Outstanding Investor Digest

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

Volume XIV Number 1 — 1999 Patient Subscriber's Bonus Edition

SEQUOIA FUND'S BILL RUANE, BOB GOLDFARB, ET AL. ANNUAL MEETING — APRIL 16, 1999

Please accept this *Patient Subscriber's Bonus Edition* as a token of our appreciation for your patience and support in 1999 and always.

FOR US, IT'S GENERALLY BEEN A TIME OF REAPING.
STOCK PRICES ARE EVEN HIGHER THAN THEY LOOK.

Deja vu all over again....

Bob Goldfarb: At last year's meeting, I began my remarks with the following statement: "Sequoia's 1997 performance far exceeded the modest expectations we had at the beginning of the year. A number of our holdings experienced increases in market valuations greater than the increase in their enterprise value."

At the risk of sounding like I have merely pulled last year's remarks off the shelf, dusted them off, and replaced all references to the year 1997 with the year 1998, let me begin today by stating that Sequoia's 1998 performance exceeded our expectations. This was particularly true given the fact that last year's results came on the heels of three very strong years for both Sequoia and the market as a whole.

I'm not trying to impress you. In fact, we can't keep it up.

Goldfarb: Sequoia was up 35% for the year, about 6 percentage points above the return on the S&P 500 Index. In fact, over the past three calendar years, the value of a Sequoia share has more than tripled — and since inception nearly 29 years ago, it has returned an average of 18.4% per year after fees, as compared to 14.4% for the S&P.

In 1998, our five largest holdings, accounting for almost three-quarters of Sequoia's assets at year-end, were each up by more than 30% for the year. Three of these five holdings were up by more than 50%. I cite these figures not to impress you with how large they are, but rather to impress upon you how unsustainable they are.

For us, 1998 was generally a time of reaping.

Goldfarb: Market valuations were high throughout most of 1998, although the late summer-early fall swoon did offer a brief window of buying opportunity. If we have entered an era of bear markets that are short in duration — as has been the case with the last three — we will need to focus on accelerating the deliberate approach to investment analysis that has served us so well in the past.

For Sequoia, 1998 was generally a year of reaping rather than sowing. In 1998, we did not add any new positions of sufficient size to materially impact the Fund's overall results.

We sold several positions in 1998, causing the proportion of the portfolio invested in equities to decline from 96% at the beginning of the year to 79% at year-end.

Mistakenly or otherwise, here's why we sold McDonald's....

Goldfarb: Early in 1998, we sold our position in McDonald's. We were initially attracted to the company in 1997 because we saw significant growth opportunities outside the U.S. However, over time, we became increasingly concerned about the competitive landscape in the States.

We also became increasingly concerned about the quality of McDonald's reported earnings. The company attempted to record what we, and subsequently the SEC, believed to be a normal operating expense — the cost of upgrading its kitchen ovens — as a special charge. In addition, the unrecorded, but very real, expense associated with stock options was growing relative to reported income.

Ultimately, our sale of McDonald's could prove to be a mistake. We may have underestimated the new management's seriousness of purpose and focus on tackling the company's long-standing challenges. Notwithstanding many difficult strategic issues, McDonald's maintains a dominant global position in fast food and continues to have profitable reinvestment opportunities abroad.

Disney has some great assets, but it had a price to match.

Goldfarb: Last year, we liquidated our position in Walt Disney primarily on the basis of valuation. When we sold our shares, Disney was trading at a multiple that was in excess of 35 times 1998 earnings — and earnings are expected to decline in 1999.

There is no doubt that Disney owns some of the most valuable assets in the world. However, Disney also owns a number of businesses with either less attractive economics or growth prospects, making it difficult to value the entire company at such a high multiple....

At a 30 P/E, we felt J&J might be hazardous to our wealth.

Goldfarb: After quadrupling our original investment over a period of four years, we sold our entire position in Johnson & Johnson in 1998. At a multiple of around 30 times reported earnings, our continued investment in J&J required a leap of faith that we were not comfortable making. J&J's ability to sustain its superior track record was predicated on several developments that were not clearly visible.

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Synergy in the Wells/Norwest merger wasn't obvious to us.

Goldfarb: Finally, late in the year, we sold our position in Wells Fargo. After Wells' acquisition of First Interstate failed to live up to expectations, we were concerned that the shotgun marriage of Wells and Norwest could also prove to be problematic. Unlike the First Interstate acquisition, which at least promised rather easily-obtained cost savings from combining branches in overlapping markets, there was no geographic overlap in a Wells/Norwest combination. Moreover, there was no obvious cultural fit between the two organizations.

In addition to these holdings, we sold a few small positions in 1998....

Concentration cuts both ways....

Goldfarb: Thus far in 1999, Sequoia's results have provided some evidence of the unsustainability of last year's results. Through yesterday's close, Sequoia's return, with reinvested dividends, was a negative 2%, compared with an increase in the S&P 500 of 8%.

There are two primary reasons for Sequoia's underperformance to date in 1999: First, our 20% cash position works to our disadvantage in a rising market. Second, and more importantly, the very same concentrated investment approach that drove Sequoia's strong performance last year has worked to our detriment so far this year. For instance, the stock prices of Freddie Mac and Progressive Corp, which together accounted for 32% of the Sequoia portfolio at the beginning of the year, have each posted double-digit declines year to date.

Progressive's historically done well in good times and bad.

Goldfarb: Taking Progressive Corp first, it is clearly facing intensifying competition in the private passenger auto insurance industry after several years of unexpectedly benign cost trends and resulting fat margins. We believe this is a predictable, if perhaps less pleasant, stage of the insurance cycle. However, Progressive has historically produced a consistent record of underwriting profitability in challenging and favorable industry environments alike.

Last year was unusually fine, but Freddie's future is solid.

Goldfarb: Freddie Mac is coming off arguably its strongest year ever in 1998. The company grew its retained mortgage portfolio by a remarkable 55%, with very high expected returns on these new portfolio additions. Credit expenses fell by over one third and earnings grew by 23%.

While the company may not match this earnings growth rate in 1999, its fundamentals remain quite strong and we expect the company to deliver continued solid earnings growth this year and well into the future.

Continued controversy? Yes. Successful challenges? No.

Goldfarb: There has been a widely reported threat of a backlash against both Freddie Mac and its competitor Fannie Mae by a number of mortgage market participants, including some of the largest originators and mortgage insurers. Freddie and Fannie have introduced a stream of innovations that should benefit borrowers, but have upset the industry status quo and squeezed the profitability of some originators and insurers. In the mortgage industry, as in any other, innovation comes at the price of someone else's ox being gored. Ultimately, we don't expect these challenges to Freddie Mac to prevail, although the controversy could persist for some time as the mortgage industry shakes out.

Notwithstanding Sequoia's unspectacular results thus far in 1999, all of our large holdings and most of our smaller ones experienced significant increases in intrinsic value in 1998 and we expect the same for 1999 as well.

STOCK PRICES *LOOK* HIGH — AND THEY *ARE* HIGH.
BUT WE THINK THEY'RE EVEN HIGHER THAN THEY LOOK.

We think multiples are even higher than they appear....

Goldfarb: When I think about the current market, I am reminded of a comment made in 1997 by Warren Buffett. Repeating an assessment made by his mentor Benjamin Graham more than four decades earlier, Mr. Buffett said, "Common stocks look high and are high, but they are not as high as they look."

By contrast, we believe that today, common stocks look high and are high, but they are *higher* than they look — at least in terms of the popular benchmark S&P 500 Index, which I believe encompasses about 80% of the market value of publicly-traded companies in the U.S. The primary reason for our belief is the widespread overstatement of earnings created by two accounting practices:

Understated compensation expense = overstated earnings.

Goldfarb: First, the fact that the cost of extravagant stock option packages are not expensed through the income statement. Generally Accepted Accounting Principles do not require companies to recognize an expense on their income statements associated with what is clearly a value transfer coming out of the pockets of shareholders. As Warren Buffett, in his inimitable capacity to concisely get to the heart of the matter, asked several years ago: "If options aren't compensation, then what are they? If compensation isn't an expense, then what is it?"

Note that many companies have options programs which, if expensed, would have only a modest impact on reported earnings. However, while high levels of equity-type awards and profit skimming were once the exclusive province of either start-ups or companies run by corporate renegades, today it is not uncommon to see annual option awards equal to 3% of shares outstanding or worse at established and respectable companies.

And restructuring charges front load future expenses.

Goldfarb: Our second reason for believing that the

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market is higher than it seems is that restructuring charges in one fell swoop cast doubt on the historical earnings record, on the current year's so-called operating earnings and, to the extent that these charges "front load" certain future expenses, on prospective reported earnings as well.

The 1998 Berkshire Hathaway annual report contains an excellent discussion of these two items and we would encourage you to read it. However, we thought it might be useful today to elaborate on the options issue, as we have become increasingly concerned about this troubling phenomenon.

Don't hold your breath for CEOs to reform their accounting.

Goldfarb: While companies are permitted by current accounting guidelines to expense options directly through their income statement, to date none has volunteered to switch to this stricter reporting standard. And who can blame them? The widespread overstatement of earnings due to the non-recognition of option expense is equivalent to grade inflation in schools. Is it at all surprising that executives, now heavily incented by stock price appreciation due to their large options stakes, have not stormed the gates to join the class of the professor who uses tougher grading standards? Unfortunately, without strict mandates from the SEC or FASB, the lavish use of options and underreporting of the associated cost will almost certainly continue.

And Wall Street hangs its hat on reported earnings....

Goldfarb: Even more unfortunate, although perhaps as understandable, is the fact that there is little discussion of option expense on Wall Street among the people who are supposed to be valuing corporate America's earnings. Prominent market strategists who make public pronouncements regarding market valuations are basing their assessment strictly on reported earnings, without much regard to the large but unrecorded options expense borne by virtually every company, not to mention so-called restructuring charges, special items, or even-more hidden adjustments to shareholders equity.

And the analysts who cover individual stocks don't do any better. We find it both remarkable and ironic that when a company's reported quarterly earnings fall even a penny short of analyst estimates, its stock price can drop by 50%, while another company that meets analyst estimates but engages in a massive unreported earnings dilution through lavish stock option grants can enjoy a flood of buy recommendations and a soaring stock price.

Of course, disregarding legitimate expenses is convenient.

Goldfarb: Perhaps the complexity inherent in estimating the true economic cost of stock options, combined with a lack of interest by their clients, is why we have yet to see any Wall Street analyst produce an estimate of options-adjusted earnings for a publicly-traded company. We also suspect that in an era in which analysts' EPS estimates are compared to the so-called "consensus" estimate, analysts' devotion to uniform standards of reporting also becomes understandable, if not especially commendable.

In fact, seeing no evil has even been *rewarding* lately.

Goldfarb: Regrettably, the overstatement of earnings constitutes an invisible tax on investors. The payment of this tax will be delayed as long as the majority of the investment community continues to accept inflated earnings at face value. It is interesting to note that until now, most of America has benefited from this delusion. Perhaps this is the reason investors have passively accepted and voted for so many option programs that frankly rob them of much of their wealth.

MGM'TS/BOARDS KNOW *HOW* TO DO VALUATIONS.
BUT THEY SIMPLY CHOOSE *NOT* TO DO THEM.

Valuing stock options is much like valuing common stocks.

Goldfarb: Admittedly, the exercise of trying to calculate the true expense of stock options for any individual company is complex. The value of a stock option is equal to the present value of a company's expected future per share free cash flows, net of the present value of the exercise proceeds. In this respect, valuing an option is similar conceptually to valuing a company's common stock, although the structure of an option does deliver some additional leverage both on the upside and the downside relative to the common.

The necessary qualitative analysis that goes into valuing future cash flows cannot be captured in any one-size-fits-all formula, such as the Black-Scholes model that is the convention in financial statement footnotes regarding stock options. In this respect, valuing option grants, like valuing common stocks, is more of an art than a science.

Lower stock price = a *higher* option value, not a *lower* one.

Goldfarb: The basic problem with Black-Scholes and other mathematical option-pricing models is that they assume the current market values accurately reflect intrinsic value — in essence, they assume the stock market is efficient.

For example, consider a company that grants stock options when its stock is selling at 5 times earnings. Using Black-Scholes, a stock option grant issued when the underlying common stock is selling at 5 times earnings is valued at a price 10 times *less* than an equal-sized grant from the same company issued when the stock price is selling for 50 times earnings. But we think it could conceivably be worth at least 10 times *more*.

And it's not like the concept of intrinsic value is unknown.

Goldfarb: In determining the level of aggregate annual stock option grants and the size of individual employee awards, the vast majority of compensation committees, by using the Black-Scholes model, accepts this flawed assumption. These committees abdicate their responsibility by relying on compensation consultants armed with seemingly scientific options valuation models and impressive peer group analyses.

This pass-the-buck mentality is ironic, when you consider that senior management and Board members frequently make estimates of intrinsic value for decisions such as whether to issue stock or pay cash in an

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acquisition or whether to repurchase existing shares or to sell new ones, not to mention whether to buy or sell shares for their own personal accounts.

Thus, current valuations are frequently off by light years.

Goldfarb: While one could debate some of the finer points of valuing the cost of option grants, any reasonable estimate suggests that the cost is much too large to be ignored. In fact, the conventional option valuation models have, over the last fifteen years, been off by hundreds of country miles in the aggregate, and by light years in many individual cases.

The fatal flaw of these models is their inability to differentiate between real diamonds and cubic zirconium — between undervalued and fully-priced merchandise. In other words, these models do not [even attempt to] capture differences in capital appreciation potential.

A QUICK & DIRTY, BACK-OF-THE-ENVELOPE ANALYSIS MAKES CLEAR THE MAGNITUDE OF THE PROBLEM....

If it was a problem before, it's a whole new ballgame today.

Goldfarb: Any method of valuing options has drawbacks. However, an indisputable point is that the number of options issued matters greatly. There was a time not too long ago when an annual option grant equal to 1% of shares outstanding raised eyebrows. However, today, yearly grants equal to 2% or 3% of shares outstanding are not uncommon.

For S&P leaders, earnings may be off by a factor of *three*!

Goldfarb: One method of option valuation that is both observable and quantifiable is to impute an expense based on a retrospective calculation of the actual value transferred — that is, the difference between the grant price at the time of issuance and today's stock price.

We thus utilized this methodology to calculate the options-adjusted 1995 earnings of the 10 stocks which made the greatest contribution to the increase in the S&P 500 Index in 1998. We excluded Lucent and MCI Worldcom which didn't exist in their current form in 1995 and replaced them with numbers 11 and 12 on the list, Merck and Home Depot.

Using this method, the option-adjusted earnings for this group of companies in 1995 would have been a staggering 65% lower than what those companies reported at the end of 1995. In fact, this adjustment to earnings wipes out the reported earnings of four of the 10. Incredibly, in the cases of Microsoft and Cisco, the derived options expense was roughly *10 times* reported earnings.

That the current method understates the expense is clear....

Goldfarb: Admittedly, current stock prices do seem frothy. And it could be argued that they presently overstate the 1995 options expense and earnings dilution. But remember — there are six years to go before these options expire!

Additionally, we would point out that any broad-based basket of option grants awarded since the inception of the Black-Scholes model had ultimate values significantly higher than the Black-Scholes model indicated at the date of grant — even when you apply a discount rate to the stock price on the date of expiration.

Adjusted for options grants, MSFT's never earned a penny!

Goldfarb: Applying the retrospective valuation methodology to Microsoft's past and current employee base is a quite interesting exercise. At the current market price, we estimate that the value of options granted since Microsoft went public in 1986 is many times the company's cumulative net income since its founding.

From this case study, we would invite you to consider the following hypotheses: First, after adjusting for the ultimate value of stock options granted during its corporate life, Microsoft has never earned a penny for its non-employee owners. Indeed, when it comes to distributing profits, this global high-tech powerhouse has operated more like an agrarian cooperative than like a publicly-owned corporation. Secondly, Bill Gates, the icon of late-20th century capitalism, could instead be history's most successful communist!

THIS IS NO PURELY THEORETICAL EXERCISE. TO THE CONTRARY, OUR HOLDINGS AREN'T EXEMPT.

These aren't some pie-in-the-sky analyses....

Goldfarb: Even if the current stock prices of companies like Microsoft overstate their intrinsic value, as these companies scramble to buy in shares ... in order to cover past option grants, there is often a huge disparity between the exercise price and the price at which shares are repurchased — resulting in a negative adjustment to shareholders equity as well as intrinsic value.

There are of course examples of companies both confident and nimble enough to avoid this potential impairment by repurchasing shares as soon as the options are granted and at prices roughly similar to the exercise price of the options. However, if the P/E is high enough and the number of option grants is great enough, there is no salvation....

I would ask you: What is the economic value of an enterprise that dazzles Wall Street with reported earnings growth of 20-25% or more quarter after quarter, year after year, ad infinitum, but all of whose earnings are consumed to fund and cap employee compensation expense?

The economics of such an enterprise are analogous to those of a highly successful sports team whose players' compensation exceeds the team's revenues. This team may be well in the black in its league standings, but deeply in the red in profitability.

Our investees aren't exempt. In a way, they're *worse*.

Goldfarb: We acknowledge that our companies are not entirely without sin with regard to the granting and proper expensing of options.... Even Berkshire Hathaway, which itself issues no options and avoids restructuring charges, suffers a true but unrecognized cost from options issuances by companies in which it holds significant equity stakes.

We have initiated a dialogue with the managements of

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our other portfolio companies on this issue. However, we must acknowledge that even the highest grade and most intelligent managements seem to have a blind spot regarding options, and we expect an uphill battle. This is particularly troubling since we feel confident that the intrinsic value of our collection of superior companies is so large that options issuances by these companies are even more dilutive than those of the average enterprise.

We believe we have a cure for management myopia....

Goldfarb: Our latest somewhat tongue-in-cheek suggestion, in fact, is that instead of mounting expensive and time-consuming dog and pony shows to lure and entice new investors, our companies should grant to each non-management shareholder, on each anniversary date of his or her initial investment, options equal to 1 or 2% of his or her holdings as a reward for remaining a shareholder and as an incentive for continuing to do so.

We suspect that this proposal would cause management to immediately acquire 20/20 vision, and might even move them to sing the famous refrain from *Amazing Grace*: "I was once lost, but now am found; was blind, but now I see."

Anyway, we always try to take such factors into account.

Goldfarb: You can rest assured that whenever we analyze our current holdings or potential new ones, we've never taken reported earnings at face value. Instead, we've always tried to capture true economic earnings, making a number of adjustments for so-called nonrecurring expenses, amortization of acquisition-related intangibles, expected maintenance capital expenditures relative to depreciation, as well as other items not found in the reported income statement.

While we've always been wary of investing in companies with unusually large stock option grants, we've recently applied a more systematic, albeit imprecise, adjustment to reported earnings to reflect this growing and all-too real economic expense.

For us to get fully invested, something may have to change.

Goldfarb: In an environment of 5.8% interest rates, when the S&P 500 is selling at about 35 times true cash or economic earnings, it is very difficult to find stocks of companies that meet our investment criteria in sufficient quantity for us to once again become fully invested.

Today's two-tier market compounds our difficulties. Investors are flocking to a handful of the highest-quality, largest capitalization stocks. As a result, we often find good value only in stocks whose capitalization is too small to allow us to take a position that will contribute meaningfully to Sequoia's overall results.

One alternative would be to buy larger companies that are solid, but not as superior, at good values. This would represent a departure from our time-tested approach — and one that, for now, we would prefer not to employ. Nevertheless, you can be sure that we are working as hard as ever and evaluating as many companies at this level of equity valuations as we do when the market is more reasonably valued. And even in this difficult environment, from time to time we are able to find a few companies to add to the portfolio.

However, more reasonable levels of valuations for extremely fine, large companies may be necessary in order for Sequoia to become fully invested once again.

WE BELIEVE PONDERING SUCH ECONOMIC REALITIES IS AT THE HEART OF RATIONAL STOCK VALUATION.

My mouth is moving, but it's a group effort all the way....

Goldfarb: That is the end of my prepared remarks. We hope no one will misconstrue any of the specific examples we have used as implying any superior ability on our part to value instruments that are, by their nature, extraordinarily difficult to quantify precisely. At the same time, I hope our discussion on options today will serve to stimulate debate and raise consciousness about this issue.

Before opening the meeting to questions, I'd like to take a moment to introduce to those of you who are new attendees the other members of our research and administrative team who are up here on the dais and in the audience today — and to reintroduce them to those of you who have attended meetings in the past.

First, I feel I must attribute a lot of the credit for the thinking and theorizing which went into my prepared remarks today to the team up here on the dais, Carley Cunniff, Greg Alexander, Jon Brandt and Paul Scarpetta. In fact, if your questions get too tough, do not be surprised if I turn to them for support.

These fine analysts spend a good deal of their time pondering the economic realities behind the reported earnings numbers of our portfolio companies as well as portfolio prospects, a task which we believe is at the true heart of rational stock valuation.

The gang's all here....

Goldfarb: As you know, Carley was recently elected to the board of directors of Sequoia Fund, and in addition to her research role, has overall responsibility for the myriad administrative tasks involved in running the firm. This permits the rest of us, gratefully, to concentrate on stock research.

Greg consumes annual reports at a prodigious rate which has only tempered slightly since the arrival of his first child last year, while Jon dissects financial statements the way Kremlinologists once poured over *Pravda*, but with a better idea of what he's looking for! For those of you who happen to be in New York near the GM building some night around 2 am, look up to the one lone light on the 47th floor — that would be Jon's office, and Jon is usually there. We suspect he's trying to keep up with Greg!

As many of you know, Paul is a relatively new member of the team, having joined us last year from Freddie Mac. He has been a great addition with significantly broadened analytical and other responsibilities beyond the obvious, i.e., following Freddie for us. You can be sure, however, that we will turn to him to answer any tough questions you may have regarding our Freddie holdings....

In addition, in the audience we have some additional members of our research staff who would also be sitting up here with us if we had more room. I'll ask them to stand

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as I introduce them to you: John Taylor, Kirk Hosfelt, Tania Pouschine and John Hayes. This is the team who know how to really dig to help us flesh out the financial statements and get to the heart of the business issues and opportunities facing our portfolio companies as well as investment prospects. They are just terrific, as are Cynthia Crystal and Michael Anker who provide us with many of the research tools to get the work done....

Finally, our newest outside director is here today, Roger Lowenstein. Roger, please stand. Roger is a highly regarded journalist, formerly with the *Wall Street Journal*. Many of you will recall his thoughtful and provocative former column for the *Journal* called "Intrinsic Value". Roger is also the author of the to-date definitive book on Warren Buffett, "The Making of an American Capitalist" which, if you haven't read, we can highly recommend. And with that plug for you, Roger, we'll open the meeting, finally, for questions.

KUDOS TO PAINE WEBBER'S ALICE SCHROEDER FOR ADVANCING THE DEBATE ON BERKSHIRE.

It's not the same old Berkshire Hathaway anymore.

Shareholder: With respect to your largest holding, are you in basic agreement with the Paine Webber analysis of Berkshire? And since it's the first public research report, would you comment on it?

Bill Ruane: I think the answer to that would be yes. The Paine Webber analyst really understands the insurance business and has certainly become very familiar with the whole Berkshire Hathaway company. Without trying to validate her specific valuation, which I don't necessarily disagree with, I think what she did in that report in a very interesting way is to provide a structure within which each investor can value it for oneself. She made a point, which I think is very important in evaluating Berkshire (maybe it's all important) of trying to make one's own considered estimate of the return Warren Buffett can achieve on any particular amount of capital.

In the last year or two, there's really been quite a significant change in the character of Berkshire Hathaway. If you go back 10 years, you would find a company that was essentially dominated by public market portfolio activity that proved to be unbelievably rewarding. The companies that Buffett owned outright did quite well with a tremendous return on assets and great free cash flow. But the largest portion of the growth in Berkshire in former years derived from Buffett's remarkable genius in selecting stocks that over a long period of time turned out to be worth far more than they were when he bought them. Today, on the other hand, with the addition of General Re, the expansion of GEICO, and the fascinating new acquisition of Executive Jet, you have a very large operating company.

You have to fill in the blank for return on retained capital.

Ruane: The Paine Webber report brought out the need for each person to try to make their own judgement about what Warren Buffett can do with the very large amount of capital now available to him — much of which is invested in cash and relatively short term, fixed-income securities today. In the case of Buffett, you have someone who's compounded money after taxes at 23-24% annually since he took over Berkshire. When you start running out a number like that, you've got one hell of a performance — which is exactly what he's had.

I don't think there's any question today that those kind of numbers will not be achieved in the next 10 years — he'd own the world! However, I think that each investor should try to come to his or her own conclusion.

Goldfarb: I was just informed that Alice Schroeder, the Paine Webber analyst, is in the audience today. We'd certainly appreciate her standing up. You deserve a lot of credit for a terrific report. If we had realized that you were here, Alice, we would have turned to you rather than Bill!

Ruane: Yes, that *would* have saved a lot of time! As Alice suggested in her report, you plug in your own percentage on, let's say, $35 billion of capital that may be currently earning roughly 5% today. Do you think over the next 5 years or 10 years Warren will make 10% on that $35 billion? Do you think he'll make 15%? When you think about it, it's very hard to take a large sum like that and compound it at significant rates. But he never ceases to amaze.

You can arrive at a nearly infinite range of values....

Ruane: Alice, would you make a few comments? I really think you did a great job and deserve a lot of credit.

Alice Schroeder (of Paine Webber): Thank you. As I said in my report, my real goal with this valuation was to advance the debate and understanding of Berkshire rather than dictate how it should be done — in effect, to create an investor tool kit. I welcome any suggestions on how to improve on that.

Regarding valuation, I guess the only other thing I would say regarding these compounding issues is that we gave quite a lot of thought to that. And you can get an almost infinite range of values for Berkshire depending on your assumptions.

BERKSHIRE NOW ENJOYS ENORMOUS ADVANTAGES. IT'S NO LONGER JUST BUFFETT PLUS A PILE OF ASSETS.

Berkshire ain't just Warren Buffett any more....

Schroeder: However, one thing that Warren Buffett did say to me is that the principal mistake people make in evaluating Berkshire is to assume it's a static business and that it can't take capital out of a business that's reached maturity and redeploy it. And that is one of the things that we tried to capture in our report.

Goldfarb: The only additional comment I might make is that I believe that traditionally analysts of Berkshire have tried to derive what they call an intrinsic value for the company and then deduce from the stock price what the Buffett premium is. Alice, because you included in Berkshire's intrinsic value the reinvestment of cash flow, you have defined intrinsic value in a way that is slightly

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different than it has been defined in the past. That's not a criticism, just an observation.

Schroeder: That may be correct. What we tried to do initially was to mathematically derive formulas based on our collection of what Mr. Buffett has actually said about intrinsic value over the years. Our intention was, in effect, to reflect intrinsic value as Buffett himself defines it. I've seen others define it far more on a liquidation value approach with the Buffett premium on top.

I tend to not think of the premium as being entirely intrinsic to one person's investment skills because I think many of the advantages the company has are now structural and inherent. For example, those advantages have to do with the fact that business owners prefer to sell their company to Berkshire for various reasons. That's something that's now become institutionalized. There's also the Nebraska investment law and Berkshire's ability to leverage its capital and the kind of shareholder base that they've cultivated over the years.

So a lot of those things you might think of as relating to the "Buffett premium" are business insights that he has institutionalized which have now become self-perpetuating and unique to Berkshire.

Goldfarb: I think you're technically correct, because if the intrinsic value of any company, including Berkshire, is the future stream of free cash flow discounted back, Warren's reinvestment success will be central to that stream of free cash. By categorizing it as you have — and as it hadn't been in the past — I think that was another contribution to investors' understanding of Berkshire.

Berkshire *will* join the S&P 500. The only question is *when*.

Shareholder: Does Sequoia have an opinion as to the likelihood of Berkshire's being included in the Standard & Poor's 500 Index?

Goldfarb: You know, we might ask Alice first. It may save us some time. Alice, we certainly welcome your comments.

Schroeder: We're talking about a company with a market capitalization of $110 billion and it meets all of S&P's criteria to be included in the Index. David Blitzer, the chief economist at S&P, gave an interview where he

(continued in next column)

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said that the only issue is the liquidity of Berkshire shares and that S&P is looking for a way to solve that issue. Standard & Poor's has created a monster. They have a broad liquidity problem to deal with as more money flows into the Index. Market caps grow larger and larger. And every time they add a stock, there's a liquidity crisis. They were subject to a lot of criticism in the last year for how certain decisions were handled. So it wouldn't surprise me if S&P tried to solve the problem on a more broad-based platform, rather than just as specific to Berkshire.

Adding Berkshire would be somewhat problematic. But to the extent the Index is supposed to represent the best of American business and the benchmark that companies measure themselves against, it seems inevitable that Berkshire gets in. So we do believe it will be added. That S&P is willing to talk about it publicly and admit the obstacles are not insurmountable is indicative, and may even be considered to be S&P preparing the Index funds themselves for the inevitable.

Jonathan Brandt: In September, Buffett himself suggested that it's a virtual certainty that Berkshire will eventually be added to the Index. The only question is when.

I don't think people should be concerned about succession.

Shareholder: Just a follow up question on Berkshire Hathaway. It occurs to me that Warren Buffett himself has a franchise as opposed to Berkshire Hathaway. What do you think will happen when Warren doesn't run Berkshire anymore? Do you believe Berkshire will still get the best acquisitions and that it has the intellectual capital to continue growing capital at 15% annually?

Goldfarb: Alice, we will turn to you again first. In fact, I think we have the dais for next year's Sequoia meeting all set up!

Ruane: What kind of a contract do you have with Paine Webber, Alice?

Schroeder: Of course we don't deny the basic concept that Warren Buffett himself is a franchise. But as we commented in our report, Mr. Buffett has said that he's divided the job into two pieces and already decided on the successors for each role, which have been given to the Board in envelopes. Having had the opportunity to meet a lot of people at Berkshire, I really don't think people should be concerned.

On the other hand, there is only one Warren Buffett....

Brandt: I would concede Alice's point. But to be fair, I think we must also state simply that Berkshire will not be worth as much *without* Warren Buffett as it is *with* him. While it's commonly accepted that he's the best investor and allocator of capital, what is less widely appreciated is his unusual ability in interpersonal skills — you could call it charisma — that I think enables him to do some deals that others who are less talented in that sphere might not be able to do. It's very hard to quantify, but there is some intangible there, in addition to his investment prowess. He's very good at cultivating relationships. And he's a very likable fellow. People like to be associated with someone like him. I think part of the challenge of replacing him is not just to find someone who's good at crunching numbers, but also to find someone appealing enough to attract

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SEQUOIA FUND'S
BILL RUANE, BOB GOLDFARB, ET AL.
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sellers of businesses.

Goldfarb: A friend of mine has commented that everybody is always looking for the next Warren Buffett. The fact is that there *is* no next Warren Buffett.

Ruane: Let's keep in mind that he's still very much with us at present.

BUT IT IS QUITE A BIG STACK OF ASSETS
— WITH A HUGE AMOUNT OF IT IN CASH.

The liquidation of Gen Re's portfolio? That's just Warren.

Shareholder: As a result of Berkshire's purchase of General Re, they now control, I think, 80% of Cologne Re. I noticed in the annual report letter that Buffett said that he was not going to take control of the Cologne Re investment portfolio. Is that something regulatory or just choice? Do you know?

Ruane: I suspect it's regulatory.

Shareholder: Was his liquidation of the General Re portfolio an implicit comment on the market?

Ruane: I think basically Warren likes to start with a fresh slate. Didn't he comment to that effect?

Goldfarb: Yes, exactly.

Brandt: He says he doesn't like to "back into" any position — in essence, suggesting that he only wants to own stocks where he made an affirmative decision to purchase the position. That was what he said, I think, in the annual report where you could probably get the literal comment. It was about a $5 billion stock portfolio. And I think General Re paid several hundred million dollars of capital gains taxes when they sold their stock portfolio prior to the closing of the merger.

Day traders will learn to stay away from Berkshire.

Shareholder: *The New York Times* had an article last week about day trading and its effect on the stock market. We have over one billion share days now on the New York Stock Exchange. I noticed the amount of Berkshire "B" shares traded is greater than it's ever been. This is a new phenomenon in the market — the day trader — which looks like casino gambling to me. Would you like to comment on the effect of day trading on the market and how it affects our stocks?

Ruane: I'd like to take a shot at that. If you'll remember, about a month ago, Warren posted his annual report over the Internet on a Saturday. Now, I just have to guess that this little tidbit was kicked around in the chat rooms and picked up by a bunch of trader types who thought, "Wow, let's buy it on Friday. He's bound to have good things to say and we can get out on Monday morning."

It's just a guess, but the stock went up $5,000 per share on that Friday. Well, what happened was Warren said nothing about the stock market. And I don't think he referred to his intrinsic value. In other words, there was no blockbuster news in the Berkshire report. So come Monday morning, the slaughter started. Somebody tried to get out. And, I believe, within three or four days, you had the stock back down $5,000 or some such number.

I suspect that traders who try to play around with Berkshire probably find out they're better off playing with the Intel's, the Dell's and so on, because Berkshire "A" stock is a murderous market to do business in. Traders may well be playing with the "B", but even that's not as liquid as you might think.

Berkshire's big cash balances may have discouraged some.

Goldfarb: Alice, would you have any thoughts on why the "B" has traded so disproportionately relative to its capitalization than the "A"?

Schroeder: Well, I agree with everything you said. I think the results do still include the General Re effect of selling shareholders. And finally, I believe that the news that Berkshire has such a large inevitable cash balance of $15 billion and is not finding a lot of investing opportunities has discouraged some "B" shareholders who are more short term in their thinking than the "A" holders. So I think there may be some sellers.

They may also learn to stay away from day trading....

Greg Alexander: I just want to add one thing to the question on day trading. I think the last couple of years has been a very fun environment for people who have been day trading. And it certainly contributed to a kind of a rosy scenario out there that makes it easier, in some respects, for us to sell stocks than to buy them. If this environment continues for the kind of companies we favor, it will be a negative for us.

But day trading generally is like an entertaining game of musical chairs. At some point, the music may stop — and then it may not be so much fun anymore.

Goldfarb: I'd add that if I were day trading, I don't think I'd pick the stocks in Sequoia's portfolio to do it with.

IN THE GOOD OLD DAYS, IT USED TO BE EASY.
TODAY, *LOTS* OF JUDGEMENT IS REQUIRED....

In hindsight, it was so easy during the good old days.

Shareholder: At this meeting two or three years ago, Mr. Ruane, talking about Sequoia's cash position, said that it had been an anchor to investment performance in the past and that going forward you might be more comfortable holding your companies even if they got ahead of intrinsic value. Has this posture changed?

And as a follow up, in August of last year, when the market was down maybe 15%, were you close to investing some of this cash?

Ruane: I think that I'll stick with what I said. We've already shown that we will hold a stock longer if we have a feeling that the five-year outlook is superior and we have confidence in it. You know, historically, back in the '70s and the '80s — and we didn't know it at the time — but some of these great companies were just absolutely *unbelievable* bargains. I think Gillette sold, in about 1979, at an average P/E of 6.9.

At that price, you really didn't have to concern

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BILL RUANE, BOB GOLDFARB, ET AL.
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yourself with the rate of growth or the return on equity. You still had to concern yourself with whether or not the company's earnings were in fact real cash earnings. But just taking a simplistic inverse of 7 times earnings, if all the company did was not grow and it paid out everything that it earned, you'd still get a 14% return on your money. You didn't have to think about Warren's basic formula of companies — of figuring out what they're worth by assuming that the average company in the universe tended then to pay out half of what they earned and reinvest it at a certain rate of return which at that time was running at about 12-1/2%.

Little judgement was required. So we often sold too early.

Ruane: If a company retains most of its earnings and is able to reinvest those earnings at a return of, say, 25%, you have one hell of a cash generating operation. And it *deserves* to sell at a *huge* P/E.

Now the certainty of the reinvestment rate is always the real question. But I think that using the arithmetic of compounding on reinvested earnings is something that we've paid a lot more attention to in the past 4 or 5 years because it's for real. The difficulty is, are those earnings going to grow at 15% or is the company really earning a 20% return on reinvested capital? Those are the judgements we have to make.

The really good companies back in the '70s and '80s were worth an awful lot more than we realized at the time. In those days, we didn't realize we were buying bargains at 8 times earnings and selling bargains at 15 times earnings that had gone up. In other words, we didn't realize that when we were selling them, they were *still* bargains.

For example, we did that with Gillette. We bought it and owned it for a few years. And when we sold it, we had a very good return because the P/E was up and its earnings were growing. But we never should have sold it.

Today, *lots* of judgement is required....

Ruane: Having said that, we're in an atmosphere today where we're talking about stocks selling at P/E's that are probably 40% higher than they were a year or two ago. And we do wonder about the certainty factor. For example, Johnson & Johnson is a wonderful company. And we made four times our money on it. At the time we bought it, we paid about 12 times earnings and the company had a pharmaceutical lineup of something like 20 drugs that were unique, albeit not blockbusters. And you didn't have to understand a whole lot about chemistry to figure out that this was a very attractive situation.

Four years later, it's a very different story. Today, it's very important to understand or have some strong feeling about what J&J's future pharmaceutical pipeline might produce and what its present group of blockbuster drugs might produce. Our vision got blurry on that. And that vision became particularly of concern with J&J selling up around 30 times earnings.

So some of the stocks we've sold have been based on considerations and concerns about their valuations — valuations which were considerably higher than when I made that original comment.

Now we look ahead five years. I don't think we used to....

Ruane: However, we're retaining Fifth Third at some 28 times earnings. We're retaining Progressive at, I think, a P/E that's higher than most people think it might be. And certainly Berkshire Hathaway is in a class by itself in terms of its P/E and what it means. And Harley Davidson — there's a wonderful company. It just reported great earnings for the quarter. However, its P/E is way up there.

We try to think about what a company's going to look like five years from now. I don't think we used that kind of thinking very rigorously back when there were bargains that we didn't recognize as bargains back in the '80s.

The difference between small companies and large ones....

Shareholder: You mentioned the values available in small cap companies which may not be available to Sequoia. Could you give us some guidelines as to what we should look for if we want to look in that area and avoid value traps?

Goldfarb: I think you look for the same things in *small* companies that you look for in *large* ones. The only difference is the number of zeros.

Shareholder: Could you be a little more specific?

Goldfarb: Since the value of a stock is the present value of the discounted future stream of net cash flows, there is no differentiation between large caps, mid caps, and small caps. It applies across the board. So, your job is to try to project that stream, compare it with what the stock is selling for and render your judgement.

Ruane: We're generally considered value investors, not growth investors. But I think there isn't any contrast between those two. Growth is just one of the components of value. And going back to the question about how long we hold stocks, a major component of our judgement on that is what we think the growth is going to be.

It seems as if every day you read articles in the newspapers about whether or not you're a growth investor or a value investor. Well, I think we're value investors. However, we pay a lot of attention to growth. I think growth is one component of buying value, which is itself what it's really all about.

Goldfarb: However, if you find something out there that's a no grower, but that's a consistent earner selling at 5 times earnings, go for it.

AUTO INSURANCE BUSINESS WILL GET TOUGHER,
BUT GEICO & PROGRESSIVE WILL GET MUCH BIGGER.

GEICO has competition — e.g., Progressive & maybe GE....

Shareholder: I was looking at the growth in voluntary policies at GEICO versus Progressive. It seems that most of the property/casualty companies are having a bit of a tough time now, except for GEICO. GEICO seems to be blowing everybody's doors off. Do you consider that to be an accurate statement?

Goldfarb: I don't believe it is because I think Progressive last year — for 1998 as a whole — grew its premiums 15%. In their annual report, they mentioned

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that their prices were down 5.3% — so that suggests something close to 20% unit growth in policies for Progressive — which is a remarkable number. There was some slowdown during the year, and we'll see if that continues. I may defer to Alice here. However, clearly the competition is becoming very intense in auto insurance.

Also, there are a number of companies out there that you should pay heed to. General Electric is one which is new to the business. So far there just haven't been many sightings of GE in this business. And we don't yet know how good they are at executing. Alice may have a better opinion on that.

Looking out, GEICO & Progressive will both be far larger.

Schroeder: The marginal growth trends are somewhat different. I think Progressive's in force growth rate is running a little under 20% now. It will probably be up in the first quarter relative to the fourth quarter. GEICO's growth is actually still accelerating and should be running closer to 25% now, which I just attribute to the difference in their strategies. GEICO is more indifferent to short-term results in terms of return on capital than Progressive is. And it's more willing to invest in future growth by completely taking acquisition costs out of their formula for incentive compensation, whereas Progressive managers have to earn back the acquisition costs over the expected life of the customer. But both companies are growing at multiples of the industry, which is probably growing about 2%.

Goldfarb: Thank you. I think when you look at the automobile insurance industry in five or 10 years, relative to where their place is today, GEICO and Progressive will both be significantly larger.

Auto insurance retention is likely to decline generally.

Shareholder: GEICO's net policy growth is evident. But, actually, their policy lapses are going up noticeably.... Why is that?

Goldfarb: I'd say that as GEICO's business mix includes an increasing percentage of standard and non-standard policies, the retention rates are going to decline significantly. So that would be an explanation.

There clearly are changes going on in the way insurance is purchased. Direct marketers, including both GEICO and Progressive, are out there spending a lot of money, along with AIG and others. And at some point, you're going to be able to shop for auto insurance on the Internet and compare prices very readily. You can already call 1-800-AUTOPRO and get three quotes and more if you want. So, I think industry retention will decline through all classes of auto insurance because of these structural or secular changes.

However, I think, with regard to GEICO, it's clear that ultra preferred has a much longer retention than non-standard.

But higher lapses are a given with unseasoned business.

Schroeder: Also, a greater proportion of new business, due to the high growth rate this year, will cause retentions to decline because new business has lower persistency than seasoned business.

Goldfarb: Yes, it's interesting because you could see the difference last year. Progressive's growth was very bifurcated. It consisted of quarters where their non-standard business — which is their historical base and was about the only business they were in when we first bought the stock — had mid-teens declines offset by 40% increases in standard and preferred. I think that says something about retention rates in different classes of insurance.

Shareholder: I had a question about Progressive and GEICO. In GEICO's case, their combined ratio is going up — and in Progressive's case, hasn't it stopped declining? With an industry flooded with capital and everyone struggling to achieve growth, is it becoming more and more difficult to find that new policy? And given the heated competition out there, are they losing their advantages in marketing, underwriting and pricing risk, and settling claims in a superior fashion, thereby making their combined ratios go up?

Goldfarb: They still have an advantage. But if they have a 6 point advantage — and I'm just picking an arbitrary number — when the industry writes at 99, that produces one very different set of economics than a 6 point edge when the industry is at 105.

Similar advantages & complementary skills, but culture...?

Shareholder: I've tracked GEICO and Progressive. It appears to me that it would be a salutary thing to have GEICO acquire Progressive. Has this esteemed group given much thought to that possibility?

Goldfarb: My own feeling is that they have complementary skills so that together they would even be stronger than they are individually. But I think the cultures of the two companies are so dissimilar because of their origins and the personalities that have evolved that I wouldn't count on it.

IT'S TRUE — A BANKING REVOLUTION IS UNDERWAY. HOWEVER, OUR MANAGEMENTS WILL COPE JUST FINE.

Managements are smarter. But don't ask how much....

Shareholder: Could you comment on the changing economics in the banking business? And in this environment, would you add to your banking portfolio?

Goldfarb: Jon, our resident bank expert, will address that.

Brandt: The former chairman of Fifth Third once said, when asked about the banking business, that it hadn't changed since the Maccabees were lending money in Biblical times. I don't know exactly what year that was, but his point was that banking is basically borrowing money from savers at 3 or 4 points below the rate that you charge the people you're lending money to and then trying to keep credit losses very low.

And for a long time, banking has operated in cycles. There are periods where lots of losses are taken. And usually in the early years when the economy recovers after those losses, bankers are very reluctant to extend credit.

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As the expansion ages, they get a little looser in their credit scoring of the customers.

I think that the current crop of banking managements in this country has probably a more sophisticated understanding of credit risk. But I wouldn't want to overstate the change. I think that as the expansion continues, it's going to create carelessness — and we'll only find out who's too careless when the economy hits a rough patch.

I think it's noteworthy that today some banks are taking some hits, for instance, on loans to subprime lenders. Also, banks are making subprime loans themselves or they might loan 125% of a home's value and call it a home equity loan. Now they'll tell you that they're pricing it as if it were an unsecured loan. However, we'll see how that turns out during the next downturn.

Has technology made banking more profitable? We'll see.

Brandt: Of course, there have been enormous changes in the distribution of banking products due to the introduction of new technologies like the ATM and the Internet, the application of older ones like the telephone, and the usage of new venues like supermarkets. And while transactions used to take place almost exclusively in traditional branches, today a large and growing percentage are made through these newer channels. Each of these new modes of distribution have much lower cost per transaction than the old way of doing business with tellers in bricks and mortar branches. So there has been a lot of change there.

But some skeptics wonder whether the incremental costs of supporting these theoretically less expensive distribution channels has more than offset the savings from closed branches and reduced teller employment and they point to the still stubbornly high efficiency ratios for the industry as a whole. At the same time, the banking industry has generally been reporting higher returns on equity than it used to. So it's possible that the industry's bottom line has to this point benefited from the changes in the distribution model.

Biggest changes are yet to come. But we're not worried.

Brandt: Perhaps more importantly, there is a lot of provocative talk about how the Internet — which has by far the lowest per transaction cost — will revolutionize the industry by an even greater degree than the prior distribution advances, and how it will ultimately commoditize the economics of banking. So while my instinct is that the basic economics of banking have not changed, we are of course closely monitoring that development.

Fortunately, we believe that the managements of our banks are ahead of the curve technologically. So we feel reasonably comfortable that they could adapt and maintain their earning power even were the Internet to play an even more significant role in the delivery of banking products in the future.

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WE THINK MORE OF A GOOD THING IS WONDERFUL. UNFORTUNATELY, THE REGULATORS DON'T AGREE.

More of a good thing is wonderful — when we're allowed....

Brandt: The second part of your question was whether we would add to our bank holdings. We think very highly of the banks that are still in our portfolio. And if we felt that the price was right, it's possible that we might add to our holdings of some of them.

I know Sequoia is under some restrictions on concentration which at the present time would preclude us from making further purchases of Fifth Third. However, more generally, we always want to buy more of the companies that we like. Given a choice between buying more of something that we really know well and a new investment that seems just as attractive, our tendency would be to put more money into the thing we know well and are comfortable with. I hope that answers your question.

The construction loan business ain't what it used to be.

Goldfarb: The only thing I would add is that whenever you see a lot of new construction, there are a lot of new construction loans. And, unfortunately, they're back today at much lower prices. Wells Fargo, which we did own, of course, had a history of successfully pricing construction loans so that over the course of the cycle they made good money. However, the rates that we're seeing on construction loans today from banks are a fraction of what Wells used to get.

The IRS rule on portfolio concentration....

Shareholder: Are you at liberty to disclose the details of that restriction on Sequoia's portfolio concentration that Jon alluded to?

Carley Cunniff: It's not a secret. It's an Internal Revenue Service restriction on regulated investment companies. So we just simply have to follow it. The actual IRS rule would give you a headache. However, in essence, it says that if your "5% or greater" portfolio positions exceed 50% of the market value of your total portfolio assets, you can't add to your current "5% or greater" positions, nor can you add another "5% or greater" position. Because of our current portfolio concentrations, this rule would preclude us from adding further to our present large positions.

Those who need it most tend to have it least & vice versa....

Shareholder: I would think in general right now that people would regard the banking industry as being fairly fully capitalized. My question is, given the position of the

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banking industry at this point in the cycle where you're worried about construction loans, is it appropriate for management to use that excess capital to buy in their stock at current market values?

Brandt: I guess it depends on the bank. What I can tell you is that Fifth Third has a hard and fast rule of keeping a 10% capital-to-assets ratio. We view that as conservative. I suspect if we were running Fifth Third, we might even be a little less conservative because Fifth Third has experienced a very low loss rate even in a recession. It's kind of ironic that the bank with the lowest credit costs has the most capital, and that many banks with *riskier* loan portfolios have lower equity to assets ratios.

I would say that banks which are vulnerable to sharply increased losses — either from a recession or because they have loan concentrations of industry exposure — are probably the ones which should have the higher capital levels. Ironically, assuming you're adequately capitalized and you have excess capital, all companies including banks should buy back their stock when it's trading for less than its intrinsic value and, probably, shouldn't buy it back when it sells for more than its intrinsic value — unless there is an alternative use that is even more destructive to shareholder value, as is often the case when companies have excess capital. Money burns a hole in their pockets and they want to do something with it — and they do something stupid.

Ruane: I don't think of the banking industry as being well capitalized. I think of Fifth Third as being well capitalized. Would you guess that there is 6% hard capital behind the assets of the banking industry?

Brandt: Yes, I would say 6% or 7%. You don't see a whole lot of 10% among the large cap stocks. Some companies have a lot of goodwill. And while we would add back goodwill amortization to earnings, it does detract from the tangible equity to assets ratio. And I know for certain regulatory ratios that goodwill does not count as capital.

WE THINK MORE OF A GOOD THING IS WONDERFUL.
UNFORTUNATELY, THE REGULATORS DON'T AGREE.

Banks are acquiring broker/dealers to be one-stop shops.

Shareholder: Could you comment on banks getting into the brokerage business?

Brandt: I think many banks have bought broker/dealers because they feel that they need to offer a wider range of products to their corporate clients. Specifically, they feel that they need the ability to do stock and bond offerings. In our portfolio, for instance, US Bancorp bought Piper Jaffrey, while Fifth Third bought The Ohio Company. It's basically a strategic move to keep their clients from being picked off by the larger broker/dealers who are able to offer a wider range of products. So you see a lot of banks filling out their product menu.

For instance, US Bancorp also bought a mezzanine finance company which is like a high yield desk or offering capability. It's mostly strategic. It's just spreading through the industry. And again, I think that's because banks want a one-stop-shop capability.

Unfortunately, the cultures & incentives are very different.

Ruane: But I think that there is an enormous culture clash that occurs when a regular type bank takes over a regular type investment house because of the different incentives involved.

Goldfarb: For example, NationsBank bought Montgomery Securities — and half of its people have moved across the street already.

Ruane: Yes, they really have such different compensation arrangements — and that just creates a *huge* problem.

Goldfarb: Another interesting example is when Travelers bought Salomon and paid a pretty good multiple of book. It wasn't very long thereafter that they shut down the major earnings contributor to Salomon — and the most profitable part of the business — at less than book, making the residual price that they paid for the rest of it extraordinarily high.

Ruane: You would have trouble finding the Salomon we used to own.

Goldfarb: Or the people that worked there.

Buying Beneficial made strategic sense. But price-wise....

Shareholder: You've owned some Household International in the Fund for a while. Going back to your comments on the Wells and Norwest merger, I was wondering if Household's recent merger with Beneficial strikes you as a sensible one?

Paul Scarpetta: I think strategically that Household's acquisition of Beneficial probably makes good sense from the standpoint that Household had been looking to move from a mix of lending that was more unsecured to one that is more secured. In fact, Beneficial brings them that. Also, there is a reasonably good overlap in terms of the location of the branches. If you look overseas for example, the two companies' UK operations are literally right down the street from each other. So it struck us as a reasonably good strategic mix.

Unfortunately, we also believe that Household paid a very full price. There was a bidding war for Beneficial. And it appears that Household just wanted it more than anyone else.

But Household is particularly good at cutting costs and Beneficial is particularly ripe for cutting costs. So from that standpoint, I think there is a good opportunity for them to build some value here. Again, unfortunately, it looks like most of that value was given right back to Beneficial shareholders in the purchase price. So this looks like a deal that makes sense from a business standpoint, but is probably, at best, marginally accretive in terms of intrinsic value.

THE GOOD, THE BAD & THE YET TO BE DETERMINED:
FREDDIE MAC, WALLACE COMPUTER & STURM RUGER.

Freddie's moved outside its normal area, but only slightly.

Shareholder: I just had a quick look at Freddie Mac's

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annual report yesterday and it looked like they want to expand to underwrite mortgages with a little bit lower quality. Is my impression correct? And, if so, is that a matter of concern?

Scarpetta: It is the case that Freddie Mac is moving a little bit out on the risk spectrum. The real question is, how far are they willing to go? Most of the growth in the mortgage industry in recent years has come in the so-called sub-prime sector, which we would define as homeowners who have a blemish of some sort on their credit history or a non-traditional employment background.

What Freddie Mac has done thus far is to move just slightly outside its traditional bounds into what's called the A-minus, or Alternative A. Alternative A is, for example, a "cash out" refinance where you're allowing a slightly higher amount of cash to come out. There may be nothing wrong with the borrower's history. So that's one example where Freddie is really relying on their improved underwriting ability to make the decision.

They have also been looking at A-minus, which is borrowers who do in fact have some minor blemish — perhaps one or two delinquencies — on some of their debt within the last year or two. They are basing that decision on underwriting models they've developed that have indicated that one or two delinquencies are not particularly troublesome in terms of predicting the ultimate probability of default.

Are we concerned? I think we certainly are being vigilant that they don't plan to go any further than that. But it remains to be seen. It's always troublesome when a business decision is based on a model because models, by definition, are backward looking and things change over time.

Bill picked up the clue at Wallace. But you could have, too.

Shareholder: I've been reading the annual report and I think in the first quarter of last year you sold almost your entire position in Wallace Computer. Two months later the company announced a bad quarter and the stock price was down significantly. I'm curious, when did you sell Wallace? And number two, what are the kind of things you do to determine if something is going to go south?

Goldfarb: That's an excellent question. The reason I did not mention Wallace specifically in my prepared remarks was that I included it among those equities that were purchased, I think, beginning in '97, but that had no material impact on Sequoia's '98 results.

The credit for selling Wallace belongs to Bill Ruane who is just an extraordinary security analyst. He's been an extraordinary analyst for 50 years and he continues to love to ponder the details and look at the footnotes. And if you were to study the footnotes on Wallace's acquisition of the commercial printing company, I think you probably would reach the same conclusion that we did.

Wallace is an interesting example because we took the bait. The bait was that the future of business forms, despite their decline in usage because of changes in technology, would be more than offset by the success of Wallace's program whereby they take over business forms management for companies. It was interesting — as soon as they made the large print company acquisition, management changed its tune and said forms are in decline, but commercial print management is the wave of the future. I think whenever you hear a management change its tune like that, you should take notice.

Uncertainty is great at Sturm Ruger. But so is the value....

Shareholder: One of your smaller portfolio holdings, Sturm Ruger, is a gun manufacturer — and there have been some recent articles that would suggest that they may have a problem similar to tobacco. I was wondering if you could comment on this?

Carley Cunniff: Rick Cunniff was planning to comment on that today. He's on the board of Sturm Ruger and is familiar with the legal issues. I think basically once legal issues enter the economic arena in this kind of situation, it gets extremely murky and difficult to make a rational judgement as to what will happen. I know the companies believe that there is no merit to the suits. However, the resolution will take years and is uncertain.

The stock, unfortunately, is very cheap if you're willing to bear that kind of uncertainty. For example, I think it has almost an 8% dividend yield. And Mr. Ruger is probably really annoyed about that.

WHATEVER OPTION A COMPANY MAY CHOOSE, RATIONALITY AND TRANSPARENCY SHOULD PREVAIL.

Dilution from options for top 20 S&P co's isn't much less.

Shareholder: Your calculation that earnings per share of the top 10 S&P companies would have dropped 65% if option expense was fully reflected is really shocking, and I'm sure people would like to know more about it in the future. I believe that those 10 included Intel, Microsoft, Home Depot and Merck. I don't know what the other six were, but certainly the four I just mentioned have had huge price increases. Do you have any idea what the percentage decline in earnings would be for the top 50 to 99 S&P companies, some of which may have been losers?

Goldfarb: That's a very valid question. And if we'd had the time, we would have done the exercise. We did do a similar analysis for the top 20 companies in the S&P. The resulting earnings dilution was lower, but not significantly lower. Given the two-tier market that we were talking about before, I would agree that the dilution for the S&P 500 as a whole would be lower. But 65% is an awfully high number. So there's a lot of room for it to be lower and yet remain extraordinarily dilutive.

If accounting treated it like real money, mgm't might, too.

Shareholder: Regarding the issuance of options, what system would you replace it with?

Goldfarb: I think the compensation committee of the board should have an opinion as to the intrinsic value of the corporation just as they would when considering a sale of the corporation. I think any option grant should be made on the basis of how much cash equivalent compensation this individual should be awarded in the

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form of options. That amount would be determined by the intrinsic value of each option at the date of the grant times the number of options necessary to get to that amount.

Alexander: One thing that I think the board should think about is what they would give in options if the options were expensed through the income statement as something extremely valuable. I think we all suspect that if companies really did have to expense options on the income statement, that it would represent a good first step in causing them to actually think about the designs of the option grants more than they do today.

I think Warren Buffett likes to look at the companies' earnings power. Therefore, he asks himself: "What in fact are we trying to compensate people for? What does it take to keep our employees happy and working hard?" Some companies have deferred compensation plans which are invested in their own stock whereby they can defer part of their pay, in effect, on a pre-tax basis. The corporation takes that money, buys stock in the open market and puts it into their deferred compensation plan. It doesn't get a tax deduction initially because the pay has been deferred and therefore the employee is not paying taxes on it. Then when the stock is issued to the employee 5 or 10 years later, the corporation gets a deduction based on what the value of the stock is at that time. But I don't know if that is universally true of all deferred compensation plans....

Bear Stearns' well-designed plan results in net *buybacks*....

Alexander: It's certainly true of Bear Stearns' plan. Bear Stearns designed its plan to operate as though it were still a private partnership with employees owning a large portion of the company that they actually buy with their own money — and it's been tremendously successful in keeping the employees motivated.

And because of the way the plan is structured — with the company buying in shares on the open market on behalf of the deferred comp plan — the number of shares of the corporation does not creep up insidiously as it does at many option-issuing companies. In fact, because of share repurchases in excess of the shares allocated to the deferred compensation plan, the number of shares actually goes *down* in many years. So we're very impressed with deferred compensation plans of this sort. And I frankly don't understand why more companies don't have them.

Unlike most firms, Bear's compensation is not disguised.

Goldfarb: I think when analysts or investors look at the compensation tables at Bear Stearns, they may think that Ace Greenberg, etc. are grossly overpaid because of the transparent nature of their compensation plan. But another deficiency of options issuance is that the true cost of executive compensation is disguised. What some people miss is that executives of Merrill Lynch, Morgan Stanley or comparable companies may be paid even more than those at Bear Stearns, whereas it's perceived that they earn less because of the disguised value of the options they receive.

You can't disguise the value of cash compensation. It is what it is. By contrast, you can enormously disguise the value of compensation through the form of options by playing with a multitude of assumptions — about things such as volatility and expected duration which usually serve to minimize the apparent cost.

Another alternative — restricted stock grants....

Brandt: We acknowledge that there are certain positive attributes that options possess which other types of incentive compensation do not. For instance, one competing type of incentive compensation is "restricted" stock grants, where the company essentially awards common shares to an employee with vesting dependent on the employee continuing to work for the firm for some period of years.

The disadvantage of just awarding stock is that if the company's share price doesn't appreciate over 10 years, the employee is still going to get the value of the shares on the date of grant, whereas an option granted on the same date would expire worthless. However, at least the restricted stock grant is eventually expensed on the income statement, so it would cause a company to perhaps be a bit more careful in terms of the volume of issuance.

Nothing like buying stock to fully align interests....

Brandt: Then there's the example of Markel, an insurance company in Virginia with company-sponsored financing programs whereby employees can purchase outright shares of Markel. And to encourage participation, Markel offers an attractive interest rate and a certain number of bonus shares for long-term holders. Markel believes that if the company employee takes out a loan to buy stock it fosters an attitude of ownership very different from the attitude of those who receive options without having to pay for them.

An added benefit of the Markel plan is that options are taxed as ordinary income to the receiver of the options, whereas someone who buys stock with their own money, with a company loan, will see the appreciation compound at the much lower individual capital gains tax rate.

Are we missing other programs? I think it's important to go through some of the various possibilities so that companies think about the available choices.

IF SHAREHOLDERS DON'T GUARD THE TREASURY, MANAGEMENTS WILL GET RICH AT THEIR EXPENSE.

Fixed-price options reward mediocre performance.

Brandt: The final thing I would say is if you *are* going to do options, the cost of capital should be embedded within the option. For example, if it's going to be a 10-year fixed-price option, the strike price should rise each year. If you had an option on a savings account that earned a 5% interest rate over 10 years, the account's value would grow by some 60% without any extra effort. One of the problems with today's fixed-priced options is that they reward mediocre performance. Options should reflect the time value of money — and they don't. So if you're going to use options (and in some cases you should) it would be preferable to build in a cost of capital.

Alexander: We would ask that directors on the compensation committee think about how they would value the option, rather than view it as free money — in other words, as if they were actually writing the option

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themselves. For example, if I came to you and said, "I'd like to buy an option on 1,000 shares of your corporation's stock for the next 10 years out of your own pocket", what would you charge for that?

If you couldn't hedge, you might charge several times the stock price! These options have tremendous value in many cases. And we only wish that we could buy some of these options at the valuations the footnotes detail.

Brandt: We happen to have a couple of quasi experts on option policy in the audience. So maybe they can also give us some of their thoughts. Bob Grusky, who works in the same building as we do, I think I see you over there. You recently helped design a new plan at one of the companies where you serve on the board. Would you mind sharing with us what you've come up with?

Ultimately, it's the shareholders' responsibility....

Bob Grusky: I think you captured all of the major issues. But I guess I would turn the question around and ask whether, as shareholders, you are willing to vote *against* these plans. As Bob Goldfarb said in his opening remarks, shareholders have almost always voted *for* these large increases in option authorization, effectively endorsing poorly structured plans that usually result in large transfers of wealth. I think the first thing owners have to realize is that it is ultimately their responsibility to decide whether the size of an option program is appropriate given the total number of shares already outstanding and whether it's structured properly.

While there are many different types of appropriate performance-based option plans, owners have to start saying "no" to fixed-price 10-year options.

But the deck is stacked in favor of runaway compensation.

Grusky: Owners are going to have to realize that outside directors are basically going up against those who have a huge vested interest — management and employees — in generous awards of fixed-price, long-term options. It's really a very difficult situation for the directors to be in. What happens in many companies is that management retains "expert" consultants and they get all the compensation data for the industry's "comparables". Every board wants to say that they get the best people — and to show they're serious, they adopt a policy of being at or near the "top" in compensation, including option grants. CEO's and management are, by nature, competitive on compensation, Therefore, every other year, a consultant that management hires comes in and says, "Your plans are no longer competitive." Management tells the board, "We're losing people because our option plan isn't competitive." And it takes a rare manager to truly think like an owner even with respect to compensation and, for example, to put in performance-based option plans.

These more appropriate plans have been adopted in a couple of places (Level 3, Colgate, Monsanto) and this sort of says, "OK, we're willing to write big checks and give management a big pay day, but only if they truly outperform and shareholders benefit". But in my view, the overall situation will only truly change when shareholders vote "no" on poorly-designed option plans.

As long as shareholders *allow* free options, they'll be *issued*.

Ruane: We've voted against some of them in the past. And in certain cases we felt were just outrageous, we've made a fuss. I won't identify the company or the people involved. This company planned to issue 5% or 10% of the company in options to people who already owned a fair amount of it. And we're talking about pretty cheap stock. So Bob and I took the two top people out to lunch. The option was at the market price and the head of the company said, "Well, this is just at the market price. It's not worth anything right now."

So in a fit of pique, I said "Look, I'll pay you $2 million for it right now". But he wouldn't accept that. He really just said, "No — no way". In that particular case, we made it known to others that we were voting against it. However, it sailed through with a huge majority vote in favor.

Goldfarb: You make an outstanding point, Bob. It gets back to the grade inflation I was referring to earlier. If every teacher wants his or her students to be in the top 25% of the class, eventually everybody is going to wind up with A pluses. And if every company wants its managers to be in the top 25% in terms of compensation, it's just going to continue to escalate with no end.

It's horrible enough in its present state, but you make a very persuasive point. We may have seen nothing yet. Thank you for your comments.

MORE INSIDER OWNERSHIP HERE THAN YOU KNOW — AND LESS OWNERSHIP OF BERKSHIRE THAN WE'D LIKE.

We want to leave taxable gains with those who enjoyed 'em.

Shareholder: Would you please comment on Sequoia's redemption policy?

Carley Cunniff: The directors for years have discussed the embedded capital gains that are in the Fund, which are significant — approaching 70% of its net assets at present. Roughly half of the assets in Sequoia belong to shareholders who are taxable and the other half are pension funds and other non-taxable stockholders. Therefore, tax considerations are important to about half the shareholder base.

We did decide last year that it was appropriate and fair, regarding the taxable shareholders, that when we experienced a redemption of significant enough size — which we describe in the prospectus as about $5 million, although we have the right to do it for smaller size redemptions — that we will be highly likely to distribute securities rather than cash to that redeeming shareholder.

We did have several of these redemptions last year. Our practice has been that we distribute a strip of Sequoia Fund roughly proportionate to what the shareholder owns on a see-through basis... — so much cash, so much Berkshire, so much Fifth Third, etc.

We deliver the stock out into a brokerage account at the choice of the redeeming shareholder. And then they arrange to liquidate the stocks as they see fit. That way the capital gains are removed from the Fund in the course of the redemption. So the policy reflects an effort to try to keep the capital gains — to the extent that we're able to do

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so — with the shareholders who have enjoyed them, as opposed to leaving them in the Fund to be paid by the remaining shareholder base.

Reported or not, my interests are aligned with yours....

Shareholder: One of the things that you've said you look for in researching companies is a significant ownership stake by key executives. Given that, could you comment on the fact that as a group you don't own a whole lot of stock in Sequoia — with one exception.

Goldfarb: My personal interest in the Ruane, Cunniff profit sharing plan — almost 100% of which is invested in Sequoia — is not disclosed in the proxy. However, I think if it were, it would represent a number that would satisfy anyone in this room that I have a significant economic stake in the value of Sequoia.

Its clients own our shares, but Schwab doesn't sell 'em.

Shareholder: What went into the decision to include Sequoia in Charles Schwab's universe? And do you think by doing so you're going to attract shareholders with less of a long-term time horizon than you've had traditionally?

Carley Cunniff: Actually, we're not in Charles Schwab's universe. Some Sequoia stockholders have moved their assets over to Charles Schwab and, by their own preference, have chosen to have their Sequoia holdings consolidated into their Schwab statements. So, we do not "see" them as individual shareholders anymore. We see them through the Schwab name. But Schwab does not sell Sequoia Fund.

Our sales of Berkshire shares were essentially involuntary.

Shareholder: In last year's mid-year report, you gave some guidance on the capital gains distribution. Is it too early now to give any guidance on distributions this year?

Carley Cunniff: To date, we have generated about $40 million of long-term capital gains. And we have about 31 million shares outstanding.

Shareholder: Most of the stock positions that you have in your portfolio you've reduced during the last year. One in particular that I'm interested in is Berkshire Hathaway. While you didn't reduce it a lot, you did sell some of the shares that you held. Was the reason why you did that based on its valuation or was it just to balance the rest of the portfolio?

Goldfarb: The redemptions in kind would explain any reduction in Berkshire. And it would explain declines not just for Berkshire, but for all the holdings.

Ruane: Yes. Those were essentially involuntary sales made by other people.

Which edition of Security Analysis is best? Not the fifth....

Shareholder: Bill Ruane once made a comment that the Old Testament of Sequoia is the book *Security Analysis* by Graham and Dodd. Well, that book took me many nights, but I finally finished it. Could any one of you share with me which edition is better?

Ruane: I still regard the first one as a great edition. I've got to tell you a story which I think is unique. We have another author in the room here, Andy Kilpatrick. He along with Roger Lowenstein and Bob Hagstrom have done great work writing about Buffett. And some of the anecdotes are great. This particular one I happened to sit in on:

Warren was asked to testify by Cravath, Swaine, & Moore who was defending IBM in the government's anti-trust suit. He was on the stand for two days before a very tough judge who clearly felt no warmth for IBM and was pretty outspoken about it. And this one prosecutor said, "Mr. Buffett, you believe that everything Ben Graham said is accurate, don't you?" Warren said, "Absolutely." And the lawyer said, "Well, let me read you this definition of depreciation..." And he read this definition of depreciation, which was pertinent to the business issue that was being raised at the time, from Graham and Dodd.

The lawyer then looked at Warren and said, "Do you agree with that definition?" And Warren said, "No". "Well, it's straight from Graham and Dodd." And Warren said, "What edition was that?" The prosecutor paused and said, "May I have an adjournment for a few minutes?"

And the lawyers came back the next day and they still didn't have an answer. Finally, Warren said, "I think you'll find that it was from the fifth edition — and that particular chapter on depreciation wasn't written by Ben Graham. It was cited as having been written by an expert on utility companies. And that happens to be the definition of this other gentleman, not Ben Graham. And I *don't* agree with it."

And I can still remember that the judge, a hardhearted guy, just looked over the bench at Warren, "Hmmm". And then, "Mr. Buffett, thank you." I thought he was going to ask Warren for a tip on the stock market. And you know, sometime thereafter, IBM was exonerated. I'm not saying it was due to Warren. But it was a great courtroom scene — right out of Perry Mason....

If there are no more questions, let me thank you all for coming and showing such interest in Sequoia Fund.

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