5 times last year's earnings or less. What is your assessment of the risk/reward of investing directly in Chinese companies?

Buffett: Well, I don't know that much about them. But certainly, if I can buy really good businesses — which we define as businesses that earn high returns on capital, that can redeploy a significant portion of their earnings at a return of 20% or more on equity and that give the promise of being able to *continue* to do both of those things — at 5 times earnings and I felt good about the quality of the earnings, that would have to be an interesting field.

My guess is it's not a large enough field in terms of the ones that meet those tests you named for Berkshire to

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profitably participate. Whether you could buy all of those companies from the U.S. — I think there could well be a lot of problems in that.

However, any time you can buy what you believe are really good businesses at 5 times earnings, you'll make a lot of money if you're correct in your assessment.

It's not in our circle of competence. But if it's in yours...

Buffett: Charlie?

Munger: I don't know much about China.

Buffett: That is not to knock it in any way, shape or form — because there could well be opportunities in areas like that if you can identify those businesses. We would have trouble identifying those businesses *ourselves*.

But that doesn't mean *you* will have trouble or that other people who are much more familiar with the economy there would have trouble. I encourage you to look at companies within your own area of expertise at something like that. If the conditions you describe exist and you can identify the right companies, you will do much better in that than you will in American markets in my view.

TECHNOLOGY HAS BOOSTED U.S. PROSPERITY.
HOWEVER, WE VIEW IT MORE AS A THREAT.

Prosperity's been aided by advances in technology.

Shareholder: ...Could you please explain how technological advances and productivity increases affect our non-fixed-income holdings — especially insurance?

Buffett: To the extent your question implies, "How have advances in technology affected inflation?", Alan Greenspan has made a lot of interesting comments on that. I think it baffles him to some extent. But he also recognizes that some important, very hard to measure, factor has caused inflation not to behave the way most people expected with this drop in employment, general prosperity, etc. And I think he attributes it in some part — albeit, again, immeasurable — to what's been happening in the information technology world.

Obviously, low inflation is good for fixed-income investments, but that's largely reflected in a long-term rate down around 5-1/2%. It does look at the moment like an almost perfect world in terms of the macroeconomic factors. That's probably a reason why people are enthused about stocks. And it's a reason — and a *good* reason in terms of price inflation — why bonds have behaved well ... really since 1982.

And it doesn't hurt the U.S. to be miles ahead of everyone.

Buffett: I don't know what it means for the future.

But I have to believe that it's very good for this country to have the lead in information technology that it does on the rest of the world. It seems to me, as a non-expert, that we are so far ahead of the rest of the world — in terms of having the leading companies and the money ... and the brainpower flowing into it — that it's even hard to think of who's in *second* place. I think that's helped this country in a very significant way, but I don't know how to measure it. Charlie?

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

We're less likely to be hurt by new technology than most....

Munger: And I would say that Berkshire's businesses on average are less likely to be obsoleted by new technology than businesses generally. You know, steel-toed work shoes — I don't anticipate a significant change in the technology. And I think we have more of the stuff that's sort of basic and hard to obsolete than many other corporations do.

Buffett: As we mentioned in the report, we think all of that activity is very beneficial from a societal standpoint. Our own emphasis is on trying to find businesses that are predictable in a general way as to where they'll be in 10 or 15 or 20 years. That means we look for businesses that in general aren't going to be susceptible to very much change. We view change as more of a *threat* investment-wise than an *opportunity*. That's quite contrary to the way most people are looking at equities now. With a few exceptions, we do not get enthused about change as a way to make a lot of money. We're looking for the *absence* of change to protect ways that are *already* making a lot of money and allow them to make even more in the future. So we look at change as a threat.

And when we look at a business and see lots of change coming, 9 times out of 10 we're going to pass — whereas when we see something we think is very likely to look the same 10-20 years from now, we feel much more confident about predicting it.

Coke and peanut brittle are subject to very little change.

Buffett: Take Coca-Cola. It's still selling a product very, very similar to one that was sold 110+ years ago. The fundamentals of distribution, talking to the consumer and all of that sort of thing really haven't changed at all. Your analysis of Coca-Cola 50 years ago could pretty well serve as an analysis today.

We're more comfortable in that kind of business. It means we miss a lot of very big winners. But we wouldn't know how to pick them out anyway. It also means we have very few big losers — and that's quite helpful over time.

Munger: Yeah. Peanut brittle has very little technological change to it.

Buffett: They *better* not change it. We like it just the way it is.

HIGH TECH IS INHERENTLY LESS PREDICTABLE
— NOT ONLY FOR US, BUT EVEN FOR BILL GATES.

I don't see the future of high tech as clearly as soft drinks.

Shareholder: You like to buy into success stories, but you don't like to buy high-tech. But it seems to me in the case of Microsoft that 10 years from now they'll be doing software development, just like 10 years from now Coke will be selling sugared water. Why do you feel that way when certain high-tech companies *are* predictable? Also, in the early '90s, you said you were going to buy a pharmaceutical company which also seems like high-tech to me.

Buffett: With pharmaceutical companies, I think we

said we wouldn't have known how to pick out which one. We thought the industry as a *group* would do well from its 1993 price levels. You can't buy high-tech companies at prices anything like the levels pharmaceutical companies sold at in '93.

Also, it's much easier to predict the relative strength Coke will enjoy in the soft drink world than the amount of strength that Microsoft will possess in the software world. That's not to knock Microsoft at all. If I had to bet on *anybody*, I'd certainly bet on Microsoft and heavily — if I *had* to. But I *don't* have to bet. And I don't see that world as clearly as I see the soft drink world.

Somebody else with a lot of familiarity with software may very well see it that way. If they do and they act on it, then they're entitled to make money based on their superior knowledge. There's nothing wrong with that. But I know I *don't* have that kind of knowledge.

We're willing to trade away a big payoff for a certain one.

Buffett: I do think if you have a general knowledge of business over decades that you would regard the industry they're in as less predictable than the soft drink industry.

However, even though it's less predictable, there may be a whole lot more money to be made — so if you're right, the payoff's much larger. But we're perfectly willing to trade away a *big* payoff for a *certain* payoff. That's just the way we're put together. It does not knock the ability of other people to make those decisions.

The first time I met Bill Gates in 1991, I asked him, "If you were going to be away on a desert island for the next 10 years and had to own the stock of two companies in the high-tech business, which ones would they be?" And he named two very good stocks. If I'd bought both of 'em, we'd have made a lot more money than we made even buying Coca-Cola. But he also would have said at the same time that if he went away, he'd rather buy Coca-Cola — because he would have felt *sure* about that happening.

Different people understand different businesses. The important thing is to know which ones you *do* understand and when you're operating within your circle of competence. And the software business is not within my circle of competence and I don't think it's within Charlie's.

The Dilly Bar is more certain [as he begins to eat one] to be around in 10 years than any software application that we know. But maybe that's because we understand Dilly Bars and not software.

One day, high-tech progress will slow — as it did with jets.

Munger: Well, I certainly agree with that. I think there are interesting questions, too, about how far the whole field can go. Take jet airplane travel below the speed of sound. It's been pretty steady in terms of the technology for a long, long time. A big Boeing airliner is much the same as it was 20 or 30 years ago.

A lot of these businesses are quite dependent on the technology continuing to gallop and do more and more for people. Take pharmaceuticals: If they never invented any more pharmaceuticals, it would be a *terrible* business.

I don't know what happens once you get unlimited bandwidth into the house and way more options. Beyond a certain point, it strikes me that there might be a surfeit of anybody's interest in the field. I don't know where that point is — whether it's 20 years out or 30 years out, but

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BERKSHIRE HATHAWAY'S
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(cont'd from preceding page)

the concept of a possible technological limit is part of the equation for me.

IF YOU STOP AND THINK ABOUT THE MATH,
YOU SEE MOST OF THEM *MUST* DISAPPOINT.

Dozens and dozens of high-tech companies will disappoint.

Buffett: Also, in the whole United States — which is, by far, the most prosperous country in the world — there are probably around 400 companies that are earning \$200 million a year after taxes.... And you can name 'em. If you're talking about banks, you can name Citigroup, Chase and Wells Fargo and you can name 10 or 15 others. If you're talking about consumer goods companies, you can name Procter & Gamble, Coca-Cola and Gillette — and you can name a whole bunch of 'em. Of those 400 companies, you can probably name 350.

Five years from now, instead of 400 being on that list, there'll probably be 450 on the list — maybe 475. And a lot of those will be companies that are earning between \$150 and \$200 million today. So there'll probably be 20 — or some number like 20 — that come from nowhere.

If you look at the number of companies selling today at a price which implies \$200 million or more of earnings right now, you'll find dozens and dozens of such companies in the high-tech arena. A *very* large percentage of those companies aren't going to fulfill people's expectations. And I can't tell you which ones, but I know there won't be dozens and dozens and dozens of those companies making a couple of hundred million dollars a year. And I know they're selling at prices that *require* them to be making that much money or more. But it just doesn't happen that often.

You want to think about the math...

Buffett: Biotech was all the rage some years back. How many of those companies are making a couple of hundred million dollars a year? It just doesn't *happen*. It's not that *easy* to make lots of money in a business in a capitalistic society. There are people that are looking at what you're doing every day and trying to figure out a way to do it better, underprice you, bring out a better product or whatever it may be.

And a *few* companies make it. But here in the U.S., after all of these decades and decades and decades of wonderful economic development, we still only have about 400 companies that have hit the level that would be required of a company with a market cap of \$3 billion. And yet some companies are getting \$3 billion of market cap virtually the day they come out. You want to think about the math of all this.

INTERNET WILL HAVE HUGE IMPACT ON RETAILING.
THE ONLY QUESTION IS WHAT — AND TO WHOM.

Internet will have a huge impact on some forms of retailing.

Shareholder: My question has to do with the

retailing industry, particularly department stores and mass merchants. Without commenting on specific companies, may I ask your opinion as to the long-term prospects for growth and profitability of this group?

Second, it's difficult to pick up a newspaper without being bombarded by what is purported to be the potential for exponential growth in the internet e-business, particularly selling directly to consumers which could possibly eat into the retailers' revenues. Even if we assume a relatively low impact of say 5-10% revenue reduction — and given that top-line growth is critical to any business, especially the bricks and mortar retailers with their high proportions of fixed overhead — what advice could you give a CEO of such a company?

In turn, given that scenario, what is your opinion of the medium and long-term prospects for this industry?

Buffett: That's a good question.... Obviously, the internet is going to have an important impact on retailing. It will have a *huge* impact on some forms of retailing — changing and maybe revolutionizing them. I think that there are other areas where the impact will be less. But anytime we buy into a business — and anytime we've bought into one for some time — we've tried to think about what that business is going to look like in 5, 10 or 15 years.

We recognize that the internet in many forms of retailing is likely to pose *such* a threat that we simply wouldn't want to get in those businesses in the first place. Not that we can measure it perfectly, but there are a number of retailing operations we think are threatened.

We do not think that's the case in furniture retailing — and we have three very important operations there. We could be wrong. But so far that would be my judgment — that furniture retailing will not be hurt.

You've seen other forms of retailing where you're already starting to see some inroads being made. But it's just started. The internet is going to be a huge force in many arenas, and it'll certainly be a huge force in retailing.

There will be beneficiaries, too. The key will be trust...

Buffett: It may benefit us in certain areas. I would expect the internet to benefit Borsheims in a very big way. In the movie [shown earlier], we talked about Borsheims.com coming online in May. There's something up there now, but you'll see a new format....

You might ask, "In jewelry retailing, with millions of things you can click onto, 10 years from now who's going to be important in terms of online retailing of jewelry?" Well, I'd argue that two firms have an enormous advantage going in. I'd argue that Tiffany has such an advantage (and we don't own any) because of their name....

Brand names are going to mean very, very much when you have literally thousands and thousands of choices. People ... have to *trust* somebody. I think that Tiffany has a name that people would trust — and I think that Borsheim's has a name that people would trust.

And Borsheim's sells jewelry a whole lot cheaper than Tiffany's. So I would say people who are *price-conscious*, but also want to deal with a jeweler they trust implicitly, will find their way to Borsheim's in increasing numbers over the internet. And I would say that people that like the blue box are going to find their way to Tiffany's over time — and they'll pay more money.

But I don't see them going for Brand X and buying

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

fine jewelry over the internet. So I think with the brand Borsheim's has and with careful nurturing of that brand, the internet offers Borsheim's a chance to have the advantage in cost of a huge one-store location and yet have access into the homes of people in every part of the world. And that kind of a company should prosper.

Some of our companies (& retail real estate) will be losers.

Buffett: GEICO is going to be a big beneficiary of the internet. We're already developing substantial business through it. But I worry about other of our companies. I can worry about them being hurt in various ways. And if I were to buy into any retailing business — whether I were buying the stock or the whole business — I would think very hard about what people are going to be trying to do to that business through the internet.

And it affects real estate that is dedicated to retailing. If you substitute 5% of the retail volume via the internet where real estate is essentially free, you can have a store in every town in the world through the internet without having any rental expense.... I would give a lot of thought to that if I were owning a lot of retail rental space. Charlie?

Predictions are hazardous — especially about the future.

Munger: It's tricky predicting technological change that either will or won't destroy some business. For example, when I was young, the department stores had a bunch of sort of monopolistic advantages: First, they were downtown where the streetcar lines met. Second, they had almost a monopoly on extending revolving credit. Third, they had one-stop shopping in all kinds of weather — and nobody else did. Well, they lost all three of those advantages. Yet they've done well — at least a lot of 'em have — for many decades since.

Other times, you get a change and just get destroyed. Our trading stamp business was destroyed by changes in the economic world. And our World Book business has been seriously hurt by the personal computer, the CD-rom and so forth. We agree it's a big risk, but it's not easy to make predictions in which you have great confidence.

Buffett: Here in Omaha, where the streetcar tracks used to cross at 16th and Farnam was the best real estate in town. It looked like there was nothing more safe — because they weren't going to move the streetcar lines. So people signed 50 or 100-year leases on it. The only thing was that they moved the *streetcars* — they took 'em and converted 'em into junk. But it seemed very permanent.

The advantage of the big department store — [like] Marshall Field's in Chicago or Macy's in New York — was this incredible breadth of merchandise. You could go and find 300 different types of spools of thread or you could see 500 different wedding dresses or whatever. And you had these million square foot — even *two* million square foot — downtown stores. They were these huge emporiums.

Then the shopping center came along. And, of course, shopping centers created, in effect, stores of many stores. So you had millions of square feet now, but you still had this incredible variety being offered.

The internet becomes a store in your computer — and

it has an incredible variety of offerings, too. Some of them don't lend themselves very well, it seems to me, to retailing and others do. But Charlie's right — it's hard to predict exactly how it will turn out. I expect automobile retailing to change in some important ways — in very significant part influenced by the internet. I can't predict exactly how that'll happen, but I don't think it's going to look the same 10 or 15 years from now.

DELEGATING INVESTMENT DECISIONS TO OTHERS
USUALLY PUTS YOU IN THE HANDS OF PROMOTERS.

We understand the process very well....

Shareholder: With the internet, I think we're seeing a change so dramatic and profound that it's unlike any other during the last 500 years. If a John Doe at Kleiner Perkins approached you and said they were starting a \$1 billion early stage or later stage internet investment fund that Kleiner would manage, would you consider participating in that investment to be within your circle of competence if it were offered at terms that looked attractive?

Buffett: I agree with the first part of what you said. I'm not sure that it necessarily would be the most important thing in the last 500 years in the commercial world, but it could well be. And if it isn't, it's right up there.... We talked about this last year and maybe even the year before. It is a huge development.

And Charlie and I both probably understand the process of early investment/promotion as well as anyone. We haven't *participated* in it. There are certain things that we don't even *like* about it, but we do understand it. [Buffett chuckles]. Right, Charlie? [Charlie nods.]

The internet doesn't offer easy investment decisions for us.

Buffett: And I would say no, we would not have an interest in investing in the fund. There's no question that if you're in the early stages of promotion, particularly if you've got a reputation for being successful in that — although in this case, it wouldn't make much difference because the whole field has gone wild — you'll make a lot of money selling to the next stage and the next stage and the next stage.

But in terms of picking out businesses that are going to do wonderfully as businesses — not as stocks for awhile, but as businesses — I don't think it's necessarily so *easy* in the internet world.

If you were to ask some very top names in the field to name the next five companies out of the chute — or the next 10 companies — and predict that one of them will earn, say, the \$200 million I mentioned earlier as a threshold six or seven years from now, I'm not so sure that if they gave you a list, they would name a single one. That doesn't mean they might not make a lot of money by being early investors in them — because they sell out to the next group and so on. But in the end, they have to succeed as businesses. And a few will.

The internet will have a *huge* impact on the world. But I'm not so sure that makes it an easy investment decision. Charlie?

Munger: At least it's not an easy investment decision for us. And that's what we're looking for.

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

If we're going to lose your money, we'll do it ourselves.

Buffett: Yeah. We will never turn our money over to somebody else. If we're going to lose your money as Berkshire shareholders, we're going to lose it ourselves — and we're going to come back and look you in the eye and tell you how we lost it. We are not going to say this game is too tough — so we'll give our money to somebody else. You can give your money to somebody else. You don't need the intermediaries of Charlie and me to do it for you.

We get approached all the time — I had a call within the last couple of days on something you'd know very well — about participating in some fund or another. It's always Stage 1, Stage 2, Stage 3. The idea is to get more people to come in later at twice the price. And maybe the fact that our name is involved ... will cause people to pay even more and all of that sort of thing. But we're not in that game.

Most often, you end up in the hands of the promoters....

Buffett: And we're not going to turn the money over to someone else to manage. It's your money. You gave it to us to manage — and we'll manage it. If you decide you don't want us to manage it, *you* decide who you give it to. We're not going to be intermediaries on it.

If we don't understand something ourselves, then we're not looking for anybody else to do it for us. The world doesn't work very well that way anyway. Usually, you end up in the hands of the promoters and not in the hands of the people who really know how to make money. Charlie?

Munger: You said it.

WE HAVE NO GREAT INSIGHTS IN COMMUNICATIONS.
BUT DON'T CONFUSE GROWTH WITH INVESTMENT MERIT.

Being in a growth industry ≠ high returns — e.g., AT&T.

Shareholder: The growth of cellular communications and the internet has given certain stocks the prospect of substantially above-average revenue and earnings growth. AT&T and Nokia, for example, earn respectable margins and return on common equity and would seem to fit Berkshire's criteria from a financial perspective. Has Berkshire reviewed stocks in the area of communications? And would you consider an investment in this area?

Buffett: There's certainly no question that amazing things have happened in communications. It's interesting that you mention AT&T because AT&T's return on equity over the last 15 years has been very, very poor. Now, they've had special charges time after time and, in effect, said, "Don't count this." But their overall return on equity ... for the last 15 years has not been good at all.

AT&T was the leader in the field. However, so far, what's happened has hurt them — at least relative to their competition — far more than it's helped them.

Communications aren't within our circle of competence.

Buffett: We have a fellow on our board, Walter Scott, ... who knows a lot more about this. He used to try to

explain these changes that were taking place. We'd ride down to football games on Saturday — and Walter would patiently explain to me like he was talking to a sixth grader what was going to happen in communications. But the problem was that he had a *fourth* grader in the car with him — namely *me*. So I never got it. But Walter did. And he's done very well in MFS and Level 3.

I think for people who understand it and are reasonably early, there could very well be substantial money to be made. There's been an awful lot of money made in Omaha by people who've participated in this.

But I'm not one of them. I have no insights that I bring to that game that I think are in any way superior — and probably, in many cases, even equal — to those of other participants.

Don't confuse industry prospects with investment merits.

Buffett: There's a lot of difference between making money and spotting a wonderful industry. The two most important industries in the first half of this century in the U.S. — in the world probably — were the auto industry and the airplane industry. Here you had these two discoveries — both essentially in the first decade of the century. And if you'd foreseen in 1905 or thereabouts what the auto or the airplane would do to the world, let alone this country, you might have thought that it was a great way to get rich. But very, very few people got rich by riding the back of the auto industry. And probably even fewer got rich by participating in the airline industry over that time.

Millions of people are flying around every day. But the number of people who've made money *carrying* them around is very limited. [Given] the capital that's been lost and the bankruptcies, it's been a terrible business [even though] it's been a marvelous industry.

So you do not want to necessarily equate the prospects of growth for an industry with the prospects for growth in your own net worth by participating in it.

Munger's contributions to their communication investments.

Munger: It reminds me of a time in World War II. There were these two air force officers I knew who didn't have anything to do at the time. And some general came in to visit and said to one of them, "Lieutenant Jones, what do *you* do?" He said, "I don't do anything." So the general turned to the second one and asked him, "What do *you* do?" He said, "I help Lieutenant Jones."

Well, that's been my contribution on communications investments.

Buffett: Feel free to address me as Lieutenant Jones for the rest of the meeting....

IT WAS DIFFICULT IN 1969 AND IT'S DIFFICULT TODAY.
HOWEVER, MORE IMPORTANT ARE THE DIFFERENCES.

I terminated my partnership, but Berkshire's here to stay.

Shareholder: Thirty years ago, you disbanded your Buffett Partnership saying you felt out of step with the market and that you feared a permanent loss of capital. Given today's market and current stock valuations, if Berkshire Hathaway were a partnership with 100 partners

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

instead of a public corporation, would you consider disbanding it as you did 30 years ago? If not, why not? And was that the right decision back then?

Buffett: Well, if our activities were limited to marketable securities and I had less than 100 partners and we were operating with this kind of money so that there was a real limitation on what we could do, I would simply tell the partners and let *them* make the decision. That would be easy enough.

However, we're *not* in that position. We've got a number of wonderful businesses which will grow in value — in some cases, very significantly. It's not feasible to stop. If shareholders decide since we're unable to find things that they'd rather go on to something else, they have their *own* way of getting out. And they can get out at certainly a premium to the amount of money they put in to the business over the years.

So if I were running a marketable securities portfolio now and were limited to that, I would explain very carefully to my partners how limited my ability to make money in this market would be. And then I would ask them to do whatever they wished to do. Some of 'em might want to pull out and others might want to stay.

I felt pressure back then. I feel no such pressure today.

Buffett: In the 1969 period when I closed up, (A) I had a somewhat similar situation in terms of finding things and (B) I really felt that the expectations of people had been so raised by the experience we'd had over the previous 13 years that it made me very uncomfortable. And I felt unable to dampen those expectations. I really just didn't find it comfortable to operate — where my partners, even though they might nod their heads understandingly and say, "We really know why you aren't making any money while everybody else is," I didn't want to face the *internal* pressure that would come from that.

I don't feel any such internal pressure in running Berkshire.

It was difficult then and it is now. But we're still looking.

Munger: There are some similarities between the 1969-70 period and today. But I don't think that means 1973-74 lies right ahead of us. We can't predict that.

You could argue that it worked out wonderfully for Warren to quit in '69 and then be able to reenter the market in '73-74 with his powder dry. I don't think that we're likely to be quite that fortunate again.

Buffett: It was a long time though from 1969 to 1973. It sounds easy looking back. But the Nifty-Fifty, as you may recall, hit their peak in '72. So although there was a sinking spell for awhile in that '69-70 period, the market came back very strong. But that's part of the game. It stayed cheap a long time from the '73 period on.

You will find waves of optimism and pessimism. And they'll never be exactly like they were before. However, they will come in some form or other. That does not mean that we're sitting around with a bunch of cash because we expect stocks to go down. We keep looking for things. We're

looking for things right now. We're talking to people about things where we could expend substantial sums of money. But it is much more difficult in this period.

WE PREFER 100% PURCHASES OVER STOCKS,
BUT WE'RE NOT FINDING MUCH OF EITHER TODAY.

Direct purchase or stock purchase? We prefer direct.

Shareholder: With Berkshire becoming so large, should we expect major future investments to be complete buyouts such as the General Re acquisition or would you still consider nibbling in the stock market?

Buffett: Well, we don't want to nibble. We would like to take big gulps in the stock market from time to time. But we've *always* wanted to acquire entire businesses. People never seemed to believe it when we were buying See's Candy, The Buffalo News or National Indemnity, but that's been our number one preference right along.

It's just that much of the time, we could get far more for our money by buying pieces of wonderful businesses in the stock market than we could by negotiated purchase.

Better bargains are usually available in the stock market.

Buffett: There may be some movement in terms of the availability of the two toward the negotiated purchase, although it's almost *impossible* to make a wonderful buy on a negotiated purchase. You'll never make the kind of buy on a negotiated purchase that you can make via stocks in a weak stock market. It just isn't going to happen. The person on the other side *cares* too much, whereas in the stock market in 1973-74, you were dealing with the marginal seller. And whatever price they established for the business, you could buy [shares at that price].

I couldn't have bought the entire Washington Post company for \$80 million in 1974, but I could buy 10% of it [at that price] from a bunch of people who were just operating based on calculating betas or doing something of the sort. They were in a terrible market. And it was possible to buy a piece of it at that valuation. You never get that kind of buy in a negotiated purchase.

Over the next five years, we'll buy direct and via the market.

Buffett: Nonetheless, we're always more interested in large negotiated deals than we are in stock purchases. But we're probably not going to find a way to use all the money that way. And we occasionally may get a chance to put big chunks of money into attractive businesses through the stock market — 5% or 10% of the company or something of that sort. Charlie?

Munger: My guess is over the next five years, we'll do some of both — both the entire business and big gulps in the stock market.

Buffett: I agree with that. We'll keep working at *both*. We're not finding a lot in either arena. We might be a little more likely to find it in a negotiated business. [But] we're not going to get any huge bargain in a negotiated purchase. We're more likely to find what I would call a fair deal there under today's circumstances than we will in the market. But I agree with Charlie. Over the next five years, I think you'll see us do both.

(continued on next page)

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

We're not in the "white knight" business....

Shareholder: You've been called the "white knight" of the investment world because you rescue companies from hostile takeovers. Are there any companies you're now trying to help? And could you please name them?

Buffett: Do you have a cell phone that you're ready to place orders with? What we really want to buy into are wonderful — or, at least, extremely good — businesses. And we want them to have managements that we like and we want the price to be attractive. We're not in the business of being "white knights". We're in the business of investing in things that look sensible to us.

I don't think that I've been approached by anybody in connection with that. We do get approached *occasionally* when somebody has a takeover bid and they say, "Would you like to top it?" — to which our answer invariably is, "No." Charlie?

Munger: We're very good at saying, "No."

Buffett: Charlie's even better than I am.

YOU CAN VALUE BERKSHIRE LIKE ANYTHING ELSE,
BUT YOU HAVE TO STICK IN THE RIGHT NUMBERS.

Your analytic approach to valuing Berkshire is correct.

Shareholder: I've attempted to calculate Berkshire's intrinsic value using the discounted present value of its total look-through earnings. I've taken its look-through earnings and adjusted them for normalized earnings in GEICO, the super-cat business and General Re. Then I assumed that Berkshire's look-through earnings grow 15% per annum on average for 10 years, 10% per annum for years 11-20, and that earnings stop growing after year 20 resulting in a coupon equalling year 20 earnings from the 21st year on. Lastly, I discounted that earnings stream at 10% to get an estimate of Berkshire's intrinsic value.

Is this a sound method? Is there a risk-free interest rate such as a 30-year Treasury which might be a more appropriate rate to use given the predictable nature of your consolidated income stream?

Buffett: That's a very good question — because that is the way we think in terms of looking at other businesses. Investment is the process of putting out money today to get more money back at some point in the future. The question is how far in the future, how much money, and what is the appropriate discount rate to take it back to the present day and determine how much you'd pay.

You've stated the approach. I couldn't state it better myself. But [as to the] exact *figures* you want to use — whether you want to use 15% per year gains in earnings or 10% per year gains in the second decade — I have no comment.... But you have the right approach.

All you have to do is stick in the right numbers.

Buffett: We'd probably use a lower discount factor in valuing any business now under present day interest rates.

Now that doesn't mean we would *pay* that figure.... But we would use that to establish comparability across investment alternatives.

So if we were looking at 50 companies and making the sort of calculation that you just talked about, we would probably use the long-term government rate to discount it back. But we wouldn't pay that number.... We would look for appropriate discounts from that figure.

But it doesn't make any difference whether you use a higher figure and look across them or use our figure and look for the biggest discount. You have the right approach.

Then all you have to do is stick in the right numbers. You mentioned our clues. We try to give you all of the information that we would find useful ourselves in evaluating Berkshire's intrinsic value. I can't think of anything we leave out — that if Charlie and I had been away for a year and were trying to ... look at the situation fresh to evaluate things, there's nothing in my view left out of our published materials.

But on some things, your guess is as good as ours....

Buffett: Now one important element in Berkshire, which is a secondary factor that gets into what you're talking about, is that because we retain all earnings and because we have a growth of float over time, we have a considerable amount of money to invest. It really is the success with which we invest those retained earnings and growth in float that will be an important factor in how fast our intrinsic value grows.

And to an important extent, what happens there is out of our control. It does depend on the markets in which we operate. So if our earnings plus float growth equals \$3 billion or so in a current year, whether that \$3 billion gets put to terrific use, satisfactory use or no use at all ... really depends to a big extent on external factors. It also depends to some extent on our energy, insights and so on. But the external world makes a big difference in the reinvestment rate. And your guess is as good as ours on that.

But if we run into favorable external circumstances, your calculation of intrinsic value would result in a higher number than if we run into the kind of circumstances that we've had the last 12 months. Charlie?

And we're not complaining, but opportunities are scarce....

Munger: For many decades around here, we've had roughly 100% — *more* than 100% — of our book net worth in marketable securities and a lot of wonderful, wholly-owned subsidiaries to boot. Then we've always had a very attractive place to put new money in as we generated it.

Well, we've still got the wonderful businesses, but we're having trouble with the new money. It's not trouble really to have a pile of lovely money....

Buffett: Have you ever run into any *un-lovely* money, Charlie?

Munger: I don't think there should be tears in the house....

Alice Schroeder is one first-class, serious analyst....

Shareholder: I read Alice Schroeder's analysis of Berkshire Hathaway with great interest. She described her analysis as a tool kit for investors. Do you see any substantial flaws in any of her tool kit — in particular, the

(continued on next page)

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

float-based valuation model that she put together?

Buffett: I don't want to comment on valuation. But I can tell you that Alice is a first-class and serious analyst who spent a lot of time on Berkshire and, probably, produced the first comprehensive report — at least that's been widely circulated — in the history of Berkshire. It's interesting that we got to \$100 billion of market value before anybody published a report about the company.

Alice understands the insurance business very well. She's an accountant by background, so she understands numbers. She did a lot of work on that report. And I do recommend it to you as a tool kit. I make no comment at all about valuation....

WE LIKE HAVING AN UNPAID INFORMATION OFFICE.
INSTITUTIONS WILL HAVE NO LUCK CALLING ME.

There's been no change in attitude towards our stock price.

Shareholder: Both of you have been quoted as saying that you don't follow your stock price on a day-to-day basis and that you're not terribly concerned about whether Berkshire is up or down. Now that you have analyst coverage — perhaps you requested it or perhaps acquiesced to it — does this reflect any change in your attention paid to the stock price or your philosophy about investor relations? And do you think that the analyst coverage is going to have any impact on the stock price going forward?

Buffett: No, it reflects no change in our attitude towards stock price. We're concerned about building the intrinsic value per share of Berkshire at the highest rate that we can consistent with a couple of other principles that we've set forth. We hope very much the stock price stays in a zone that is not too wide around intrinsic value. There's going to be a zone of some sort — in part, because intrinsic value is not precisely calculable. In addition, you wouldn't expect stock price to track value penny for penny. But we don't want it to go crazy in either direction in relation to intrinsic value.

Institutional investors get no special treatment here.

Buffett: When we made the deal with General Re, that attracted more analyst attention and institutional investor attention because General Re's shareholder base was overwhelmingly institutional. So institutions had to decide whether they were going to continue with their investment or clean it out. And we knew we would end up with more institutional ownership subsequently....

Prior to the merger meeting, Alice Schroeder said that there were a group of institutions coming to the meeting — which I liked. I liked that they were serious enough about their investment to come see what Berkshire was all about. A few even had a requirement, I think, from their boards that they at least had sat down with management. So I spent an hour or so with a group that she'd put together that came to Omaha.

But that's the last contact I've had with any institutional investor. And we'll have no special meetings

with institutional investors or anything. Of course, they're absolutely welcome to attend this meeting. They get all of the information that's dispensed.

Having an unpaid information office agrees with us.

Buffett: But I think it's very useful, frankly, to have analysts that are well versed in Berkshire, that think straight and do their homework. That's a plus because it means we don't have to do it; and, in effect, if institutions want to talk to somebody, they don't call me — because they're not going to have much luck calling me. So they can call Alice or some other analyst that wants to do it. And that's perfect. It's not investor relations because that's somebody who's sort of pumping your stock. But at least we have a non-paid information office now. And that goes along the grain of my nature.

Individual or institutional shareholders? We don't care....

Buffett: People ask, "Do you want individual owners or do you want institutional owners?" What we want are *informed* owners who are in synch with our objectives, our measurements, our time horizons — all of that sort of thing. We want people who'll be comfortable owning Berkshire.

We don't want shareholders who own it for reasons way different from our reasons for owning it. We don't want people who are concerned about quarterly earnings. We don't want people who're concerned about stock splits. We don't want people who need to be pumped up about the stock periodically. It's not of interest to us because it would require that we keep living that way in the future. And that's not the way we want to live today — and it's not the way we want to live in the future.

There's been no change in attitude, just in coverage.

Buffett: What we really want are a bunch of people like we have in this audience who sit down and read and think and understand that they're making an investment — that it's not just a little ticker symbol: that they're buying part of a business. They know what the business is all about. They know how we think. They know how we measure ourselves. And they're comfortable with that. They could come in individual or institutional form. And when we *get 'em*, we like to *keep 'em*.

So there's been no change in our attitude about that. There has been a change in coverage in that there is some limited amount of coverage on Wall Street — which I guess there should be for a company with \$110 or \$120 billion of market value....

WE CAN'T MAINTAIN HISTORICAL FLOAT GROWTH,
BUT THAT WON'T STOP US FROM TRYING.

An important question that I don't know how to answer....

Shareholder: You've taught us that a key concept of Berkshire is the amount of float it has, the cost of its float and how fast it grows. Can you please help us understand what amount of float Berkshire has currently and what the goals are in the future for its growth over a 10-20 year period — understanding that it will be a lumpy advance? Looking at the historical data for Gen Re and Berkshire

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

regarding the amount of its float and its cost, it's grown at a great rate — in the high teens or low 20s. Could you comment on the future expectations we should have?

Buffett: Well, that's an important question, but I don't know how to give you a good answer. Our float has grown at a much faster rate since 1967, when we went into the insurance business, than I thought it would. I didn't anticipate it would grow that way. I didn't anticipate necessarily that we'd get a chance to buy GEICO or that we'd acquire a General Re. So it's been very hard to forecast.

What we've tried to do is grow cheap float as fast as we could. And sometimes it's been easy — and sometimes it's been impossible. But if you'd asked me that question 30 years ago, I'd have given you an answer that really hasn't proven out very well. So I don't know how to give you the answer now.

We've had growth rates that we simply can't maintain.

Buffett: It's very much our goal to grow float as fast as we can while maintaining a very low cost to it.... [I]t will be lumpy — in terms of cost and in terms of growth rate. But it's something we think about all the time — both in terms of our operating decisions and perhaps some big capital commitment decisions.

And we know that if we can solve the problem of how to grow it with it costing us relatively little that we will make Berkshire a whole lot more valuable in the process. We've always laid out the facts as to what we were doing, but people basically seem to ignore that. And we have had this growth rate which we *can't* maintain — because the numbers are too big. But it's something that Charlie and I think about all the time.

Hopefully, we'll get a chance to enhance our float growth.

Buffett: We have some good vehicles for growing it. But we don't have any that will grow it in aggregate at anything like the rate at which it's grown in the past. We may get a chance to do something that adds to our ability to do it. If we get that chance and the price is right, we'll add it. If we don't, we'll do as much as we can internally.

But the growth in intrinsic value of Berkshire over the next 10 years will be determined in a very significant way by the rate at which we do grow it and also [by] ... what it costs us to achieve that float. Charlie?

Munger: Yeah, if we grow very low cost float at the

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same rate that it's grown in the past for another 30 years, you can be confident of one thing: If you look to the heavens, there'll be a star in the East.

Cheap float is best, but cheap debt is good, too.

Shareholder: With regards to the insurance company, if you can use the float for cheap financing, why would you issue a fairly-priced bond?

Buffett: Well, the best form of financing for us is cheap float. Of course, most insurance companies don't generate cheap float. So plenty of companies in the insurance business have a cost of float that actually makes it unattractive to expand their businesses. Our insurance companies have had a terrific experience on cost of float — and we'd like to develop it just as fast as we can.

Right now we'd have no interest in issuing a bond because we have more money around than we know what to do with — and it comes from low-cost float. But if a time came when things were very attractive and we'd utilized all the money from our float and retained earnings and all of that to invest and we still saw opportunities, we might very well borrow moderate amounts of money in the market. It would cost us more than our float was costing us, but it would still provide us with incremental earnings.

We would try to gain more float under those circumstances, too; but we just wouldn't quit when we ran out of money from float. We would go ahead and borrow moderate amounts of money. However, we would *never* borrow *huge* amounts of money. Charlie?

Munger: Well, I agree.

Buffett: You can see why we've been partners so long.

FLOAT WON'T GROW OR HELP MUCH SHORT TERM.
BUT OVER THE LONG RUN, IT WILL DO BOTH.

What are we bringing to the party? Nothing — at least yet.

Shareholder: Could you give us a few hints about the incremental value of Gen Re's float under the Berkshire umbrella and the potential for the growth of Gen Re's float?

Buffett: Gen Re's float is now available to Berkshire. It's a 100%-owned subsidiary, although part of that float is attributable to Cologne [Re] — which is only an 83%-owned subsidiary of Gen Re....

I would say the incremental value of its float today because it's under the Berkshire umbrella is *zero* — because we're bringing nothing to the party that Gen Re's own investment people would not have brought....

We obviously think that there will be important incremental value over a long period of time. But when that value will appear or how much of it develops is a matter that's out of our hands. Right now, we have close to \$24 billion in total invested assets at Gen Re and Cologne. Again, 83% of the Cologne part is ours and 17% belongs to somebody else. But we're bringing nothing to that party right now in terms of any managerial skill that is going to add value. I would hope that over time, we would.

Gen Re won't be GEICO growth-wise, but growth will come.

Buffett: [As to your] second question, the growth of float ... at General Re and Cologne will certainly be very slow in the short term. The growth of float at GEICO will

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

be significant percentage-wise. The reinsurance business does not have the same potential for growth as we have at GEICO and growth is much slower to come about because there are longer-term contractual commitments. People are reluctant to change reinsurers. And they should be....

So at a level of \$6 billion-or-so of premium volume and already \$14 billion of float, you won't have growth of float unless premium volume becomes significantly higher in the future. I think that will happen over time. It will not happen in the short term. Charlie? If I may interrupt your breakfast...

Munger: I've got nothing to add....

We don't expect Gen Re's float to grow much short term.

Shareholder: ...Did you buy General Re mostly because you think you can grow the float or because you felt like you could do better with the investments?

Buffett: We don't think General Re's float will grow rapidly in the near-term future at all. The float actually declined very slightly in the first quarter. And at its level of \$6 billion± of premiums, the paid losses are likely to run at a rate that would cause the float to remain more or less steady. So it will take a period when premiums grow for the float to grow — and premiums would have to grow fairly substantially to have any significant impact on the float. And like I say, that won't happen in the short term.

We *do* expect the float to grow over the *longer* term. We expect General Re to probably grow considerably faster in international markets than in the domestic market.

We think float will grow long term and the merger will help.

Buffett: We think their reputation — which was as good as could be found from an operational, technical and managerial standpoint — will be further enhanced by Berkshire's capital strength. So we think their reputation is likely to grow over the years and that premium volume will follow, but not in any major way at all for a few years at least.

As we said earlier, we think there will be the *opportunity* to do better with that float from time to time. Right now, it's not a plus that it's in our hands. It may not be a plus a year from now. But we think it *will* be a plus at some point. And there could be tax advantages for General Re to be part of Berkshire, too.

So there are some things going for it. But none of 'em will have an impact in 1999 — and they may well not have an impact in 2000. We obviously think Berkshire will be worth more on a per share basis with General Re included 10 years from now than if we had not made the deal. So we don't necessarily think that will be the case on a one or two-year basis, but it is our judgment that it will be on a 10-year basis. Charlie?

And hopefully our past will be prologue....

Munger: If in the future we do *one third* as well with the new float that came to us with General Re as we've done on average in the past, it will work wonderfully. Our past use of float ... would be an interesting study showing vast advantage gained.

THE BEST WAY TO LEARN? BY READING A LOT.
AND TO SPEED THINGS UP, FIND A GOOD TUTOR.

Lorimar Davidson taught me about GEICO and insurance.

Shareholder: Many of us know less about insurance than equities. I wonder if you could put some references for us on the Berkshire Hathaway website that might help us increase our knowledge about insurance....

Buffett: Good question.... But I can't think of a good book I've read on the subject.

I got my knowledge of insurance by reading.... Actually, I got a huge head start when Lorimar Davidson, who's now 96, spent four hours with me one Saturday morning in January, 1951, explaining how GEICO worked. It was a marvelous education. It got me so interested — not only in how GEICO worked, but in how its competitors worked and how the industry worked — that I started reading a lot of other reports.

If I'd been out west, we might be in streetcars.

Buffett: ...I took one course in school on insurance, although I don't remember a thing from it. I have no idea what the textbook was or anything. It had no value to me. So I never really had any background in insurance. Nobody in the family was in the insurance business. And until I talked to Davey, it just hadn't been something that had ever crossed my mind.

The only reason I was down there at all was because my hero, Ben Graham, was listed in Who's Who as being the chairman of Government Employee's Insurance. He was *also* the chairman of the Market Street Railway Co. in San Francisco. Fortunately, I went down to GEICO instead of out to see the Market Street Railway Co. It was *closer*.

I used to do a lot of reading....

Buffett: My own education about insurance came from reading lots of annual reports. If I were starting today fresh and I didn't know anything about the insurance area and I wanted to develop some expertise, I'd probably read the reports of every property/casualty company around. I'd go back some time and probably get the best manuals and look at them.

I used to do a lot of reading. I used to go down to the Department of Insurance in Lincoln and go through the convention reports and the examination reports. They'd give me some little table someplace and I'd keep asking for these reports. They'd have to go way down to the bottom of the kettle to get 'em out for me. But they didn't have much else to do so they were always happy to do it. And that's the way I learned about it. It had to be a productive field to learn about it that way.

Read a lot. And to accelerate the process, find a tutor.

Buffett: I really think something akin to that would be the best way now.... You could read some analysts' reports. I think you can learn something, frankly, by reading the Berkshire Hathaway annual reports for 20 years and reading the insurance section. I think it'll teach you something about the economics of insurance.

So I'd do it by reading. And if you can find somebody who knows the business well who's willing to spend some time talking to you about it, they can probably shorten the educational period and give you some help on that.

—OID

JULIAN H. ROBERTSON, JR. TIGER MANAGEMENT

"Tiger was down 2.1% for the month of November versus a positive 2.0% for the S&P 500 and a positive 2.8% for the Morgan Stanley Capital International World Index. This brings the year-to-date results to a negative 22.6% versus a positive 14.3% and a positive 15.6% for the two indices, respectively. Obviously these figures are not satisfactory. The only explanation I can give for these poor results is one which you're justifiably tired of hearing. We are in a momentum market and value stocks, no matter how cheap, are out of vogue. Many of them have gone to levels that I could not have imagined. I would have thought that at current prices, they would send the LBO funds into a feeding frenzy. Such is not the case.

"However, it is encouraging that the companies and managements themselves are actively purchasing shares in these value situations. They are as incredulous as I am at the levels where their stocks are trading. Unfortunately, the investment world could care less. Nevertheless, it may give you some comfort to know that our two largest investments in the U.S. are huge buyers of their own shares. In six of our nine largest positions, either the management or the company are significant buyers. Strangely, the only real booming stock market is in biotechnology, technology, telecommunications and Internet shares where management are primarily sellers.

"I cannot tell you when things will change. But I can tell you that stocks do not trade at four and five times earnings and two and three times cash flow forever. In the past, significant sized companies at sixty to seventy times earnings have never proved to be good long-term investments. Further, I can tell you that stocks do not trade at one hundred times sales (many today trade for higher than that) for very long. Historically paying above fifty times earnings for an equity has been a mistake and yet there are not a whole lot of respectable technology stocks selling below those levels.

"...[T]he Internet is a great new technology that will change our lives. But there have been other great developments that created equally important lifestyle changes. In the past, investors overreacted to the promises of these changes.... We're in a wild runaway technology frenzy; meantime most other stocks are in a state of collapse. I have never seen such a dichotomy. There will be a correction. As to whether or not this correction will take the form of a total market collapse as in 1929, 1973-74 and 1987, I have doubts. Why? The out-of-phase stocks are just too cheap. There is almost always a strategic or financial buyer willing to acquire a good company at twice cash flow and four to seven times earnings. We could witness a version of what happened in Japan in the period 1990 to present when its market halved while markets in the rest of the world trebled. This would imply a long-term underperformance of technology (believe it or not, it's happened) while the rest of the market continues to advance. Of course, this would be the ideal situation."

Letter to clients of Tiger Management — December 8, 1999

Dear Subscriber,

During this Holiday season, we would like first to take this opportunity to belatedly (like there's any other way) express our heartfelt gratitude for our many blessings.

At Berkshire Hathaway's annual meeting this year, Warren Buffett said, "Certainly there's nothing you'd value more than good health for yourself and your family.... If I were able to trade away a very significant percentage of my net worth — either for some extra years on my life or to be able to do during those years what I want to do — I'd do it in a second." Partner Charlie Munger added, "There are a lot of things in life way more important than money.... I'll take health any time." — to which we would like to add a hearty "Amen!"

Your editor got the opportunity earlier this year to make that decision when the two people in the world closest to me — my mother and my better half — each faced life-threatening health conditions. Thankfully, between our all-out focus and the grace of God, both are doing fabulously — and both appear healthier than ever.

Also, based on what we learned, your editor seems to be well on the way to being new and improved, as well — health-wise, energy-wise and knowledge-wise. (Of course, everything's relative.)

Meanwhile, it's not lost on any of us at *OID* how lucky we are to have the most patient subscribers in the world. Thank you for your patience and your support. As always, we'll do our very best to deserve both.

We're very pleased about the quality of the ideas in our latest edition. As pointed out by Julian Robertson, Tom Russo, Robert Ross and the general partners of Tweedy, Browne, more than a few of the stocks which have been left behind in this two-tiered market look intriguing — including more than a few discussed in this edition.

Until next edition,



Your Editor

P.S. Happy Holidays to you and yours.

P.P.S. We hope (and expect) to publish our next edition much sooner than you probably expect.

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