

Outstanding Investor Digest

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

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OAKMARK FUNDS' BILL NYGREN
 "INVESTMENT STYLE PROBABLY WON'T MATTER.
 BUT THERE'S NO NEED TO PUT ON A STRAITJACKET."

With Oakmark Select Fund having just recently celebrated its five-year anniversary, one might reasonably wonder how *OID*, with the long-term focus that we claim, could be so comfortable including its manager, Bill Nygren, among those we follow.

Well, that's easy. The only tough part is where to start. Nygren has indeed knocked the cover off the ball so far — having earned a compound return of 27.9% per year for the
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WEITZ FUNDS'
 WALLY WEITZ & RICK LAWSON
 "IF YOU EXPECT THE WORST AND INVEST THAT WAY,
 YOU PROBABLY WON'T BE DISAPPOINTED."

After founding Weitz Partners Value Fund on June 1st, 1983, portfolio manager Wally Weitz got off to a slow start — underperforming the S&P 500 for six years in a row during one stretch (from 1986 through 1991). But since then, his performance keeps getting better and better. For example, its compound annual returns over 5, 10 and 15 years (through 11/30/01) have been 20.7%, 19.2% and 15.9%, respectively, versus 10.1%, 14.1% and 13.5% for the S&P 500. And he's done it while maintaining large cash balances and
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BERKSHIRE HATHAWAY'S
 WARREN BUFFETT & CHARLIE MUNGER
 "IT'S STUPID THE WAY PEOPLE EXTRAPOLATE THE PAST
 — AND NOT SLIGHTLY STUPID, BUT MASSIVELY STUPID."

Anyone with the good sense and vision to invest \$10,000 in Buffett Partnership, Ltd. at its inception in 1956 and reinvest the proceeds in Berkshire Hathaway at the partnership's termination in 1969 would today own shares worth over \$280 million — *after all taxes, fees and expenses* (the reason why one of our favorite contributors calls Berkshire "the gift that keeps hurting").
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GABELLI FUNDS'
 MARIO GABELLI & TIM O'BRIEN
 "EVERYTHING'S GONE WRONG IN MEDIA LATELY.
 BUT THAT'S BEEN THE BEST TIME TO BUY."

For the 23 years ended 12/31/00, value equity accounts managed by Mario Gabelli's GAMCO Investors have earned a compound annual return before all fees and expenses of 20.7% versus 16.1% for the *Ibbotson* S&P 500. His firm has outperformed its benchmark in the small-cap area, too. Its small-cap equity accounts have earned a compound annual return before fees and expenses of 15.2% versus 13.0% for
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OAKMARK FUNDS'
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(cont'd from page 1)

five years ended November 30th, 2001 versus 10.1% for the S&P 500 and 10.5% for the Russell Midcap Value Index. But that would only begin to scratch the surface. Nygren has run circles around whatever index you might want to choose for all trailing periods of three months or more.

He does just fine in comparison with his peers, as well (although one might argue that he's *had* no peers during that period). Oakmark Select ranks in the top 3% of funds for its 1-year and 3-year performance and in the top 1% for its 5-year performance. (Figures provided by *Morningstar*.)

In our experience, his investment performance has only been matched by his keen insights — some of which we're very pleased to share with you in the following pages. The following excerpts were selected from Oakmark Fund and Oakmark Select Fund conference calls dated May 3rd, August 6th and November 7th. We believe you'll find them to be extremely rewarding reading.

IT'S NOT US THAT'S CHANGING
— IT'S THE OPPORTUNITIES....

We feel very good about 2001.

Bill Nygren: Year-to-date through November 6th, the S&P 500 was down over 14%, Oakmark Select was up 20.7% and the Oakmark Fund was up 11.3%. I just recently finished Michael Steinhardt's autobiography. Michael is obviously one of the longest-term legendary hedge fund managers. His book, *No Bull*, is a great, great read. And I'd like to repeat a quote he had in this book: "Nothing gives a better feeling to a money manager than making money for his or her investors when almost everyone else is losing."

That pretty much sums up our thoughts on a very good fiscal 2001....

The anomaly in big companies has largely corrected.

Shareholder: Do you see opportunities in midcap-size companies or larger size companies on the value side?

Nygren: Two years ago, I would have said that the magnitude of opportunities that we saw almost inversely correlated with market cap — the smaller the company, the greater the expected return in our models. That's one reason why in the Oakmark Fund, you saw it move — using *Morningstar* style boxes — from a large value fund to a midcap value fund. We continued to buy the same big businesses, but their prices had become so inexpensive, they were falling out of *large-cap* territory into *midcaps*. And as such, we thought, they were much more attractive than what *Morningstar* was defining as large caps.

Today, that situation has largely corrected to where we don't see that much difference in expected returns in the true large caps versus the true midcaps. Basically, most big businesses now are large caps and most mid-sized businesses are midcaps. And you don't have the perverse results that we had a couple of years ago where

you had small companies with large capitalizations — and large cap then wasn't implying the same risk reduction that we got used to large cap meaning.

And we're finding more bargains among the large caps.

Nygren: The Oakmark Fund has always focused on larger companies. But in buying larger companies, we've focused not so much on the market capitalization as we have on the business characteristics — on companies that are big relative to sales, net income, shareholders' equity: fundamental characteristics....

By continuing to do the same thing we've always done — looking for big businesses that are selling cheaply — we're finding that those ideas are no longer just in the midcap area. We're also finding large-cap companies that are priced on terms that meet our criteria. So if you look at the new holdings that we've had the last few quarters, many more of them have been true large-cap names, even though almost all of them have always been large businesses.

Names like Guidant, Hughes Electronics, Kraft Foods, Waste Management, U.S. Bancorp — the five new names that we added in the second quarter — all of those are by *Morningstar* standards not just big businesses but true large-cap ideas. So the average market cap in the Fund is moving up as the midcap sector has been so strongly outperforming the large-cap sector over the last 15 months.

In the larger co./larger-cap universe, techs weren't cheap.

Shareholder: You still don't own a lot of tech stocks in Oakmark Select.... And I know you've stated in the past that you thought the Nasdaq was way overpriced and that it would take years to get to the old highs. But when the Nasdaq got down to the mid-teens, weren't you intrigued?

Nygren: Intrigued? Yes. And our research analysts spent a lot of time looking at technology stocks that were down 70-80%. But what we basically came up with around the end of March of 2000 when the Nasdaq was very near its bottom was that in larger company/large-cap names, we were finding very few that were below our estimates of their business value, a lot that were around our estimates of their value and still some that were significantly above.

But our criteria requires us to only buy names at less than 60% of business value. And we were finding far fewer technology companies that met that criteria than traditional companies....

Companies with above average growth appear underpriced.

Nygren: Our market view at this time continues as it has been for most of the year. We think the technology sector continues to be overpriced, but we find non-technology companies with above-average growth outlooks appearing significantly underpriced. From an academic perspective, the lower that interest rates go, the more of a premium P/E that these stocks deserve. Paying less than 20 times earnings for companies we expect will achieve double-digit annual EPS growth appears to be a bargain in an environment where long-term government bonds yield less than 5%.

Today's biggest market inefficiency...

Nygren: The biggest theme I see is that away from the technology industry, you can buy high quality companies whose earnings are growing more rapidly than those of the

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S&P at ... two-thirds the S&P multiple. That's the kind of area that I think is probably the most promising hunting ground today....

Examples of this would include companies like ... Kraft — a leading consumer packaged food company — and U.S. Bancorp, one of the more rapid-growth financial services companies. We feel that they have strong franchises, less than average risk and earnings growth potential superior to the S&P 500, yet sell for about two-thirds — some a bit less — of the S&P 500 multiple.

A very good time for a stock picker to add value.

Nygren: Some of our older holdings also fit that profile. One example is Kroger — which was the one name we added to the Select Fund in the second quarter. Kroger's the largest grocery chain in the U.S. It's grown EPS at more than a 15% annual rate for the last five years. And we believe it can continue to achieve its corporate goal of meeting or exceeding 15% annual growth.

Despite that track record and outlook, Kroger sells at less than 14 times expected year-ahead cash earnings — again, putting it at about two-thirds the S&P 500 multiple. Kroger in 1998 sold at a *premium* to the S&P multiple. We think that could happen again. And if we're right, Kroger will have substantial returns from this level.

It's not us that's changing, but the opportunities.

Nygren: If the market continues to present us with these opportunities, look for the Oakmark Fund to own more companies that look like growth stocks, but expect us to purchase them at prices that look like value stocks. Because of these opportunities, it continues to be a very good time for a stock picker to add value to portfolios....

In both funds, the percentage of the portfolio today that is invested in undervalued stocks that happen to be growth companies is growing. It's important to us that you understand it's not us that's changing, but rather the opportunities the market presents to us. Our criteria — purchasing stocks with growing values beneath 60% of their current value run by owner-oriented managements — will never change. The stocks that these criteria lead us to will *always* be changing....

WE HAVE NO EDGE ON NEAR-TERM FORECASTS,
BUT THAT'S OK. THEY AREN'T WHAT COUNTS.

We actually made money in our tech stocks.

Shareholder: What then was your rationale when you bought Teradyne?

(continued in next column)

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Nygren: We have had a number of technology investments in the two portfolios over the last year. In fact, we've actually *made* money in our technology positions over the last year because the prices we bought them at were depressed enough relative to business value that they've been immune from the decline that we've seen in the rest of the technology sector.

The market treated short-term problems like long-term ones.

Nygren: We've owned positions in Sungard Data, EDS, Teradyne and Sterling Commerce. And all of those were cases where the market got very disappointed with short-term results and priced the companies [as if] what we believed were short-term issues were secular problems....

Teradyne was a position that we established in the Oakmark Fund in the fourth quarter of 2000. They're the industry leader in semiconductor test equipment. I think its high was in the second quarter of last year — it peaked a little later than the rest of the tech market did. But its peak, anyway, was at about \$115 a share — and it hit a low in the fourth quarter of about \$23 a share. So it had fallen over 80% from its peak. We didn't hit the low, but we have bought stock both in the \$20s and the lower \$30s.

Our belief was that given the long-term positive outlook for both semiconductor demand and for Teradyne's market share, we felt investors were too focused on the cyclic decline that the semiconductor companies, as well as the test equipment companies, had gone through.

We didn't think 2001 was the right variable to focus on.

Nygren: This is one of those odd situations where the longer the time horizon you look at, the clearer the outlook gets. Teradyne isn't making much money this year. The estimates are for somewhere around break even. And it's hard to predict when the semiconductor cycle will turn. I can't tell you if that's going to happen next quarter or the first or second quarter next year.

So we knew that we couldn't forecast 2001 earnings for Teradyne ... any better than anybody else could. But we didn't think that was the right variable to focus on. The market though was very focused on the uncertainty in 2001. So we just disagreed.

The future is what counts. And it's actually quite clear.

Nygren: But I think it gets pretty easy when you think about the long-term time frame that we use to say that over the next five years, semiconductor demand is going to be much higher than it is today, that demand for test equipment will continue to be just as strong per unit of semiconductor demand as it is today, and that Teradyne is very likely to have a higher market share in semiconductor test equipment than it has today.

If you believe all of those things, then Teradyne's earnings five years from now ought to be higher than they were last year at the peak of the cycle — which was almost \$3 a share. So we see something on the order of 15-20% trend demand growth here in a business that's currently earning well below trend demand.

[Editor's note: Great minds think alike. Nygren seems to be echoing the comments of another of our favorite contributors — Third Avenue's Marty Whitman. (See our Year End 2000 Edition.)]

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Teradyne has given us lots of opportunities to buy and sell.

Nygren: I don't think the stock was ever worth the highs that it sold at. And in fact, as the stock has bounced around here — as all technology stocks have — it's hit prices where we've sold some and it's hit prices where we've added more. And it seems to have hit both extremes with some regularity over the last nine months. So it's a holding I like.

It's a name that for some reason the financial press has really seemed interested in us owning because it is one of the few tech stocks we own. But the interest the financial press has shown has been of a magnitude that is not representative of my thoughts on this idea. I think Teradyne's a good idea. But I don't think it's an outlier in terms of being an exceptional idea relative to the other names we hold in the Fund....

INVESTING IS ABOUT A LOT MORE THAN P/ES.
WE TRY TO THINK MORE LIKE AN ACQUIRER.

Chiron's cheaper than drug companies and growing faster.

Shareholder: When I first got into the Fund a few years ago, one of the things that attracted me was that you looked at other types of value stocks that traditional value people wouldn't look at — such as an Amgen....

Are you back looking at biotech companies like Amgen and Genentech — because they seem to be down significantly? Do they represent good value or are they still not low enough for you to consider getting back in?

Nygren: Well, ironically, I just went to New York for a biotech conference. And Amgen is a company I like a lot. However, the valuation still doesn't make sense to me. But we own Chiron in both portfolios.

The logic is similar to the reason we owned Amgen before. Relative to its pre-R&D-spending cash flow, it sells at a discount to traditional pharmaceutical companies despite the fact that it's growing much more rapidly.

But Chiron's still the exception today...

Shareholder: So you're saying that these companies still aren't low enough to get back into today?

Nygren: Well, Chiron's a biotech — and we have about 4% of the portfolio in that. But I have not found

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Have you gained an investment idea
from this edition of *OID*?

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the most recent stock purchases
of more than 75 top managers
in over 150 of their portfolios?

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large-cap and midcap companies in the biotech area that I'm comfortable are cheap enough yet.

To us, value investing is about a lot more than P/Es....

Nygren: You're right though that we're not among the class of value investors who look strictly at a multiple like a P/E ratio and demand a certain discount based on that number. We try to be more broad in our definition of value — and approach valuing a business as an acquirer would. For example, we've used non-traditional value logic in the past to buy names in the cable industry....

AT&T'S QUITE UNDERVALUED. NET OF CABLE,
TELEPHONY ALONE IS WORTH TWICE THE PRICE.

AT&T's quite undervalued according to bull and bear alike.

Shareholder: Can you talk a little bit about the ability of AT&T's management to realize value for the shareholders — or your perceptions of that?

Nygren: AT&T is a position that we took in both

PORTFOLIO REPORTS estimates the following were Oakmark Fund's largest equity purchases during the 3 months ended 9/30/01:

1. PHILLIPS PETROLEUM CO
2. FEDERAL NATL MTG ASSOC
3. INTERPUBLIC GROUP COS INC
4. HONEYWELL INTL
5. SAFEWAY INC
6. SUNGARD DATA SYS INC
7. AT&T CORP
8. GAP INC
9. ROCKWELL COLLINS INC
10. LIBERTY MEDIA GROUP CL A

portfolios in the second half of last year.... The reason we invested in it initially was we felt most of the investor focus on AT&T was on the disappointing results in their consumer long distance business, yet we felt a very large piece of the value was in AT&T Broadband and AT&T Wireless. In fact, we felt that the stock had fallen to a level that was beneath the value of their broadband and wireless businesses.

The company made an announcement that they were working on a plan to split the company into its pieces. And what intrigued us was that ... when you read the reports by the analysts as to what the pieces were worth, bears tended to come up with a number around \$30 and bulls tended to come up with a number in the \$40s. Either way, at \$20 — or even the low \$20s — we felt it was quite undervalued....

We've been sellers of Wireless based purely on valuation.

Nygren: Obviously, the Wireless spin-off was completed in July.... And I have not been able to come up with a valuation argument that suggests AT&T Wireless is worth a dramatically different number than it's selling at in the marketplace. So we have sold that stock. It's not that I'm negative on AT&T Wireless. I just didn't have an opinion that it was cheap, as I did with the rest of the pieces of AT&T.... We didn't feel it was as attractively

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priced as the other names we owned....

The implied price is too cheap. And it won't stay that way.

Nygren: We think the Comcast offer is a pretty reasonable offer. We think that at that kind of valuation, it's unlikely to be matched by the spin-off plan.... Assuming [the] transaction does happen there that monetizes the cable assets [at a] value roughly in line with the Comcast offer — which is about \$13 per share — the current AT&T price then equates to about \$7 a share for a telephony business that we feel has a value that's closer to *twice* that level.

I don't think this is entirely in the hands of AT&T management. I don't feel that AT&T's telephony business would stay in the public market priced very long at the level implied by the current stock price without another potential acquirer surfacing as it did with broadband because the AT&T brand and the assets there are just too strong to have them priced at such a small valuation.

And I have more confidence that the AT&T board with members like Amos Hostetter (who was the founder of Continental Cablevision) and Sandy Weill (from Citicorp) will respond in ways that make sense for outside shareholders. So we're quite comfortable that the right outcomes will be reached there and that the value will be maximized and get into the hands of the shareholders.

AT&T'S LONG DISTANCE BUSINESS IS DECLINING.
BUT ITS VALUE IS STILL IN THE MID-TEENS.

We're factoring in the decline in AT&T long distance.

Shareholder: Have you factored in the declining rates for long distance telephony in your valuation? The concern I have about AT&T ... is that we get calls every day [from people] who are selling lower and lower long distance rates. I'm just curious how that factors into your valuation.

Nygren: Sure. The way that factors into our valuation is that we assign a very low multiple of cash flow to our estimated value of AT&T's long distance businesses. I think almost anyone would predict that the long distance business at AT&T will continue to produce lower EBITDA next year than it did this year — and less the year after that. So it's not a question of *whether* or not it will decline, but rather a question of what the steepness of that slope will be. Over the last couple of years, the steepness of that decline has been very, very dramatic. And we think it will continue to decline, but at a slower rate than it has.

Even in decline, the long distance value is in the teens.

Nygren: The big value on the telephony side of AT&T is the cash flow that can be pulled out of the long distance business. It generates very large positive cash flow that doesn't need to be reinvested in the business. We think, based on fairly conservative assumptions, that on a discounted cash flow basis, you still get a value for their declining long distance business into the teens per share.

That's a lot, lot less than anyone would have guessed a couple of years ago when AT&T's stock reached its high of about \$60. But it's still a very powerful brand name

that has to have a value to someone.

The consumer business is the one so much attention is placed on. Yet that's a very small piece of the value. The business side is declining in terms of voice, but demand for data continues to grow very rapidly. Therefore, by our forecasts at least, the overall business will continue going down, but not by as fast as it has the last two years.

WHAT'S MY FAVORITE STOCK? THAT'S EASY.
WASHINGTON MUTUAL IS INCREDIBLY ATTRACTIVE.

My favorite stock? That's easy....

Shareholder: What's your favorite stock today?

Nygren: The largest holding in both funds is Washington Mutual. And it's the largest holding because it's a name not only that I find to be significantly undervalued, but also because I'm the most confident that the range of potential outcomes is not wide enough to bring that undervaluation [into question]....

Washington Mutual's an incredibly attractive stock.

Nygren: Here you have the lowest-cost S&L in the U.S. with the best geographic exposure and, I think, the best management in the industry — and one of the lower risk loan portfolios because their target market is the middle market. Yet it's available at 8 times earnings — which is ... less than half the average multiple of the S&P 500. And we believe it has a growth profile substantially better than the S&P 500. So I think it's an *incredibly* attractive stock.

Within the financials, the closest comp is Fifth Third.

Nygren: In the area of financial services, the company that looks most like Washington Mutual — both over the past decade as well as going forward — is a company like Fifth Third Bancorp which is one of the few financials that has achieved a premium to the S&P multiple.

I spent a lot of Oakmark Select's June 30th report outlining why we continue to like Washington Mutual. We think its growth rate of 15% or so annually is intact. Management continues to have most of their own net worth invested in the company. And we just don't find ... companies of this kind of quality at an 8 times multiple.

We think WM's advantages will serve it well in New York.

Shareholder: And you say that, even though they're going into the very, very competitive New York market with their acquisition of Dime Bank?

Nygren: The strongest thing that's emerged over the last couple of years for Washington Mutual is how the spread between their cost structure and the rest of the industry's has continued to grow. Washington Mutual has become a distant low-cost producer — as an S&L, as a deposit gatherer and, perhaps more importantly, on the mortgage banking side — both in mortgage origination and mortgage servicing. They seem to have really been able to cut costs in a way that their competition has not.

So in what is to a certain extent a commodity business, we think a company like Washington Mutual — that not only does an excellent job in customer service, but that has a lower cost structure than its competitors —

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ought to be very successful even in a highly competitive marketplace like New York. And the New York market's had a lot of turmoil as a result of bank mergers which may give Washington Mutual via its acquisition of the Dime an advantage in gaining new accounts there....

THE MARKET'S REACTION IS PUZZLING.
WE THINK THEY'RE MISSING IT BIG TIME.

Washington Mutual doesn't fit the profile of a laggard...

Shareholder: Any idea why Washington Mutual has tanked since late August — especially given an incredible period of time when refinancing is high and the fees that they make off of those new loans and the fees they make, off of servicing just kind of blows you away?

Nygren: Yeah, you wouldn't think a company that's announcing a 60% increase in profits year over year — from a record year — that sells at 8 times earnings would go down on that announcement.

Shareholder: Right.

Nygren: So it was a bit of a puzzle. First, I'd like to put "tanked" into perspective. Washington Mutual obviously had a very good year in 2000. It had a very good first three quarters of this year. And the stock price had more than doubled off its bottom. It has fallen from a high of about \$42 to its \$31 price presently. So I guess in a value investor world that is a "tank". But relative to what's gone on in some of the rest of the marketplace, I want to make sure we have that word in perspective.

Shareholder: Right. It's not Level 3.

Nygren: Yeah, that's correct.

Washington Mutual is a better business than people think.

Nygren: Our belief is that Washington Mutual is much better hedged against changes in interest rates than the market gives them credit for. I think there's a belief out there that the kind of doggy old thrift businesses are cheap when they're at 6 times earnings and they're expensive when they're at 10 times earnings. And the earnings historically for the industry have been very volatile — hitting peak earnings when interest rates are at their troughs and then, in many cases, losing money as interest rates rise.

But as you correctly point out, this is no longer just a business of lending long and borrowing short and keeping the mortgages on the balance sheet. They make a lot of money today from mortgage origination. They make a lot of money from mortgage servicing. And they do continue to make good spread income on the mortgages they hold — but that's not the entire business anymore.

In addition, the liabilities on their balance sheet are much better matched to their exposures on the asset side. And the company has also used financial derivatives to further fine-tune the risks that they're taking.

This isn't your father's S&L — earnings wise or otherwise.

Nygren: So we believe Washington Mutual is much

better hedged against interest rate changes — not just with what they've done with the balance sheet, but how they've changed the basic business. They're not *nearly* as sensitive to interest rates as they used to be.

When interest rates moved sharply against them a couple of years ago, it had the effect of knocking down their one-year numbers by maybe 20¢ a share. And obviously, it's having the flip effect this year in that we believe Washington Mutual will report results that are somewhat *above* trend-line in 2001. But as we look toward next year, as we move towards a more normalized year, we're looking for cash earnings of around \$4 a share.

And we don't see any reason to lower our expectations from a long-term trend growth rate of about 15%.

IT WASN'T MUCH ADO ABOUT *NOTHING* —
IT WAS MUCH ADO ABOUT *GOOD NEWS*.

All loan losses are not created equal...

Nygren: There were two issues that seemed to spook investors on the third quarter report in our judgement: one was credit quality in the wake of some of the high profile declines in credit quality, like at Providian. There was a concern when there was a small tick up in non-performing loans at Washington Mutual. Despite the company's assurance that most of the reason for that increase was purchased loans from the Bank United acquisition that were identified at the time of purchase as loans that were likely to become non-performers, they were not able to squelch the fears that investors had that financial institutions with declining credit quality are generally bad places to invest.

We obviously don't feel that this is a meaningful issue for Washington Mutual. We think that the company's credit quality matches up favorably versus anybody else's in the financial services business.

It's true they took a write-down on their servicing rights.

Nygren: The second issue that spooked people was the write-down that they took on mortgage servicing rights. Washington Mutual makes a lot of money servicing mortgages they don't own. They are the low-cost provider of that service. And because of that, that has been a very rapidly growing business for them.

With refinancings going through the roof, obviously the length of time they had expected they'd be able to service mortgages that they had acquired rights for ended up being less because people prepaid. That meant they had to take (and I don't remember exactly) a \$400 or \$500 million write-down on their mortgage servicing rights.

But they actually added more than they lost.

Nygren: The offset to that, which didn't seem to get nearly the same attention, was that because of all the refinancings, Washington Mutual's originations also went through the roof in the quarter. That means onetime fees on origination. It also means they have a new pool of lower interest rate mortgages and the associated servicing rights.

Numbers that are released deep in page 20 or 30 of the Washington Mutual third quarter report show that their estimate of the value of the mortgage servicing rights that were *created* during the quarter was actually greater than the write-down they took on the mortgage servicing

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rights that they had owned going into the quarter.

Lies, damn lies and accounting...

Nygren: But because of how the accounting works, the loss goes through above the line and the gain goes through below the line. And there is some view on Wall Street that because of that, the quarter was disappointing. We think that's silly.

The company's done a good job of setting up hedges to offset risks based on interest rate changes. And the fact that the accounting world sees some of that as above the line and some as below the line [in terms of its impact on the income statement] we view as basically irrelevant.

I FIND NOTHING REMOTELY AS ATTRACTIVE.
IT'S DISTANTLY MY FAVORITE INVESTMENT.

I find it hard to imagine that we're that far off....

Shareholder: Would you ever cut back the 15% of Oakmark Select's portfolio in Washington Mutual you have just to be a little more in balance — or do you care?

Nygren: Since we started the Fund, I've always said that I was willing to take a 15% position when everything aligned correctly — the degree of undervaluation as well as our confidence that that undervaluation is real.

And in this case, I just find it so hard to see that our analysis could be wrong enough that Washington Mutual would actually, in hindsight, be overvalued at this price.... They just don't have the risk level in their portfolio that creates the huge onetime write-offs a lot of the larger banks have suffered from that you'd need to make us that far off.

Washington Mutual is *distantly* my favorite investment.

Nygren: Because I think the stock is so extremely attractive, I'm very comfortable having the position size that we do in it. But I would *consider* reducing it if I could find a company that has the many fine attributes of Washington Mutual at as cheap a price — a company run by people I trust, with significant cost advantages relative to its competitors, at less than 8 times earnings, that yields more than money market funds and that's expected to grow its earnings per share at a double-digit annual rate in almost any economic environment.

But I find nothing *remotely* close to that. It is *distantly*

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my favorite investment. The reason why it's an outlier on the large side is that I just can't find anything I think has such a high probability of achieving excess returns over the next five years.... Therefore, I am not in any way, shape or form reducing our Washington Mutual position. And I have no intention whatsoever of reducing the position unless market opportunities suggest that we do. In fact, we've *added* to our position.

This *mgm't* allocates capital wherever it makes sense.

Nygren: One of the reasons I have that comfort level is that I've met several times with the CEO, Kerry Killinger. He's a solid guy. He came out of the investment business. And he approaches his job at all times with a focus on return on investment. Plus, he's got almost all of his family's net worth in Washington Mutual....

One of the things we like so much about management is their single-minded focus on deploying capital into the areas that offer the highest long-term rate of return. So when that means writing a new mortgage, then that's what they do with the money. When it means entering into agreements to purchase other businesses, that's what they'll do. And if it means repurchasing their own stock, that's what they'll do.

And today it makes sense to repurchase their own shares.

Nygren: When the stock had gotten up into the \$40s, they decided that they had more attractive opportunities to grow their business that would increase the value faster than a simple repurchase. With the stock down around \$30, that has changed again and they're redirecting the focus of their excess cash toward share repurchase.

We don't view it so much as a crutch to support the stock price, because so much of the value of any company comes from how they reinvest their excess cash. We're just delighted that this management team approaches it in such a shareholder friendly way. And at the moment, that means using most every dollar they can get their hands on to repurchase shares....

THE COMP SHOULDN'T BE OTHER S&L'S.
IT SHOULD BE OTHER GREAT COMPANIES.

It has less in common with doggy S&Ls than Wal-Mart.

Nygren: So our view of this continues to be that Washington Mutual is likely to earn something near \$4 next year — and that from that level, they will continue to grow earnings at a double-digit rate. Management has had a target of 13% growth which they have been exceeding. We think a double-digit number should be quite attainable for this company over a long-term time period.

I think the biggest point of difference we have relative to the Street is that we don't think it should be looked at as a doggy S&L anymore. Instead of comping this to other S&Ls — on which basis it probably looks fairly valued today — you should think about other commodity industries with a cost-advantaged competitor that have attained a long lasting premium that's helped them slowly put their competitors out of business. When we do that, we start thinking that the comps here aren't other smaller S&Ls. Maybe a comp like a Wal-Mart makes more sense — where a company went into a business that we all thought was

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lousy and because of a cost advantage, they slowly put most of their competition out of business.

It's worth an awful lot more than 8 times earnings.

Nygren: All the way along while we own a stock, we continue to revisit the fundamental assumptions that underlie our sell target. And we've become increasingly comfortable with the idea that the discount P/E that's historically been accorded to both banks and S&Ls is not deserved in the case of Washington Mutual.

In any case, in a 5% interest rate environment, a company that ought to grow its earnings at more than 10% a year in most any environment is worth an awful lot more than 8 times earnings....

Whether it's sooner or later, we'll be well compensated.

Nygren: And to me the big question on this stock is will investors come around to the point of view we have now — that this truly is a company that's going to crank out above-average growth pretty much year after year with small interest rate cycles superimposed on a significantly above-average growth rate? Will they accept that now and move the P/E up more in line with where other companies with that growth profile trade? If that happens, obviously, Washington Mutual will be a great stock again for us over a short time period.

Or will it happen over a long time period where you see a very gradual multiple improvement compounded with above-average earnings such that we're able to hold it for a very long period of time and modestly outperform the market with it year after year after year. Of course, I'd prefer the outcome where the market recognizes it quickly. But the other outcome wouldn't be a very bad one either — and from a tax-efficiency point of view is much preferable. I just don't see much risk that our forecasts are way overstating the company's potential....

The Fed can postpone our payday, but they can't cancel it.

Shareholder: And if the Fed started to raise rates a year from now, you would take it in stride?

Nygren: Yeah, I would. And if that happens next year — if they were to make a couple of interest rate increases — our \$4 number probably ends up being \$3.85 or \$3.90. But I don't think it would change our estimate at all of what we think they could earn 3-5 years down the road....

EXPECT A BREAKOUT CHRISTMAS AT TOYS "R" US.
IT REMAINS VERY ATTRACTIVE AND VERY CHEAP.

The new store opening represents a key event....

Shareholder: Are you still into the Toys "R" Us story?

Nygren: Toys "R" Us is still an important holding in both Oakmark and Oakmark Select. We own more shares of it now than we did three months ago. We believe that the opening of the Times Square store ... will be a very key event in terms of turning analyst perception and opening

people's eyes to the level and degree of change that's taken place in this company under John Eyler in what's approaching two years of his tenure as CEO. And I expect most every visitor who sees that store will be likely to give Toys "R" Us another chance to earn back their business when they go back to their home market.

I expect this to be a breakout Christmas for Toys "R" Us.

Nygren: I think the stock reacted negatively after September 11th on concerns that were shared across the retail group that perhaps Christmas sales would be very disappointing this year. We take some comfort in statistics that have been put together (by Toys "R" Us along with some of the other toy manufacturers) that show that spending on traditional toys really is not down at all post-September 11th — that the increasing focus on family time has perhaps shifted some of the spending from other luxury areas to things that can be enjoyed by the whole family.

So I expect 2001 to be a good Christmas season for the toy companies and that this is really a breakout year now for Toys "R" Us to show that they've turned the

PORTFOLIO REPORTS estimates the following were Oakmark Select Fund's largest equity purchases during the 3 months ended 9/30/01:

1. FIRST DATA CORP
2. WASHINGTON MUTUAL INC
3. CHIRON CORP
4. ELECTRONIC DATA SYSTEMS CORP
5. AT&T CORP
6. BURLINGTON RESOURCES
7. TOYS R US INC
8. TRICON GLOBAL RESTAURANTS
9. MATTEL INC
10. DUN & BRADSTREET

company around.

Kids "R" Us may have gone from sow's ear to silk purse....

Shareholder: What's the status of their Kids "R" Us division?

Nygren: Their Kids "R" Us division has been marginally profitable for the last couple of years. They've been trying to figure out what to do with it. Their options range all the way from shutting it down to spinning it off to slowly closing stores down to trying to find a buyer for it.

Well, that started to change about six months ago when they opened up a new test store with a better layout and better merchandise presentation that had results that were off the charts relative to their expectations. They're in the process of testing a handful of newly remodeled stores in various markets. And if the results of those remodels are as strong as the one test store's was, then they'll be rolling out the remodel program throughout the Kids "R" Us stores.

Also, Kids "R" Us has had some value to them by the store-inside-a-store approach where a small Kids "R" Us department is among their more profitable uses of square footage inside a Toys "R" Us store....

Toys "R" Us remains very attractive — and very cheap.

Nygren: Despite the positives, Toys "R" Us stock

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sells at only 12 times our estimate of next year's [cash] earnings. And we think a large amount of the upside in this stock remains ahead of us. We continue to view the stock as very attractive. And it remains a large holding in both Oakmark Select and Oakmark Fund.

OUR RETAILERS ARE MASTERS OF THEIR OWN FATE.
IT WON'T HINGE ON THE ECONOMY EITHER WAY.

If you think the consumer will disappear, don't own stocks.

Shareholder: You touched on Toys "R" Us. But you own J.C. Penney and other consumer kinds of companies. Do you have any concern about consumers, their lack of confidence, high unemployment and that kind of thing that could have an impact on some of those stocks?

Nygren: There are a bunch of different answers to that question. But I think it's very hard to be positive on any part of the stock market if you think the consumer is going to disappear on us. And if that's really your view — that the consumer just isn't going to show up and is going to retrench and dramatically cut back on purchasing — it's tough to be positive on the stock market in general.

The economy will be a secondary factor at Toys "R" Us.

Nygren: But more specifically to the names you've mentioned, I guess I don't think about it so much in terms of the dollars that we've exposed to the retail sector per se, because each of the companies that we're invested in is involved in very company-specific change that I think will determine whether or not they're successful investments much more than the general economic environment will.

Toys "R" Us is basically in transition from a store that was such a lousy place to shop that customers decided they would rather buy their toys at Target and Wal-Mart and K Mart rather than take a special trip to Toys "R" Us. They're in transition trying to make the Toys "R" Us store a destination store that people want to go to.

If that transition fails, it doesn't much matter how strong the consumer gets — Toys "R" Us won't be a successful investment. If that transition's successful, the degree of weakness you would need to project in overall consumer spending would need to be so dramatic to overwhelm the change at Toys "R" Us that I think it's at least a very unlikely, if not nearly impossible, scenario.

Ditto for J.C. Penney and our other retail investments.

Nygren: J.C. Penney: similar story. A year-and-a-half ago, it was one of the most mismanaged large companies in America. New management came in last fall — Allen Questrom, who had had such a successful track record at Federated Department Stores. And in a year's time, Allen has implemented massive change there.

We're seeing good comp store numbers and dramatic cost-cutting at the J.C. Penney store. Given that they are one year into a five year plan of fixing the J.C. Penney side of the business — the department store side — I think we have to give them very high marks in terms of the change that has been put in place at that company.

I was in Tampa recently for Eckerd's presentation. They're the third largest drugstore chain in the country and owned entirely by J.C. Penney. And by some analyses, if the Eckerd turnaround is successful, the Eckerd side alone will be worth more than the entire price of J.C. Penney.

Again, this is a company which in a stronger economic environment was not performing well at all. But new management came in with a new store layout and much better focus on serving the customer. And a year into their tenure, we're seeing dramatically improved results despite weaker results through most of the retail sector.

So I think there's much more of a company specific turnaround characteristic in our retail investments than there is just participation in the overall retail environment.

IS WASTE MANAGEMENT UP 100% OR DOWN 50%?
IT ALL DEPENDS ON YOUR PERSPECTIVE.

Everything's relative...

Shareholder: I was wondering if you could speak to your accumulating shares in Waste Management — especially after the big gain it's had from its lows?

Nygren: I think it depends on your perspective — whether you talk about a big run-up or a big decline here. As I mentioned in our quarterly report, there are three things we look for in any company. First is the discount to intrinsic value. We don't like to pay more than 60%. But we also like to believe the business value is growing and that we can trust management to act in the interest of shareholders.

We started getting interested in Waste a couple of years ago after the stock had gotten cut in half — ironically, to about the same price it's at today. We felt the stock met our valuation criteria, but we were not comfortable with the qualitative criteria. We did not have the confidence that management was acting in our interests, nor that they had the right information to even truly understand what was wrong with the business. So we elected not to buy the stock. Then the stock fell another 50% — from about \$30 down to \$15. Now it's rallied back up to \$30.

In the last quarter, having had the opportunity to meet the new management to get a better understanding of how vast the improvement had been in their MIS systems and with the stock still selling at less than 60% of what we thought the underlying business was worth, we got comfortable that it met both the quantitative and qualitative criteria. That's why we purchased it.

So even though it's had a strong rally, it's still selling at half the price it sold for two years ago....

Tricon's done well. But the value gap is closing.

Shareholder: Tricon's had a pretty good run. Is that something you still feel is undervalued?

Nygren: I still feel it's undervalued. I'm very, very comfortable with the way the company has been executing. But clearly, the stock at \$51 isn't as undervalued as it was at \$25 a year-and-a-half ago.

They've done a lot of things well. Their business is more profitable today than it was a year-and-a-half ago, but it's not twice as valuable as it was then. So the valuation gap is closing there, but it has not reached a

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level yet that we have wanted to get rid of the position.

Tremendous potential synergies for Hughes/Echostar.

Nygren: An Oakmark holding that's been involved in a takeover offer is a new position for us: Hughes Electronics. Echostar announced an offer to purchase Hughes at a small premium to their current market price. We agree with the Echostar management that there are tremendous synergies between these two companies — and if they do combine in the way that is currently proposed, we would likely remain a shareholder of the combined entity to benefit from the improved profitability that a combined company would likely exhibit. At a minimum, this Echostar bid should increase the price News Corp or any other potential bidder would have to pay to buy Hughes....

BUSINESS QUALITY WAS NEVER AN ISSUE W/CENDANT.
AND MALONE ANSWERED OUR OTHER QUESTIONS.

There have only been two issues with Cendant...

Shareholder: I was wondering if you would comment a little bit on Cendant which you own in Oakmark Fund. I know they've had some financial difficulties in the past. Could you tell me what you find attractive about it?

Nygren: I don't think there's ever been much dispute about the quality of their businesses. They have a nice portfolio of businesses — mostly in the travel industry, franchising hotels, Avis and real estate brokerage. Cendant is a very good cash flow business.

The question surrounding Cendant has been management quality and the acquisition that they made several years ago of CUC — the Walter Forbes company that wasn't worth anywhere near what they originally thought it was. There've been lawsuits over fraud which the prior management of CUC had been found guilty of. And we had the same questions about Henry Silverman and his management ability that everybody else did.

The trigger for us on Cendant was John Malone...

Nygren: But what got us over the top in terms of being able to have the confidence to make the investment was the investment made in Cendant by Liberty Media and their chairman, John Malone. John is someone that we've invested with over a long time period — throughout the entire history of the Oakmark Fund — with Liberty Media and then Tele-communications, Inc. We think highly of John's ability as a businessperson and as a person to make money for shareholders.

John not only had Liberty make an investment in Cendant, he also made a personal investment in it and joined its board where he is a very key figure that Henry Silverman relies on for strategic planning. So although the stock had looked cheap relative to the assets for a long time, it was because of his involvement that we got to the point where we were comfortable enough in the management, in the way the business was going to be run and the valuation [to buy the stock]. So it was really John's involvement on the board that was the trigger for us to get involved....

There's a reason why REITs don't tend to get dirt cheap....

Shareholder: REITs are an area that you've generally, if not always, shied away from. Could you just comment briefly why?

Nygren: I don't have a predisposition against REITs. I do think that their structure, with the high income yield, tends to keep them closer to their fair value.... Where cash-on-cash returns for fairly valued properties are typically around an 8% or 9% level and REITs paying all of that out, for it to get to less than 60% of business value, it would require a teens yield. And it's very rare that they're allowed to get that cheap.

Non-REIT real estate tends to get more mispriced.

Nygren: It's not that we don't like real estate investments. We bought Starwood in the first quarter [and in subsequent quarters] in the Oakmark Fund. And we bought Park Place Entertainment — the large casino company. It's only corporate structure that makes them different than a REIT. But because they're not paying out the dividend (and I tend to prefer that the gain come through capital gains rather than dividends for tax reasons) the stock is allowed to fall to a cheaper price.

USG HAS LEFT ME PERMANENTLY SCARRED.
SO MUCH FOR LOGIC — IT DOESN'T SEEM TO APPLY.

The inmates lawyers are running the legal asylum...

Shareholder: Regarding asbestos and USG, are you tempted at all to venture into that area again in companies like Crown Cork — companies with a little less exposure to asbestos — or are you pretty much scared away?

Nygren: I think for the rest of my career, one of my flaws will be that I'll be afraid of litigation — because the playing field seems so unfair. The examples of cases USG was losing just got more bizarre as each quarter went by.

For example, in the first quarter, shortly before I sold the stock, I was in their offices meeting with the CEO and the head of their legal department. And they were talking about a case in Florida where a construction worker, who had mesothelioma and was going to die from it, was suing for asbestos damage. Typically, the industry hasn't fought those cases. But in this case, he contracted the disease years prior to USG making the product.

Well, the case went to trial because USG wasn't going to pay for a case where someone was exposed to the product before they made it. But the judge said it was a question for the determination of the jury as to whether USG had actually made the product at the time the guy contracted the disease.

And believe it or not, USG actually ended up losing something like a \$30 million settlement on that case for someone who to a near medical certainty had contracted the disease prior to USG even making the product.

Our mistake was applying logic where it didn't apply.

Nygren: When you have states where that kind of outcome is possible in the judicial system, I don't know how a sense of logic can be applied to the problem and

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result in a conclusion that means anything.

[Editor's note: Amen.]

Nygren: The big mistake I made in analyzing asbestos liability was taking comfort in the assumption that the enterprise values of the companies that were going into bankruptcy were likely to exceed the asbestos liability that they'd have — and, therefore, those companies going into bankruptcy would not make USG's claims snowball.

However, what's happened is, remarkably, now that Owens Corning is bankrupt, very few of the claimants remember being exposed to Owens Corning's products. And very few remember being exposed to Armstrong World products. But a much higher percentage now seem to recall using Durabond — which was USG's product. *

So I don't know how you can apply typical logic. And it's left a permanent scar where I will be very reluctant to get involved in a company where litigation has the potential to be such a major issue....

[Editor's note: Unfortunately, there are probably relatively few industries where it *doesn't*.]

And the extent of the problem only dawned on me slowly....

Shareholder: [So you haven't taken another] look at USG now that it's about 25% of its value of six months ago?

Nygren: ...The minor mistake we made in USG, I think, was overestimating trend income. If that had been the only problem, it would probably still be in the portfolio and we'd probably have made some money on it.

The real problem with USG, as I mentioned, was the snowballing of the asbestos litigation costs. I very slowly got to a point of view last year where I had conceded that future asbestos costs would probably run up as much as \$1 billion and that the company would have to take a charge for that in the fourth quarter — which they eventually did. The problem was the \$1 billion wasn't for *all* future asbestos costs, just the next three years. So there was a dramatic increase in *their* estimate of annual asbestos costs.

We saw the writing on the wall and got a lucky break....

Nygren: When we first took our position in USG five years ago, our anticipation was that they had more than enough insurance to cover them for litigation expenses relating to asbestos. As recently as a year ago, even though those costs had gone up dramatically, we felt the business value was so substantially above any likely potential asbestos claims that the stock was still undervalued.

It was only after seeing the costs for excess insurance on asbestos go through the roof in last year's fourth quarter as well as seeing some of the court decisions where there seemed to be less interest by the court in figuring out who was truly to blame than there was in compensating sick victims [that we reevaluated our position].

That's when I decided that the asbestos liabilities had reached an uncontrollable level and that the company was very unlikely to be able to find a way to stay solvent. We, in hindsight, were very fortunate that the combination of a very large short position in USG and the attention that was

drawn to it with Warren Buffett's purchase allowed us to exit the stock at higher prices actually than where we first decided that the position had to be sold.

If the value is being decided in a courtroom, count us out.

Nygren: Yes, USG has gone down a lot. It's also declared bankruptcy. And I have such a hard time as an analyst trying to make a guess that I have any confidence in as to how bad the asbestos situation can get that I have a very hard time assigning any positive value to USG's gypsum business — their main wallboard business. I know some have advanced the argument that the corporate veil ought to protect USG's non-gypsum wallboard businesses. If that's right, the stock could be a very good investment from here.

But I think a lesson we've learned ... is when the business value outcome is being decided in a courtroom, we are at a disadvantage in trying to compute that value — as opposed to our typical situation where a company's acquisition department, or the marketplace itself, might be trying to determine that business value. That's a skill that I think we've proven to be reasonably good at.

I have no idea how to predict the outcome at USG.

Nygren: But I have zero interest in revisiting a purchase decision in USG. It's a very, very tiny market cap at this point — almost too small even for a small-cap fund. But I also think you have the full range of outcomes from completely losing your capital to maybe more than doubling it if you get the right court decision. But I just have no idea how to predict that.

OUR HIGH REGARD FOR A MANAGER
LED US TO MISJUDGE HIS BUSINESSES.

We looked at U.S. Industries through rose-colored glasses.

Shareholder: I wanted to know what lessons you may have learned from U.S. Industries....

Nygren: We had a lot of confidence in David Clarke as the CEO of the company. We liked the way he approached the businesses. He had a portfolio manager approach — sell 'em when somebody will pay you more than what you think they're worth and buy things opportunistically.

I think the combination of that glow over the pool of assets he managed and the consistent cyclic improvement that we were seeing during the first three years that we owned U.S. Industries led us to mistake cyclic improvement in those businesses for operational improvement that David and his management team were infusing in the company.

With the first downturn, our mistake became clear.

Nygren: And it was in the downturn in the economy in the second half of last year and the first quarter [of this year] when their results started to fall far shy of what we had hoped they'd be able to earn in a slight downturn that prompted us to go back to ground zero for analyzing their businesses. And when we did, we weren't as pleased with what we saw as we thought we'd be.

Outside of the Jacuzzi business which continued to perform quite well, every other business unit that had experienced cyclic improvement saw that improvement go away. We had misinterpreted it as a secular fix on

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businesses we thought had been previously mismanaged.

With the benefit of hindsight, I think all it was that they bought the companies at the right time and the business environment got better for a couple of years. But then the business environment got worse and [these companies went] right back to the group of subpar performers they were at the time U.S. Industries bought 'em.

And we reduced our sell target too slowly...

Nygren: U.S. Industries reached a level, I believe in January of '98, where we were very close to selling the stock. Our judgment at the time was that we had not increased our sell target multiple as much as had been appropriate given the strength that was being shown in both Jacuzzi and the other U.S. Industries businesses. In hindsight, I think we were accurate. We did raise our multiple. The stock got very close to our target. And then results started to move down hill. It was kind of the classic example of a stock where you kept reducing your targets and the stock always looked too cheap to sell.

We eventually made the decision when U.S. Industries was having more trouble refinancing some of its debt than we thought it should. We just decided that we didn't have as good a handle on the future outlook of the company as we would like to have.

Next time, I'll be more skeptical — probably overly so.

Nygren: In hindsight, the lesson that can be applied more broadly than just U.S. Industries is as we look at what caused us to increase our target multiple on their businesses — most of which were building products businesses — the reasons for the strength there had less to do with U.S. Industries' performance relative to the industry than with cyclic improvement in the industry.

So I'll be very reluctant going forward in a company enjoying cyclic improvement to allow myself to believe that the improvement is due to secular change in the business. Therefore, probably, as is usually the case in this business, because I made such a big mistake in that direction this time, the next time we own a cyclic company that really is improving, I'll sell it too soon. Nonetheless, I think I'll be more reluctant to allow a target multiple to be raised on a cyclic business....

COMPARISONS TO THE MASTER ARE FLATTERING,
BUT THERE ARE SIMILARITIES AND DIFFERENCES.

The benchmarks that we care about most...

Shareholder: I think in one of the recent reports, you mentioned that you were primarily interested in comparing your fund to five other funds.... Well, I was just curious. I assume [a couple are] Longleaf and maybe Tweedy, Browne. But what would the other funds be?

Nygren: Comparables that I would consider would be Weitz Value, Longleaf Partners, Clipper, Sequoia and Legg Mason Value Trust.

Shareholder: Really? Bill Miller's fund?

Nygren: Bill's a great large-cap value investor....

Warren says he doesn't understand techs. We think we do.

Shareholder: How does your ... investment approach differ from that of Warren Buffett's buy-and-hold strategy?

Nygren: I've been flattered by some of the comparisons of our approach to that of Warren Buffett. But the reality is that none of us know him personally. So any of my comments as to his style are only based on what's been written about him in the press.

My understanding of his approach is that he's looking for very strong businesses with owner-oriented managements where business value is growing — which is very similar to what we're looking for on the buy side. But one difference on the buy side might be that Warren has said that he doesn't feel he understands technology stocks well enough to consider investing in them.

We haven't ruled out owning technology stocks. We haven't owned many of them over the last several years, but that's been based on price considerations rather than considering them outside the bounds of our universe.

And our favorite holding period isn't forever either.

Nygren: The bigger differences, as I understand Warren's style, come on the sell side. He's been exceedingly reluctant to sell positions when he felt that they'd attained fair value in the market. I'm not sure how much of that may be influenced by his size which makes it very difficult for him to trade in and out of positions.

Our belief is that if we believe our estimates of business value are accurate enough — not perfect, but accurate enough — if a stock has exceeded 90% of that estimate, we're likely to make more money [by selling it and buying] something that's trading at 60% of value, and enough more to make it worth paying the taxes associated with the long-term gain.

"VALUE" INVESTORS NEED TO REMAIN FLEXIBLE.
THERE'S NO NEED TO PUT ON A STRAITJACKET.

T. Rowe Price arguing against "value"? You're kidding...

Shareholder: There was a recent interview in Investor's Business Daily with Brian Rogers who runs T. Rowe Price's value fund. And he suggested that he believes that — and this is his quote — "It appears as though most excess return from a value strategy has probably been realized. So one should be a little bit more balanced now". His argument was for getting back into the growth side of the markets. I was just wondering what your comment on that might be.

Nygren: Gee, that's odd that T. Rowe Price would suggest going with a growth strategy.

Shareholder: [Laughing] Yeah.

It all depends on how you define "value".

Nygren: Well, I guess I'd have to say I partly share his view — depending on how you define value investing. In the last two years, as a value investor, it's been very easy to show good numbers and outperform the market. And I think during the next few years, you may see more of

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OAKMARK FUNDS'
BILL NYGREN
(cont'd from preceding page)

a spread based on what form of value investing your particular value manager uses.

To us, value doesn't necessarily mean buying stocks with the lowest P/E, highest yield or lowest price-to-book value. If the type of value approach that's statistically focused on the absolute cheapest numbers is how you define "value" — without consideration of business quality and growth prospects — then I'd agree with his comments.

To us, value investing basically in its simplest form means getting more than you're paying for and trying to take advantage of whatever opportunities the market presents to you.

Being a value investor doesn't mean never paying up.

Nygren: I think the best opportunities that we're seeing today are the above-average growth companies that are not especially economically sensitive where P/Es are at substantial discounts to the market. And if you look at the fundamental characteristics of those companies, a lot of them would be called *growth* companies. It just happens that their prices today are at levels that we consider them to be *values*.

I don't think being a value manager in any way prevents me from saying, "It's worth paying up. Instead of buying a below-average grower at 12 times earnings, I'm going to buy an above-average grower at 15 times".

I certainly believe that that's *entirely* consistent with being a value investor. And in fact, that's how you're seeing our portfolios change today.

A rigid value investor may have a very difficult time today.

Nygren: The easiest way to sum up how I see how things have changed in the last 18 months is if you look at the newer holdings in the Oakmark Fund in March of 2000, they tended to be names like Cooper Industries, Fort James — companies that were selling at maybe a quarter or a third of the market multiple that we wouldn't for a minute argue were better than average companies, but if you saw that multiple gap close somewhat, you had a great performer.

The ideas that we're seeing today are more like the new names that I mentioned in the Oakmark Fund report: American Express, Gap Stores, and Guidant (which we'd purchased in the second quarter) — and then some of the holdover names in the portfolio, H&R Block, First Data Corp. and EDS — where you're looking at companies that are selling between two thirds of the market multiple and the market multiple for businesses that we think are *substantially* better than average businesses.

I think that's where a value investor needs to be shifting today. And a value investor who is utilizing a stock selection criteria that prevents him from doing that may have a very difficult time.

EVERYONE IS FIXATED ON STYLE —
SO IT PROBABLY WON'T MATTER.

The only way we know our theme is to look at our portfolio.

Shareholder: Do you see the trend continuing that

value will outperform growth? Or do you not look at trends — you just go more towards a bottom-up style?

Nygren: Well, first off, everything we do is bottom-up, stock specific: Do we think the stock is undervalued? Are we comfortable its value is going to grow? Are we comfortable that the management is acting in a way that's in the interest of the outside shareholders? If the stock passes those screens, it's something we're interested in.

We don't invest in a thematic way and push it down. Our themes come up when we start saying, "Wow, look at this list of companies we've been purchasing and see how different it is from the list we were purchasing a year ago." And, when we communicate what we're doing, sometimes it's easier to utilize themes than to talk specifically about each individual stock. But make no mistake — what we do is bottom-up security selection on a stock-by-stock basis.

We don't care about trends. We don't try to make a guess as to whether value or growth is likely to outperform in the upcoming one, two or three years. We try to buy undervalued stocks that are growing in value and then patiently wait for the market to recognize that value.

The relative importance of style itself has been an anomaly.

Nygren: If you think back over the last three years, there are so many ways it's been a period of anomalies. But one of the biggest in my mind is that prior to the last three years, you would always say if you could only have one statistic about an individual's portfolio to help you judge how well he'd performed, you'd like that to be what percent exposed he was to the equity market. And actually over the last three years, that statistic has done very little in helping to explain somebody's performance.

What's mattered almost exclusively has been whether you've been in the growth style box or the value style box. That's really unusual historically.

A radical thought — that skill will matter most...

Nygren: Now that everyone's so focused on whether their manager is a value manager or a growth manager — that being the most important statistic that they look at — maybe the market will do what it usually does, surprise us and what will matter is how good a practitioner you are of either the value or the growth philosophy.

I think that we could be in an environment where value managers have the opportunity to add value via stock picking as do growth managers and that the bias the market presents in favor of or against either style will not be nearly as significant as it was the last couple of years.

—OID

For additional information
you may contact:

OAKMARK FUNDS
TWO N. LA SALLE ST.
CHICAGO, IL 60602-3790

(800) 625-6275
(312) 621-3800

WEITZ FUNDS'
WALLY WEITZ & RICK LAWSON
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very low turnover — and therefore high tax efficiency, too. (Performance figures provided by *Morningstar*.) Incidentally, since its inception through 9/30/01, Weitz Partners Value Fund has earned a compound annual return after all fees and expenses of 17.1% versus 13.8% for the S&P 500. (Figures provided by Weitz Partners.)

For some time, we'd been planning to give Weitz and Weitz Hickory Fund portfolio manager Rick Lawson a call the next time they hit a dry spell to see if they might be willing to share some of their ideas and insights with you. So when we saw that both Weitz Partners Value Fund and Weitz Value Fund were actually down a bit over 6% for the first nine months of 2001 (about as close to a train wreck as Weitz has tended to get) and that Weitz Hickory was down even more, we didn't hesitate.

By way of introduction, prior to 2000, Lawson had been matching extra base hits with Weitz — having managed to earn a 30%+ return for five consecutive years from 1995 to 1999 and rank in the top 1% of funds in his category in two of those years, the top 2% once and the top 4% in the other two years — before moving to the other end of the see saw with 100th and 98th percentile returns in 2000 and so far in 2001 (again, our favorite time to chat).

The result is what you see before you — excerpts from more than a few conversations with Weitz and Lawson which occurred between October 18th and December 24th. However, first, we're pleased to bring you excerpts from several events — also featuring Weitz and Lawson — a conference call from May 4th, Weitz Funds' annual meeting from May 30th, another conference call from August 8th and their most recent conference call from November 5th. We found our conversations with Weitz and Lawson to be quite enjoyable and enlightening and believe you will, too.

EQUITY RETURNS MAY BE LOWER FOR AWHILE.
 IF SO, AN EXTRA 2-4% PER YEAR WILL BE HUGE.

I want stocks with plenty of staying power — just in case.

Wally Weitz: Rick [Lawson] and I would always say that we have no idea what the market's going to do or the economy, but everybody insists on asking. So here are *my* working assumptions....

I still feel the same as I did a month ago when I wrote the third quarter letter. The economy is in recession. Travel-related companies were *especially* hurt by the terrorist attacks. And a year or two of their business lives may have been taken out of their hides by those events, but they're recovering.

Parts of the market seemed overpriced *before* the attacks happened. Now, after the market has rallied back to pre-September 11th levels, some of those stocks may still be overvalued. So I'm assuming that we'll be in kind of a soggy market for some time to come.

Historical valuations are a dime a dozen. They don't *prove* anything. But if you think about S&P earnings of

something like \$50 on a normalized basis maybe next year, we're still at 20+ times those earnings.

P/E's *could* go up from here, but they're above average. So I'm personally looking for companies that are not only cheap today, but that have plenty of staying power — [just] in case we have a year or two of a subdued economy....

We may be in a period of extended single-digit returns.

Shareholder: What do you think about the prospects for [long-term] future returns?

Weitz: Well, 25 years of a bull market with the S&P returning 15-18% per year seems to me like too much of a good thing. So maybe stocks will have to spend two, four, six or even 10 years working their way sideways. And that's not because those companies won't be doing well or because the economy won't be doing well most of the time. It's just that the business values of those companies need to grow up into their stock prices.

Therefore, my working assumption is that this may be a period of low-to-mid single-digit returns over the next five or 10 years.... Buffett's article in *Fortune* in the fall of '99 laid out a real good case for not expecting much more than a 6% [per year return] for the S&P for 5, 10 or 15 years. Munger says similar things. And [Grantham, Mayo's] Jeremy Grantham can make a more bearish case still.

[Editor's note: As you may recall, Grantham laid out his quite compelling case in our July 31, 2000 edition.]

That doesn't mean it won't be worth buying stocks....

Weitz: All of us active managers and investors hope that we're going to be the ones who are above average. And because of the arithmetic of the way the S&P is calculated, where a group of 10 or 20 stocks that had gotten very, very overvalued pulled up the average, you might have a period where the vast majority of stocks do a lot *better* than the S&P for a change. However, that may be wishful thinking. I don't know.

That doesn't mean it won't be worth buying stocks.... It does mean that if we can make 8-10% per year in a world of 6% returns, maybe that will turn out to have been sort of hero material.... In any case, the compounding difference you get from those extra 2, 3, 4 percentage points is *huge*. So I think it will be worth the trouble.

I know a lot of people think that we're crying wolf because we keep saying this and then have a good year. But we actually mean it. Nevertheless, we'll keep trying to make ourselves look bad on those predictions.

LOTS OF STOCKS MAY BE STATISTICALLY CHEAP.
 BUT OVER TIME, OTHER FACTORS TAKE PRECEDENCE.

Good questions can leave scars....

Shareholder: If you had to pick just one stock for the next five years, what would it be?

Weitz: My first reaction to that question is a visceral one.... I was on a plane with Warren Buffett 20+ years ago ... and he asked me that question. Actually, his question was what I'd want to own if the market were going to be closed for 10 years. And I gave Buffett the *lamest* answer. In fact, I've been embarrassed about it for 20+ years now. So I'm hesitant to answer that question now.

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But it shouldn't be all that hard to answer...

Weitz: But it's a good question. And if you have a whole lot of trouble with that question, it may be a sign that you're not thinking long term — that you're thinking about trading, getting in and out of sectors, etc.

To think in five and ten-year periods, you have to think about companies with an impregnable position — that can't be knocked off by somebody out-hustling it, somebody being smarter or the world changing somehow. And I think that's one reason why we don't do much with technology stocks — because things change so fast.

It might be one reason why Warren's been attracted to Coca-Cola. Coke and Pepsi can fight it out and ice tea can come and go, but Coke's going to be important 10 years from now.

Mgm't should be able to deal with adversity — like Berkshire.

Weitz: Another thing I think about — and I think Rick would agree with this — is how good management is at *dealing* with change and adversity. And that's one thing that's so wonderful about something like Berkshire with all of its different moving parts, each of which generates cash, where he has a choice about what to do with that cash and where he makes *good* choices and he invests where the returns are going to be higher or surer — not in the places where the returns will be lower and more dangerous.

Liberty Media might be a different version of that kind of company. Would you like to add anything, Rick?

As time horizon lengthens, price becomes less important.

Rick Lawson: I agree completely.... The key, I think, when you're thinking about what to hold for a very long time is that valuation becomes less important than the rate at which the underlying value is growing and the assuredness of that growth. There are lots of companies that I like where their stocks are cheap, but fewer that are really good companies. And they may not be the cheapest today. But to answer that question, I'd probably think more in those terms....

Take the specific stock stuff with a grain of salt.

Weitz: But I'm uncomfortable telling anybody that in real serious terms because I'm afraid that they'll go out and buy it. And I don't know of any company that's good enough to [justify] putting 80-90% of your money in that one stock. I just don't think that's the way to invest.

We sometimes may sound like we're recommending that somebody go out and buy these individual stocks, but that's really not the case. When we write about why we own something, it's to give you an idea of our thought process,

(continued in next column)

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not that we think it's a great stock to buy at that moment. And I say that because by the time the printer gets done with it, we may not own it anymore.

Lawson: Or, more likely, we may not want to buy it at that *price*.

Weitz: Right. Things change. What's really scary to me is that sometimes people ask me about some stock that I mentioned a year or two ago where things have changed completely. And I didn't know to call 'em and tell 'em....

So take the specific stock stuff with a grain of salt.

I've never enjoyed public embarrassment...

Shareholder: What's the stock that you told Warren you'd want to own for 10 years?

Weitz: Well, let me just say that if I've been feeling bad about how dumb my answer to Buffett was for the last 23 years, I'm sure not going to tell 500 *more* people.... Let's just skip that one....

BUSINESS MODELS ARE OVERRATED.
 IT'S BUSINESS QUALITY THAT COUNTS.

We're not so focused on a company's business model...

Shareholder: My question has to do with gaining a better understanding of what types of companies you feel more comfortable analyzing and/or investing in. I asked another advisor the same question recently and was told the money managers didn't care what the company did. It was the business model they were most interested in.

My concern is with the term "business model". As the price decline in many stocks has recently revealed, the "model" is all there really was....

Lawson: There are a couple of questions wrapped up in what you're asking.... In terms of the kinds of companies that we own from an industry perspective, if you start analyzing what we have relative to all the companies that are out there, you'd find that we tend to focus in some parts of the market and tend to avoid others. That partly has to do with the comfort level we've developed over time and with some structural factors in certain businesses.

We've ended up owning a lot of service businesses of one sort or another: financial services, media, telecommunications. And while that is by no means the only place we'll look and the only kinds of companies we'll own, there's been that tendency for a long time. I would expect it to change slowly, but it'll probably be with us for a long time to come in one way or another.

You then raise another question — the "good business" versus "business model". And those can be related and separate at the same time. When I analyze a company, one question I ask if it's doing well is, how do I know if it will *continue* to do well? And to me the answer to that question has to do with its underlying business model and its underlying economics.

But there are exceptions...

Lawson: That said, there are great opportunities at times [in companies whose prospects are unfolding]. Taken together, overall, they're probably riskier. But to find a company with a business model in the process of being realized, but where it's not yet so obvious that the

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stock price reflects its prospects — well, its stock can be quite attractive.

I'm probably more comfortable with that kind of a situation than Wally. And of course, the further out you go in predicting cash flows and the less cash flow there is today, the riskier the situation. But if you can find a situation where the business isn't yet working at full scale, but it is working and people don't recognize that it's working, that can be the hallmark of quite an attractive investment opportunity indeed.

In certain circumstances, any business can do well.

Weitz: Yeah, I think it may be a matter of semantics. When you use the term "business model", I think every company has a model of what they mean to be or how they mean to work — just like a map is an approximation of the reality of a city or of a country. And a lot of people threw the term around loosely, "We have a great model".

But if that business model only works under certain circumstances, it's a *bad* model. In certain circumstances, *anybody* can do well. Then one of those variables changes and all of a sudden it's like they say, "When the tide goes out, you find out who doesn't have a bathing suit on." Anyone can talk about a model and draw something on the back of a napkin or make a spreadsheet with hundreds of lines and lots of details. But if there's a fatal flaw in it... Well, that's the problem....

A truly good business can do well over the long term.

Weitz: On the other hand, a good business has the right kind of economics — it has control over its destiny, it doesn't require a lot of capital, it has choices of what to do with the cash it generates and it's sheltered from competition. The fact that you have a model or you don't is not the issue. It's either a good business or it isn't.

Lawson: And to be a good business, it has to be a good business over lots of economic cycles — over a long period of time. It's not enough that the numbers look good today. That, to us, does not define a good business.

We don't have absolutely identical investment criteria.

Weitz: Right. In the 10 years that Rick and I have worked together, I think we've had a pretty similar idea of what makes an attractive company. However, I think our temperaments, comfort levels and willingness to have volatility in our results has lead us to apply the same philosophy with different tactics....

But one place Rick and I differ some is that while my first choice is a great business at a fair price, I'm probably more willing to buy a mediocre business at a very cheap price than Rick is. That would include things like savings & loans, some kinds of real estate companies and so on that don't have great economics. By definition, they're more trades than permanent investments. Incidentally, when I say "trade", I mean maybe two, three or four years.

But a good business with good economics that has staying power is a lot easier for a manager to deal with because it doesn't need to be changed all the time. You can buy it and hold it for a long time....

WE'RE BORING FOR A REASON
— BECAUSE IT WORKS.

I can see that you guys have been reading Morningstar...

Weitz: We had two or three questions mailed in about diversification and asset allocation between large cap/small cap, growth/value, etc. You can tell people have been reading *Morningstar* or too many magazines when they start using this terminology. I want to be careful how I say this because how you allocate your assets is an important thing. And diversification is a *very* important thing. But there's been a whole cottage industry made out of helping people rearrange the chairs — and they're possibly outsmarting themselves.

Not having all of your eggs in one basket is important when the basket leaks. But it's not necessarily important to have 100 different stocks — or 10 different mutual funds that *each* have 50 or 100 different stocks. You may own two funds where one is selling the same stock that the other one's buying that same day.

You can put us in a box, but be prepared to change it...

Weitz: The idea of large cap/small cap and all these different categories is sort of artificial. It's a function of the consulting world that wants to help people do things in a complicated way. I think in all of our stock funds, what we try to do is look in theory at *any* kind of a company — whether it's large or small, growing fast or slow, etc.

Now we do eliminate the ones we can't understand and the ones that we think are crummy businesses — and that does narrow the field quite a bit. We also eliminate most foreign companies. So we manage to get our list narrowed.

But for people who look at *Morningstar* or some of the magazines and see the Weitz Value Fund categorized as a midcap value fund, that may be an accurate description of what's been in there lately, but it doesn't mean that we're limiting ourselves to those. We're happy to own large companies or small companies.

What worked for Noah ain't such a great idea in investing.

Weitz: So I'd caution you not to get too carried away with the mystery of having one in this category and one in that category. Some call that the Noah's Ark Principle — you get two of these, two of those and two of the next ones until pretty soon you've got a zoo. You want to be careful about inadvertently doing that in your portfolio.

Lawson: In the same way we're not trying to target a market cap style box, we're also not trying to target a value versus growth style box. We have a very strong sense in our minds of what we mean by value. And that has to do with the long-term future prospects and cash flow a business can create. It doesn't necessarily have anything to do with its book value, or P/E or other traditional measures.

So we don't tend to perform like other "value investors", nor do we worry about where mechanically our average P/E is or where we would fit in a style box.

We're boring for a reason — because it works.

Weitz: We're trying to do simple, predictable things and grind out a good return over a long period of time.... The strength of what we do — for better or worse — is that

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it is boring.

I remember being on the board of trustees of the Presbyterian Foundation for 10 years. And we hired outside managers for all of the endowment funds. So we'd have the prospective managers come in and talk to us. And the growth managers would come in — and they'd have all of these stories about biotechnology, computers and all of these fancy things that were changing the world. If the internet had been invented then, they'd have been talking about it. But they'd have the trustees on the edge of their chairs. They couldn't get enough of those guys at those meetings.

Then the value guys would come in. And they'd say, "We've found some pretty cheap stocks. And we don't know when they're going to go up. But we just did 5% better than your growth managers did." And the trustees would fall asleep within the first five minutes.

Well, we suffer from that. But I think that's what you hired us for — again, for better or worse. And maybe that's why we don't have a meeting more than once a year — because you probably couldn't take it.

RULE #1. BUY GOOD BUSINESSES
WHEN THEY'RE UNDER APPRECIATED.

OID: How have you guys done it? I assume that it wasn't with techs and telecoms.

Weitz: Part of what worked was owning things that looked like techs and telecoms to other people, but that really weren't. It sounds so simple, but we just do what most of your contributors do: We think of a stock as a business. We identify businesses that we'd like to own. And we figure out what we'd be willing to pay to own the whole company.

Doing that doesn't necessarily result in your buying stocks that only go up. But it keeps you out of trouble. And it usually keeps you from giving your gains back. Compounding takes care of the rest.

OID: Sadly, some skill might also be involved.

Weitz: The relative importance of the winners versus avoiding the losers is different at different points in time. Through most of the 1990s, our big gains came from a handful of stocks that did really well — like the cables where our little ones went up 10 times and our bigger ones went up 5 times. And by being stubborn and doubling up when they were down, we wound up having big positions when they worked.

OID: Obviously, you don't believe in stop loss orders.

Weitz: I get a lot of questions about stop loss orders. My performance would be mediocre if I used stop loss orders. And I don't try to measure all of this, but I'm pretty sure some big proportion of our performance over the years has been from stocks that went down first.

For example, doubling up in 1994 when re-regulation

hit and the Bell Atlantic/TCI deal fell through resulted in us having a pretty big position. Today, I can hardly remember why people were quite so negative back around the end of 1996. I think the promise of modems and digital and all of that was postponed — or fears regarding satellite competition. But for whatever reason, the cable stocks totally collapsed again. I think that's when John Malone surfaced after having been gone for a year-and-a-half. At any rate, we doubled up *again* in 1996.

And then those stocks got sort of sucked up into the tech and telecom and broadband hysteria in 1998 and 1999 and got pulled into that orbit.

OID: Priced into the stratosphere.

Weitz: That's right. Anyway, they went up a lot. There were takeovers. And most of ours got taken away from us in acquisitions. We had MediaOne, TCI, Century, Falcon.... We even sold all of our Comcast — which I love. I just couldn't live with the price. So by the end of 1999, we were *mostly* out — although we did retain an interest in Liberty and some of our Adelphia.

I've tended to gravitate toward a handful of industries — media, entertainment and financials. And partly, I've been drawn to them for *positive* reasons — because they're understandable, have good characteristics, etc. But partly, after *doing* it for 30 years, I may be guilty of being in a rut.

OID: Is there room in that rut for a newsletter editor? It sounds like you're following the strategy that Buffett and Munger talk about — of the hedgehog — knowing a great deal about a few things.

Weitz: I like that characterization better. [Laughs.] But I really *do* like companies that have some control over their destiny and some flexibility in terms of what they do. So many companies — from retailers to manufacturers to high-tech companies and on and on — are locked into a treadmill. And in recent years or even recent decades, it seems like the buyers have had the upper hand and that the manufacturers and the sellers have just been squeezed and squeezed and squeezed.

OID: Yeah. Half-a-dozen years or so ago, Jean-Marie Eveillard of First Eagle Sogen Funds pointed out to us that the balance of power was shifting to retailers — and manufacturers were increasingly being squeezed. But we missed it entirely — until around the time that Buffett began loading up on publicly-traded retailers.

Weitz: [Laughs.] Eveillard was right. It's similar with the cable companies. If TCI or Comcast wants to order 2 or 3 million boxes, they can go to General Instrument or Scientific-Atlanta or somebody else. So they can say, "Here's the price we'll pay — if you want the business. Otherwise, we'll wait a year." It's a one-sided negotiation.

So that part of the story is the good business that was *under* appreciated that came to be *over* appreciated.

RULE #2. STAY OUT OF TROUBLE.
IN OTHER WORDS, DON'T GIVE IT BACK.

Weitz: The other side of the story — and really where the *majority* of my relative performance in Weitz Value and Weitz Partners Value has come from — has been the

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staying out of trouble part.

OID: That's the toughest part for most people, I think — certainly for me.

Weitz: Well, it was pretty easy for us because we avoid the tech arena. But I think it was pretty easy for *everybody* to recognize the internet bubble. Some just couldn't bear to leave it *alone*. That was the problem. But I don't think it took great genius to miss the craziness of the tech stocks.

OID: Please disregard the OID.COM stationery.

But isn't there plenty of opportunity to be dumb in the so-called old economy, too?

Weitz: Yeah. But what *really* helped in Weitz Value starting back in mid-'99 was to accommodate the Wall Street knee-jerk reaction of selling all of its financials when the Fed was raising interest rates. We just held a basket out and bought Countrywide, Washington Mutual, GreenPoint and North Fork — and a lot of pretty vanilla financials.

Maybe it was really dangerous and we were just lucky to have escaped. But I don't think it was. I think it was an arbitrage between long and short investment horizons — or long and short attention spans — because I don't think anybody really questioned the long-term value of the Washington Mutuals of the world. There wasn't really any question about credit quality because most of these companies dealt with conforming single-family mortgages.

[Editor's note: A theme that has been echoed in the pages of *OID* time and time again — by Warren Buffett and Robert Noel regarding Freddie Mac and Marty Whitman regarding miscellaneous S&Ls, to name just a few.]

Weitz: But I think the idea was that when the Fed starts raising interest rates, they raise 'em several times — and financials always go down. So you better sell 'em and buy something different. Actually, going into the middle of 1999, our cash was up to 30-35% of our assets — and I was wondering what to do with it.

Then they started throwing those companies away. So it was really a matter of going and hiding in what seemed like a safe place — even if it might take three, four or five years for the stocks to respond. But as it happens, nine months later, they responded. And we got 30 points in 2000 against the S&P.

OID: Speaking of hiding in what seems like a safe place, might we ask you about your cash levels today?

Weitz: Sure. At its peak this year, cash levels were about 35-36% for Weitz Partners and 30% for Weitz Value. Our cash today is up around 23% in Weitz Partners and maybe 20% in Weitz Value — despite some cash inflows since that time.

OID: Do you recall what it is in Weitz Hickory?

Weitz: Probably the low single digits. Rick [Lawson] runs fully invested all the time.

OID: On its face, your high cash levels sound surprisingly high for post September 11th.

Weitz: I'm comfortable having cash around. And

when there's that much, I don't really track it that closely — because it's not a worry. If you're running 3%, you need to watch it every day. So Rick pays a lot more attention to his cash balance than I do.

Of course, I'd claim that the cash is strictly a residual [laughs] and not a market timing call. But I'm probably responding subconsciously to the signal of stock prices seeming high, too. That doesn't mean I dislike the stocks that make up 80-85% of the portfolio. Maybe I'm just being greedy and hoping to get things even cheaper.

But I think it is a matter of valuation, not a matter of a liquidity problem. And that's a natural question when one grows as fast as we have. Are you going to close it? etc. And we can talk about that, too.

OID: Only if we expand beyond 64 pages...

[Editor's note: Lawson's fund — Weitz Hickory — is closed to new investors. But the two funds Weitz manages — Weitz Value and Weitz Partners Value — remain open.]

Weitz: In theory, I'd like to be fully invested. And I'd like to have 10 totally different industries represented. But as a practical matter, I've almost always had what looks like a lot of cash by typical mutual fund standards — 10-20% — and had more industry concentration than I would like, although it certainly doesn't trouble me by any means.

[Editor's note: We don't need to note how remarkable that makes his overall returns — both on an absolute and a relative basis — or what it implies about the returns that he's achieved on the 80-90% of his assets which have actually been invested.]

I LIKE TO BUILD IN A LOT OF CONSERVATISM
— IN FACT, I DRIVE MY ANALYSTS NUTS.

OID: One thing I know that our subscribers may not is that you're a master of, shall I say, understatement.

Weitz: Either that or inarticulate.

OID: I suspect you're just trying to be conservative on your valuations. But I don't want it to sound like you're paying 65¢ on the \$1.00 when you're not.

Weitz: I wrestle with that because I know what you want to hear and I know what other people want to hear. But I just don't think it's possible to be all that precise. For example, I'm very skeptical about the predictions that go into discounted cash flow models. On the other hand, if you use a 15% discount rate — as we do — and everybody else uses a 7-1/2% rate, then there's quite a bit of conservatism built in.

Even then, Rick will put something through his model and conclude that it's worth \$40. And meanwhile, I'll say I'm comfortable with a value of \$20.

OID: Do you think he might be able to join us?

Weitz: So if we buy it at \$16, I'm buying an 80¢ dollar and he's buying a 40¢ dollar.

OID: And yet somehow you earn the same return.

Weitz: That's right. We're buying it at the same price. We're simply measuring the value differently. I'm using lower assumptions.

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WEITZ FUNDS'
WALLY WEITZ & RICK LAWSON
 (cont'd from preceding page)

OID: Would you mind holding while I give him a call...

Weitz: And one thing that I don't do explicitly, but that I think is in a way what I'm doing...

Legg Mason's Bill Miller describes looking at multiple scenarios. I believe that he puts it down on paper and has scenarios #1 through #10. And he figures, "Okay, in scenarios #3 through #10, we have a 50¢ dollar or better. So we'll go ahead and buy it." He describes that kind of process in evaluating Amazon, AOL and that sort of thing.

Well, I don't formally calculate 'em and put 'em down on paper. But if I say, "I'm really comfortable that something is worth X," I'm also thinking that here are five other factors that might make it worth a whole lot more. However, I'm just going to know that they're there and hope for the best. I'm not going to quantify it.

OID: Never go into investment publishing.

Weitz: Yeah. It's part of the thought process. I do drive my analysts nuts around here — because I respond to one idea and I don't to another even though in a quantitative way they look the same. Whether you want to call it a qualitative thing, a subconscious element, gut feel or whatever, I'd like to think it's internalized experience. And I'd like to think that there is *something* of value there. But I do tend to neglect explaining what that is.

I'm often asked why I'll buy something I think is selling at well above 50¢ on the dollar. I think the answer is that basically, if you're 100% confident in a valuation that will give you a return equivalent to your discount rate, you can pay 100% of that.

OID: Makes sense.

Weitz: So if we have a 15% required return, and we could buy a Treasury Bond that was yielding 15%, we'd be happy to pay 100¢ on the dollar.

OID: You can bake the conservatism in the value cake in the price you pay or the discount rate you use.

Weitz: Correct. Or in paring back your assumptions for your cash flows before you get to a number.

OID: Absolutely — God forbid.

Weitz: The concepts are the same. It's just that the words are confusing.

OID: Can you summarize your current perspective in a nutshell — in terms of investment themes, etc.?

Weitz: Well, the market had been going down for a year-and-a-half and we were in a recession when 9/11 came along. So as horrible as it was, it was as if we were already marching downhill and somebody pushed us hard from behind so that we fell on our noses. It wasn't a change in direction. For certain industries that were in fragile condition — like the airlines — being pushed on your face might turn out to be terminal. And even if it doesn't turn out to be terminal, it might cause so much dilution because of the form of the bailout that they might never recover as investments.

The planes will fly again and *somebody* will own 'em. But it may be like real estate developments where the second owners often end up being the ones that make the money — although with the airlines, frankly, probably no owners will ever make any money. [Laughs.]

OID: Sounds similar to investment publishing.

Weitz: Meanwhile, I'd felt for *years* as if stocks in general were *already* overvalued. And I know this sounds like a market call, but because of the peculiar arithmetic of the S&P, the draw of indexing and closet-indexing and that sort of thing, I'd felt that there needed to be a bear market or at least a sideways market for a *long* time while the business values grew into their stock prices.

So I've felt as if we've been in a long correcting process and some of the great companies that I'd love to own — like the Coca-Colas of the world and a lot of the old favorites — weren't cheap and *still* aren't cheap.

Others that were on the margin — like some of the banks and thrifts that had rallied this year — got knocked back down 20-30% and got cheap enough again for me to add to those. Then some — like some of the entertainment-related things — *really* got crushed. And they got *very* interesting. So that's where a lot of our cash has been invested post 9/11.

THERE'S A LOT TO BE SAID FOR AMUSEMENT PARKS —
 GOOD MOATS, PRICING POWER, LOW REINVESTMENT...

OID: And today?

Weitz: When you first called about doing an interview, I thought I didn't feel very compelled by my stocks. But when I began to look down the list, I thought, "Gee, *that's* a great price. *That's* a great price. *That's* a great price. And *that's* a great price."

OID: Let's be sure to talk about those.

Weitz: We can do that.

OID: But just in case I'm unable to drag it out of you — and to help keep you from being *too* conservative — might it be possible for Rick to join us?

Weitz: Absolutely....

OID: I understand that you guys believe Six Flags [PKS/NYSE] is a bargain today.

Lawson: We do.

Weitz: Six Flags' stock has gotten crushed.

OID: That sounds like a good start.

Weitz: And it was already weak. Wall Street has gotten so fixated on predictability — earnings momentum, making your number and so on. Six Flags has had a series of quarterly disappointments for Wall Street that, as far as I can tell, have been legitimate onetime items for the most part — like really bad weather last year.

And so the stock was already off its highs. But then it went down a *lot* with the events of September 11th and the fear that nobody is going to travel anymore, nobody is going to go to places where there are crowds that might attract

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WEITZ FUNDS'
WALLY WEITZ & RICK LAWSON
(cont'd from preceding page)

terrorists or whatever. And it also is a leveraged company.

Lawson: The stock is a bargain now because they've had a couple of years of growth slower than they would've liked and slower than the market expected. Last year's disappointing results were mostly related to weather. But they're pretty diversified geographically with their parks. So they're less dependent on weather than someone with just a few locations. But it's an exogenous factor that can affect any single year's performance.

OID: Absolutely. And please feel free to continue while I look up "exogenous".

Lawson: And this year, the economy's been somewhat weaker — and they've seen signs of that. They've particularly done worse than they expected in Europe where they're still getting started and working up to full levels of performance.

So basically, they've disappointed Wall Street the last couple years. And that's what's created the opportunity.

OID: If you think it's a bargain, fire away.

Lawson: I do. Six Flags owns and operates amusement parks in the U.S., Canada and Europe. So let's first talk about what a regional amusement park is — because it's a really interesting business. One of the interesting things about them is that there are *very* few examples of the successful new development of a regional amusement park.

OID: Really?

Lawson: Really. In a small to medium-sized market, it's something of a natural monopoly. And its monopoly area is basically the area surrounding the park from which people can conveniently access it. You don't want to put two in Omaha — you may not put *any* in Omaha because it's too small. But you don't want to put two in Kansas City.

OID: Because the economics of trying to get the second amusement park established within any reasonable proximity of the other are pretty nasty.

Lawson: Right. Getting that second park established is very hard — except in places like Los Angeles and really big cities or big tourist destinations where it may make sense to have several. So as primary demand grows, the first park's going to be the beneficiary.

In contrast, shopping malls' natural monopoly area is much smaller. It's too easy when new suburbs grow around a city for a new mall to make economic sense. So the fact that a population is growing in a town won't necessarily benefit the existing mall.

OID: Very interesting.

Lawson: Therefore, an amusement park generally has a somewhat larger moat than a shopping mall. And once you've established it, if you run it well, you should be able to grow your attendance with population — maybe faster — depending on how established you are. Plus, you have pricing power. So as people get wealthier over time, you can raise prices slightly faster than the inflation rate.

Meanwhile, your cost structure consists of the people to run the rides and the capital you need to put in to keep the place fresh. Those line items can grow largely in line with inflation. So you can grow revenue somewhat faster than inflation and you can grow your profits at a somewhat faster rate still.

OID: A great combination.

Lawson: Meanwhile, the amount of capital you need to put in the ground is growing somewhat more slowly. And that leads to a reasonably fast — maybe 10% or so — growth rate in free cash flow. And that, to me, makes for a pretty interesting business.

OID: No question about it.

But why, then, does Value Line show Six Flags as having capital expenditures in excess of cash flow today and for the next three or four years?

Weitz: Value Line shows Six Flags' capital spending up around \$4-5 per share — or \$300+ million — for 1999, 2000 and beyond. But I can tell you management believes that they're going to be at much, much lower levels than that in 2002 and going forward.

It does get complicated because they buy new parks from time to time. And I would guess that shows up in the capital spending line.

Lawson: They do two things: They buy new parks. And in the process of buying 'em, they often buy a park that is in their view underdeveloped. So they have in their heads when they buy the park that they're going to spend a certain amount to upgrade it to an appropriate level. Therefore, there's a onetime bump in capital expenditures which comes before all of the cash flow. That's just the way the world works — you have to spend the money first to get the people through the gate. And in that process, cap-ex is much higher than what it's likely to be going forward. And I think that's what you see in the numbers.

OID: In other words, the Value Line figures include not only maintenance cap-ex, but capital reinvested for growth.

Weitz: That's right. The chain goes back decades. But they bought the Six Flags parks a few years ago. And they spent a *lot* of money working on those — as Rick describes. They also bought some parks in Europe. And at least what they say is that they're set for awhile.

OID: Interesting. According to their annual report, they have 39 theme parks in the U.S., Canada and Europe.

Weitz: That's about right.

Lawson: It's really developed relatively rapidly over the last 10 or 15 years. They started with a park in Oklahoma City and have made a number of acquisitions over time. However, the largest acquisition by far was the Six Flags group which included several Six Flags parks around the country. Then, following that acquisition, they converted several other parks to the Six Flags brand and upgraded them in that process. So today, something like half of their total parks have the Six Flags brand.

OID: And Value Line points out that they recently bought Sea World in Ohio.

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Lawson: Yeah. They already owned a park adjacent to it. So by owning and managing both, they hoped to have the ability to create a more attractive venue that would generate a higher level of interest than either of those parks had enjoyed historically at that location.

OID: Very interesting.

And yet, on that score, you mentioned the difficulty of successfully starting a second amusement park near an existing one. Is clustering a part of their strategy?

Lawson: As you say, there aren't many opportunities for them to have two parks exactly like these two. However, it's very much a part of their strategy to have a water park next to more of a traditional amusement park.

OID: And has that been a successful strategy?

Lawson: Yeah, I think so. There are all kinds of benefits to having both. You can draw people in from further away. You can have a family group — some of whom want to do one thing and others who want to do another. For example, if you're in Omaha and thinking about driving down to Kansas City for the day, you might be more likely to do it if there are more things to do — if there's both the amusement park and the water park.

OID: You're more likely to achieve critical mass.

Lawson: Exactly. So by having both of them there, you really can create some benefits for both parks.

SIX FLAGS HAS DISAPPOINTED WALL STREET,
BUT ITS FREE CASH FLOW TIDE IS ABOUT TO TURN.

OID: What makes them a bargain?

Lawson: Well, as we see it, Six Flags is generating a rising free cash flow stream that's been hidden by a cycle of heavy capital investment. And we think that the company is now coming to the point in time where their free cash flow stream *won't* be hidden.

Just speaking in rough figures, I think Six Flags is likely to have something in the neighborhood of \$1.00 per share of free cash flow next year. And in the early years, we think that free cash flow stream can grow *very* rapidly. The growth rate will slow down from there. But even then, it should continue to grow very nicely for many years to come for the reasons that we discussed earlier.

OID: Could I ask you what kind of value you come up with for Six Flags?

Lawson: Well, I don't have any problem — if you've got \$1.00 of free cash next year that's growing at a very fast rate in the short run — thinking in terms of a value of 20-25 times free cash. That doesn't seem crazy to me.

OID: Why do you say that?

Lawson: Let me answer you this way: You're familiar with valuing businesses using a dividend discount model. I'm sure you've seen those and know how they work.

OID: Let's pretend Of course.

Lawson: Basically, they take the dividend rate and divide it by the difference between two factors — one being your required return (which is your discount rate) and the other being the growth rate of that dividend. For example, if your discount rate were 15% and you thought a company's free cash flow stream could grow at 10% — as we do here — the difference between those two is 5%. And dividing by 5% is like multiplying by 20.

OID: However, in the example that Buffett presented some years back in his annual report, isn't that multiple only applicable when no incremental capital is required?

Lawson: Again, we're talking about *free* cash.

OID: Good point. In Buffett's hypothetical example, he was using earnings, not free cash. I see, said the blind editor. Thanks for turning on the lights.

Lawson: So I don't have any problem talking \$20-25 a share in the short run. And I think that's probably *low* — because if you're willing to project Six Flags' cash flows out two or three years and discount those cash flows back to the present, you wind up with even *larger* numbers.

OID: What's the order of magnitude of value you get?

Lawson: Oh, I sort of tend to think about Six Flags as a \$30 stock. And I can get higher numbers. But at this point, I don't *need* to. The stock's only around \$14 today. There's not a lot of point...

OID: Obviously, I haven't explained the ground rules. This is investment publishing...

Weitz: And I don't know what book value means to anybody on this one.

Lawson: Because a lot of that book — about \$15 of it — is goodwill.

Weitz: But Six Flags' book value is around \$18.

SIX FLAGS ISN'T DISNEYLAND. TODAY, THAT'S GOOD.
INVESTOR WORRIES ABOUT SIX FLAGS ARE MISPLACED.

OID: How sharp are they as acquirers and operators?

Lawson: I think their track record is very good. They understand that they're in the business they're in. They understand that managing their costs is very important. They've done a good job of buying parks at prices that have proven over time to be good prices. They're able to get the cash flow of their acquisitions up enough that the returns have been pretty good.

In any company like this where you're dealing with lots and lots of consumers and you're trying to balance your expenditures with making consumers happy every time, you end up with some people who don't like them. But I think that they've found the right balance. And if you look at the attendance of their parks over time, you have to conclude that they do a good job.

OID: When their park visitors are unhappy, what is it exactly that they tend to be unhappy about?

Lawson: If you go and look at an online chat room of comments about Six Flags, you'll see consumer comments

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(cont'd from preceding page)

of, "This park was dirty" or "Its concession stands were closed when I was there" or "The lines were too long" — something of that sort.

Weitz: It's not Disneyland. They're not trying to provide the perfect consumer experience. They don't try to pretend that they're Disneyland in every aspect — which is good news and bad news.

Lawson: From the consumer's perspective, I can appreciate the difference and understand the complaints. But from an investor's perspective, I'd much rather own this than Disneyland — because by making that decision, they're able to spend a lot less money and yet still make a lot of people very happy.

One problem with Disneyland is that it's much harder to say that you're going to just level off cap-ex because you really have to go out of your way to convince somebody to make the long trip to come in the first place. If it's not spectacular, why not just go to Six Flags this summer? After all, it's a lot closer for most people and a lot cheaper.

OID: Would you like an advertising rate chart with your invoice?

Weitz: One reason Six Flags' stock took a hit — and way too much of a hit in my view — is that there was a comparison with Disneyland. But Disneyland is a destination resort. So people fly there. In the case of Six Flags, people are coming from 150 miles away at the most. So it's a day trip. And it's probably not affected so much by the fear of travelling.

Yet that may be another reason why the stock's down.

Lawson: Yeah, I think it really is. When you asked why it was cheap, I should have led with that point. People are worried about anything travel related. And I think that their worries are misplaced here. This is a company that will probably benefit, all else being equal, by any propensity of people not to fly — because virtually everyone who comes to Six Flags' parks drives there.

And to the extent that we're in a bad period and nobody's traveling, well, Six Flags' parks are closed right now by and large — except for a little bit around the weekends.

[Editor's note: According to their annual report, more than 90% of park attendance occurs during the second and third calendar quarters.]

Weitz: Yeah. We were joking this morning that it's too bad that Hilton and Host and retailers and all those folks can't just stay closed until next spring and not have Wall Street be upset. That's how Six Flags operates. It's a seasonal business.

OID: Sounds like they operate OID style.

Weitz: No. They're open more than twice a year.

OID: I strongly resemble that remark.

Weitz: We'll find out next spring the impact on Six Flags of people not traveling. But they don't come this time of year anyway. So they're not losing business right now because of the economy or fears about terrorism.

BASED ON ITS EBITDA, SIX FLAGS IS DIRTY CHEAP.
IT COULD EASILY TRADE FOR 3 TIMES TODAY'S PRICE.

OID: You mentioned that you basically value Six Flags at 20-25 times its free cash flow.

Lawson: That's right.

OID: So you're basically assuming \$1.20-\$1.50 per share of normalized free cash flow?

Lawson: I think that's right. We're clearly not going to see that in 2001. But that's how I'm thinking about it. Again, when we project the cash flows out into the future and discount them back to the present, we actually arrive at a much higher value.

OID: Besides free cash flow, what valuation yardstick do you use with Six Flags?

Lawson: We also look at the company in terms of its multiple of enterprise value to EBITDA — which, of course, is Wall Street's favorite yardstick.

And all of those measures have some meaning if you can believe the business model and turn that ratio into something that does eventually relate to free cash flow. And it also has meaning when you look at those numbers for one kind of business and compare them to other related or similar businesses and think about whether the multiple Wall Street is touting is one that we can live with.

OID: When you value Six Flags using EBITDA, what kind of valuation do you come up with?

Weitz: The fully diluted shares outstanding figure for Six Flags is a little fuzzy because of a convertible issue that's outstanding. But for the sake of our discussion, let's assume 106 million fully diluted shares outstanding. There'll be about \$2.1 billion of net debt at year end 2001. And I expect net debt at the end of 2002 to be more like \$2.0 billion. Plus, there's some restricted cash that really is cash.

My guess is that gross cash flow [EBITDA] for 2001 is going to come in at something just north of \$400 million. And I'd guess that next year's gross cash flow would be around \$450 million. Do you think that's a reasonable figure for 2002 EBITDA, Rick?

Lawson: Yeah. That's probably not crazy.

Weitz: And what would Wall Street call a fair multiple — 9, 10 or 11 times EBITDA?

OID: I asked first.

Lawson: That's very hard to say because the transactions that take place tend to be one-offs — for individual parks.

Weitz: And the buyer always thinks that he's going to run it a lot better when he puts his name on it and cuts out the fat. So the transaction price gets stated as one multiple, but the buyer thinks he's paying a lower multiple.

Lawson: In this case, I think of EBITDA multiples more as a way of getting a handle on where this stock might trade — which is a different number than what it might be worth. Given other kinds of businesses, I'd be quite skeptical if somebody assumed that in the short run,

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(cont'd from preceding page)

it was going to trade at 15 times EBITDA. That wouldn't make any sense to me.

But if you told me that over time it's traded in a range of between 7 and 12 or 13 times EBITDA and that it's now trading at closer to 7 times EBITDA, that would tell me that we're close to the bottom end of the historical range.

And then the question becomes whether or not the range is sensible. And that's where trying to think about a free cash flow stream begins to give some sense of what that might mean over longer periods of time.

OID: So using your range of between 7 and 12 or 13 times EBITDA would imply a trading range next year of something between \$11 on the low end and \$36 on the high end.

[Editor's note: Which, of course, we arrived at by multiplying the \$450 million figure for Six Flags' EBITDA by each multiple, deducting the \$2.0 billion of debt and dividing by its 106 million fully diluted shares outstanding.]

Lawson: Yep. That's right. So what's an appropriate EBITDA multiple for Six Flags? Well, just think about the other kinds of entertainment and media businesses and what kind of EBITDA multiples they trade at. Or you can even think about other kinds of businesses of all types and what kind of EBITDA multiples they trade at.

In the case of Six Flags, not all EBITDA gets turned into free cash because they must continue to reinvest capital into the business as well as pay interest and, at some point, taxes.

[Editor's note: From Six Flags' latest annual report:

"As of December 31, 2000, the Company has approximately \$751,468,000 of net operating loss carryforwards available for federal income tax purposes which expire through 2020...."

"The Company's deferred tax liability results from the financial carrying amounts for property and equipment being substantially in excess of the Company's tax basis in the corresponding assets. The majority of the Company's property and equipment is depreciated over a 7-year period for tax reporting purposes and a longer 20-to-25 year period for financial purposes. The faster tax depreciation has resulted in tax losses which can be carried forward to future years to offset future taxable income."

Lawson: But the nature of the business is one with
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some monopoly characteristics that over time should allow it to turn its EBITDA into a pretty healthy free cash flow stream.

OID: Sounds logical. But what's your view about how Six Flags' EBITDA is likely to change over time?

Lawson: The basic way I think about the trend line of cash flow growth is that over time you get a couple percent of increase per year in number of attendees. And then you get another 2-3% in increasing spend by those attendees — from a combination of inflation, pricing power, getting 'em to stay longer, offering 'em new services, etc. Therefore, revenue growth on a same store basis is something in the 5% range. So that's the revenue side.

And then there's room for gradual improvement in operating margins. Therefore, cash flow growth is probably closer to the 7-8% range.

But then their growth in maintenance cap-ex — meaning enough maintenance and spiff here and there to keep their visitors coming back — should be slower than their revenue growth. Therefore, free cash flow growth should be closer to 10%.

OID: Not bad at all.

Lawson: Now that's all trend line. And we're in a questionable environment as we speak. We had an event in the fall that reduced attendance for the last few weeks of the season. We don't know what the economy's going to do next year. You can make all kinds of cases from zero attendance growth to down a couple percent to up a couple percent in 2002 over 2001.

OID: And you can also argue about whether we might have been above the trend line before that event.

Lawson: You can. But I can also make all kinds of arguments on the other side that this is a company that's been in the process of upgrading a number of its parks. And during the year in which it's upgraded, revenues and cash flow tend to fall back a little bit. But then, in the years following the upgrade, the trend line growth becomes somewhat higher as more people recognize that there's something good going on.

They've also had an issue with unusually bad weather. I'm not sure Six Flags is above trend right now. I think that you can argue it both ways.

But the regional park business is not such an economically sensitive business that...

OID: So guesstimating Six Flags' normalized level of cash flow is much more difficult than it sounds.

Lawson: Yeah. I'm not sure I'd feel good about saying exactly what a normalized level is relative to where we are.

OID: Howsabout a wide range?

Lawson: Well, if I had to hang my hat on a normalized level of cash flow, I'd guess that we're somewhat below the long-term trend line — maybe 10% below — for a number of reasons. As for free cash flow, I'd say that because of the big spend that's gone on the last couple of years that's now coming to an end, there's room for free cash flow to grow more rapidly in the short run. And I'd guess that Six Flags' sustainable free cash flow today is well north of \$1.00.

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WALLY WEITZ & RICK LAWSON
(cont'd from preceding page)

WHAT COULD TURN SIX FLAGS INTO A MISTAKE?
ITS BUSINESS PROVING TO BE WORSE THAN I THINK.

OID: *I'm sorta shocked — because I was very skeptical on this one. But I think you've almost managed to convince me. But just to play devil's advocate, I don't see much in the way of insider buying.*

Lawson: No. I don't think they've gone out of their way to buy additional shares. But they already own a lot. They have a lot of options — many of which are reaching the point of maturity. Therefore, a couple of years ago, they exercised and sold some of them. However, they definitely own enough to care.

Weitz: The chairman and CEO, Kieran Burke, owns a couple hundred thousand shares.

Lawson: But that's just direct ownership. Six Flags' proxy shows Kieran Burke and CFO James Dannhauser owning approximately 1 million and 530,000 shares, respectively. In the case of Burke, that consists of the 200,000 shares that Wally mentioned plus options to buy close to 800,000 shares. And Dannhauser owns 60,000 shares that are directly held plus options to buy an additional 470,000 shares.

OID: *That sounds sufficient to focus most minds.*

Lawson: I think so. Plus, they each own additional restricted stock — another 300,000 or 400,000 shares — not to mention other options to purchase 350,000 shares that haven't yet vested. So they care about the stock price.

OID: *If Six Flags turns out to be a mistake, what do you think the reason is likely to be — aside from a prolonged period of depressed economic activity or people not going to amusement parks, exacerbated, of course, by their leverage?*

Weitz: Debt always reduces flexibility, but for all the reasons that we've discussed, we're reasonably comfortable that debt won't be a problem for Six Flags.

Lawson: The key question that needs to be answered over time is this idea that the amount of capital they have to spend is less than they *have* been spending — and that you can spend that amount and continue to grow the business. They need to be able to ratchet down cap-ex and continue to grow revenue. If indeed it turns out that over time that doesn't work, then the economics aren't going to be nearly as good as we expect.

OID: *Anything else?*

Lawson: I think there are *always* things that could happen in *any* situation. So if it's a longer list you want, we can give it to you.

OID: *If it wouldn't be too much trouble. We were thinking about a 64-page edition, after all.*

Lawson: There's always management screws up — they make big acquisitions that don't work...

OID: *Which isn't such a remote risk in a company like Six Flags that's actively making acquisitions.*

Lawson: That's right. And to the extent that it's a management intensive business, that's a risk, too.

OID: *But it's not something you worry about because of your opinion of management and their history.*

Lawson: Exactly. And I don't worry a lot about technological risk. But it's certainly possible that there could be so much improvement in virtual reality technology that people don't bother to go to amusement parks. But that's not something I worry about either. It could happen — but I don't think it's very likely.

OID: *No other obvious Achilles heel?*

Lawson: None that I see.

YES, SIX FLAGS LICENSES ITS CHARACTERS.
BUT THAT'S NOTHING TO WORRY ABOUT EITHER.

OID: *Can you tell us where Six Flags ranks in the theme park business?*

Lawson: In terms of total attendance system-wide, they're a solid #2 behind Disney. For calendar year 2000, Disney's attendance was 89 million versus 46 million for Six Flags. Well behind those two is Universal with attendance of about 24 million and Anheuser-Busch with attendance of about 20 million.

And of those four, Six Flags is the only company that licenses the characters it uses in its amusement parks.

OID: *So they don't own their character set, if you will.*

Lawson: That's right. They license them from AOL/Time Warner. But it's a very long running license.

OID: *Does Six Flags face what some might call extortion risk at some point? Is its license renewable at some set rate or fixed formula or is it wide open?*

Lawson: Well, Six Flags' exclusive rights run through 2053. So it still has a little over 50 years left. And the fee it pays is fixed until 2005 and then subject to periodic scheduled increases payable on a per theme park basis.

OID: *That is a good long time. But the language sounds like it could mean just about anything.*

Lawson: It does. But given that it doesn't show up in the income statements and given that their margins are pretty high, I don't worry about it a lot.

And I think it would be an interesting negotiation in *both* directions. Yes, Six Flags derives value from using the Warner Brothers characters. But there's also value derived by AOL/Time Warner associated with having all those characters out there being seen and constantly refreshed in the mind of the consumer. I think there are benefits to both sides — which makes the negotiation a little easier.

Plus, Six Flags not only has the AOL/Time Warner characters, but also characters from Hanna-Barbera. And although it's controlled by AOL/Time Warner, I don't think the license renewals necessarily come due at the same time.

OID: *Equally important, is the agreement onerous, cheap or somewhere in-between?*

Lawson: It's definitely not a big number. My memory

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is that the license agreement was negotiated during the time when Time Warner was selling Six Flags. Nobody was going to buy an asset like that without a license agreement that they felt comfortable with. And although I can't tell you exactly what the fee was, as I recall, it's a small number.

OID: For now.

Lawson: And given that they negotiated something that they could live with long term, I feel quite confident that it's not onerous in the longer run.

[Editor's note: Very shortly before we went to press, we learned that the license fee is a flat \$2.5 million per year through 2005 and, as Lawson informed us, "will be subject to periodic scheduled increases and will be payable on a per-theme park basis."

We believe Lawson is correct about future escalations in Six Flags' licensing fee not being onerous for the following reasons:

First, Time Warner sold its remaining 49% interest in Six Flags to Premier Parks (the predecessor to today's Six Flags) for about \$475 million in cash. Had the license agreement been onerous in any way, it's unlikely that they would have been able to get that high a price.

Second, the fee was a small number initially. And the language describing the increases makes it sound like the increases aren't so onerous either.

Third, were its licensing agreement unfavorable, Six Flags would probably not be retooling its other parks to utilize the characters licensed thereunder.]

OID: What are the odds of AOL/Time Warner deciding they want to start their own parks or buy Six Flags back — possibly under some duress of their own making?

Lawson: As I mentioned earlier, Time Warner was the owner at one point. And I think that there is a natural combination there. So it wouldn't shock me at some point to see AOL/Time Warner buy Six Flags. But there's nothing in the short term that makes that look like it's going to happen — at least not in most normal people's investment horizon, although it could easily happen in ours [laughs].

OID: Do you have any sense of the latest thinking of AOL/Time Warner in terms of whether they would prefer to own the theme parks in which their characters are used or whether they like the idea of having somebody out there aggressively promoting and building parks using their characters?

Lawson: There are advantages both ways. You clearly want to have lots of those parks with your characters out and about. On the other hand, it's such a different business than the business of making movies or the other things that AOL/Time Warner's involved in. The capital needs are different. The management challenges are very different. It's a much more management intensive business. So I think the ideal world is a way where you control it, but you let somebody else do the dirty work.

OID: Sort of like McDonald's or Coke.

Lawson: Yeah. And that ideal world almost never really exists in the real world. So you swing back and forth in how you think about it as to whether you'd rather have the control or whether you'd rather have the advantages.

But I have no real insight there. There are two things I can add: First, AOL/Time Warner is still at a stage where it's trying to find itself corporately since it's just gone through such a big merger. Second, AOL/Time Warner's Co-COO is Bob Pittman — who earlier in his career was in charge of Six Flags.

OID: Really?!

Lawson: Yeah. So he knows a lot about it. But I don't have any particular insight as to whether or not he'd like to get it back again.

MORE IMPORTANT THAN THE SIX FLAGS BRAND
IS A MANAGEMENT AND A BUSINESS WE LIKE.

OID: One thing we didn't discuss was Six Flags' brand. And just based on a quick glance at the annual report, it looks like there might be some value there.

Lawson: I think that there is. They started life as Premier Parks not doing as much with their brand. But since they acquired Six Flags, they've been doing more. They know they have a brand that has some national — even some international — recognition. And they're trying to take advantage of it. So they've been converting parks to the Six Flags name as they've been upgrading them.

And it's certainly not a *bad* thing. But I think of that as being less significant than some other factors — because in most of their markets, there isn't a lot of competition. So the brand isn't really differentiating between a Six Flags park and the Brand X park. Therefore, in my mind, it's not the most critical factor.

OID: On the other hand, in the latest annual report, management mentions rebranding their parks and thereby garnering huge increases in attendance and per capita spending.

Lawson: Yes, you're right. And there are examples where that's certainly been helpful. They do think of brand building as part of what they're trying to do. So I'm probably underplaying that factor, but...

OID: You or Wally actually underplaying something? That's hard to imagine.

Lawson: [Laughs.]

[Editor's note: We read Lawson a portion of the following excerpt from Six Flags' latest annual report:

"(W)e were especially pleased by the strong market reaction to our newly branded Six Flags parks. Those four, which included our first two international Six Flags parks in Holland and Mexico, enjoyed spectacular full seasons with year-over-year growth of 43% in attendance, 66% in revenues, 16% in per capita spending and over 100% in park level cash flow.

The strong response to the brand internationally is very exciting, particularly in Europe where we own several parks and have a very significant opportunity for both internal and external growth using the brand and our licensed characters. Our European parks performed very well in 2000. Total

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European attendance in 2000 was in excess of 6.7 million people, with year-over-year revenue growth of 9.5% and EBITDA growth of 79% on a constant currency basis.

Establishing Six Flags as an internationally recognized brand will clearly accelerate the growth of our European parks and enhance the overall value of our Company."]

Lawson: That's right. Absolutely. That is part of what they're doing. But I guess all I'm saying is that rebranding is not just changing the name. It's putting a lot more attractions into the park. It's spending a lot more on advertising. It's doing a lot of things to the property.

OID: So it's management plus branding.

Lawson: Exactly.

OID: Even better.

Lawson: So what they're doing is smart. And it's working. But it's sort of a onetime bump. Then the object is to sustain the new level of attendance they generate. You can't keep doing it over and over again to each of your 39 parks. You can do it once to most of them. But some of 'em are just too small and not capable of being upgraded to the point where you'd want to make them a Six Flags.

So yes, that is something they can do. And to the extent that they're developing new parks, they'll try to take advantage of it. It's a good thing. But as I think about how the company develops going forward, that's not the critical factor in my view.

OID: What is? The monopoly characteristics...

Lawson: Exactly. The monopoly characteristics and how well they manage it, etc.

OID: But those figures sound like they reflect well on the brand and the management.

Lawson: I think so.

OID: And I'm not sophisticated enough to discern between a well written, promotional annual report and good management...

Lawson: Are any of us?

OID: I'm counting on you.

But what they're doing sounds very impressive — in terms of their EBITDA margins, revenue growth, etc. — in what they describe as a difficult environment.

Lawson: We are very comfortable with management. We think they're doing a good job. I don't disagree. But the proof will be whether or not they can continue to get good attendance without spending as much on cap-ex.

DEPENDING ON THE APPROACH THAT WE USE,
WE CONCLUDE ADELPHIA TRADES AT 35-55¢ ON THE \$1.

OID: According to Portfolio Reports, Wally's been buying Adelphia. Have you been buying that one, too?

Lawson: Oh, yeah... I have. It's definitely at a point where it's very interesting. I think it's very compelling.

OID: So both of you think Adelp~~h~~ia's [ADLAC/Nasdaq] a bargain?

Lawson: Oh, yeah...

Weitz: ...in spite of many things. Adelphia, on a statistical basis, is cheaper than the other cable stocks. And it's cheaper than the others because it has flaws that scare investors — like more leverage and a family ownership structure that gives them complete control. So most investors fear that they may have less of a chance of cashing in eventually via a takeover.

OID: Because there are two classes of shares.

Weitz: That's right. But that's pretty typical.

Lawson: That's very typical in this industry. And for reasons that we'd be happy to go into, that's not something we worry about.

OID: What's the fundamental valuation aspect that you find so attractive today?

Lawson: There are lots of ways to think about the value of a cable system. You can value it on a per subscriber basis. You can value it relative to cash flow. You can value it based on a discounted cash flow model that looks out and estimates the amount of free cash that's likely to be generated and discounts that back to the present. Or you can do it based on private market values — which are often themselves based on cash flow or value per subscriber.

When you go through those kinds of analyses on a company like Adelphia, the numbers I'm comfortable with — and [laughing] we'll see whether or not Wally is comfortable with those same numbers or not...

Weitz: [Laughs.]

Lawson: But in my mind, the valuations for Adelphia sort of start at roughly \$50 per share and go up from there.

Weitz: And the stock's at \$28.

OID: And I see that Adelp~~h~~ia's stock price has been as high as \$87.

Lawson: Yeah. So there have certainly been times when people thought private market value was a more meaningful number than they think it is today. And if you can believe that any of those numbers have meaning, there's a lot of room here. I think the real question is how you think about those various numbers and whether they truly have meaning.

OID: Could you give us an idea of how you arrive at your valuation?

Lawson: Sure. It looks to me like Adelphia has EBITDA for 2002 of something north of \$1.6 billion. So if you were just to take \$1.6 billion and give that a multiple of 16 — which is definitely below what the multiple for a cable company has been historically — that would give you an enterprise value of \$25.6 billion. If you then take out Adelphia's debt — which I think will be about \$14 billion at year end 2002 — that leaves you with an equity value of about \$11.6 billion. And then when we divide that by the

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250 million fully diluted shares that we estimate Adelphia will have outstanding at that time (which includes both the conversion of some of its convertible debt to equity and some additional issuance of shares), that implies a value of about \$46 per share.

OID: What does that equate to per subscriber?

Lawson: I've got pro forma subscribers for year-end 2002 of about 5.9 million. So that would be about \$4,300 per subscriber.

OID: How does that compare to transactions that have taken place recently in that industry?

Lawson: Transactions have definitely taken place at prices that are higher than that.

Weitz: Yeah.

Lawson: Comcast is bidding a little over \$4,000 per subscriber for AT&T — but those are *bad* subscribers because they're not generating very much cash flow.

OID: Well, I hope that they're sending 'em to bed without their HBO...

Weitz: And I think it's pretty well acknowledged that the right price even for those properties ought to be at least \$4,500 per subscriber. If AT&T were to say, "I think \$4,000 is too cheap, but \$4,500 is the right number", I think Comcast would accept it and go on. But again, those are less attractive subscribers.

[Editor's note: Indeed, on December 19th, AT&T's board reportedly accepted a sweetened offer from Comcast for its cable segment which valued its subscribers at almost exactly \$4,500 each. A valuation of \$4,500 per subscriber for Adelphia would imply a value of something north of \$50 per share.]

Weitz: But one problem with looking at transactions on a per subscriber basis is that different systems at different stages of their development might look like they're selling at a higher or lower multiples of cash flow or higher or lower prices per subscriber, but not be comparable. And that's even more of a problem where systems haven't built up their cash flow yet.

OID: What can you tell us about the penetration and buildout at Adelphia?

Lawson: Their buildout is a little bit behind the absolute leaders. But by the end of 2002, they should be virtually caught up. Some systems will be done this year. There are going to be more done next year. And Adelphia's not one of the leaders, but they're not that far behind.

OID: And their penetration?

Lawson: In their absolute penetration cable-wise, they're pretty comparable to others. But that metric has become less important these days because penetration is a measure of how many subscribers relative to the number of homes your system passes. And these days, that's less important because the growth in cash flow is increasingly coming from the rollout of new services — cable modems,

video-on-demand, digital cable and, eventually, telephony. So more important is how far along they are in the process of adding these new services.

OID: I'll bite. How far along are they?

Lawson: Because they've been a little bit behind in getting their system upgraded, they're also a little bit behind in terms of how many cable modem subscribers they have.

OID: Which suggests that they have an above average opportunity to improve their cash flow.

Lawson: Exactly.

[Editor's note: In its projections, *Value Line* seems to expect the same kind of dynamic. It shows the cash flow generated by the cable industry increasing by something over 77% between 2001 and 2004-2006, whereas it shows Adelphia's cash flow per share increasing by a factor of more than 3-1/2 times — from \$1.65 to \$6.05 per share — despite some mild dilution.]

OID: And that your valuation of \$50+ is in no way a pie-in-the-sky number.

Weitz: That's right.

Lawson: I don't think it is. For example, if you look at where the cable companies were trading this summer... Let me read you an excerpt from an analyst's report that calculates the cash flow multiples of some of the leading companies at that time: Charter was at 16.6, Cox was at 18, Comcast was at 15 and Cablevision was at 16.

[Editor's note: And it looks to us like those multiples were at a multiple year low — at least a 3-year low — at that time.]

Lawson: Therefore, for me to suggest that Adelphia's private market value is at least 16 times cash flow doesn't strike me as being very aggressive at all. Certainly, it isn't relative to what we've seen in terms of comparable stocks trading recently.

OID: What's the range of what you come up with?

Lawson: I don't feel like I have to stretch a tremendous amount to get up to \$80.

OID: I consider myself pretty flexible, as well. But how can you stretch all the way from \$46 to \$80? Wouldn't that be nearly \$5,800 per subscriber?

Lawson: Your math is probably about right. I get there by working with longer-term discounted cash flows. That isn't necessarily where the transactions would take place today. But I don't think it's an inappropriate price.

[Editor's note: Again, that conclusion would seem to be consistent with *Value Line*'s projections for rapid growth of cash flow at Adelphia over the next three to five years.]

ONE REASON ADELPHIA IS SO CHEAP —
A LIABILITY THAT USED TO BE AN ASSET.

Weitz: And I agree that the value is \$50 and more. But the amount of leverage in a company like Adelphia that's been very aggressive in acquiring other companies

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and taking on debt *justifies* a larger margin of safety.

OID: Yeah. According to Value Line, Adelphia has something like \$14 billion of debt.

Weitz: Plus, it has a *very* complicated structure.

Lawson: Yeah. One of the things that's going on here and one reason why the stock is so cheap is that Adelphia controls a company called Adelphia Business Solutions [ABIZ/Nasdaq]. And ABIZ is a company that people would call a troubled CLEC [Competitive Local Exchange Carrier]. They're moving forward with their business plan, but they're not yet to the point of having free cash flow. And they're not to the point where they have a clear path to reaching break-even cash flow. That's not something we like.

And Adelphia controls ABIZ in such a way that, from an accounting perspective, causes all of its debt to be consolidated on its own balance sheet. But they're only responsible for a relatively small part of it. Most of it, they're *not* responsible for.

OID: Equally fascinating, it looks like there's actually been a lot of insider buying recently at ABIZ.

Lawson: Yes, there has. And ABIZ may well turn out to be a wonderful business. It's just not one that's front and center about how we think about Adelphia or one that we would want to be buying on its own at this point.

Weitz: Incidentally, part of the reason why Adelphia sold in the '80s awhile back was public excitement about its CLEC business. Adelphia spun out a small part of ABIZ to the public. That's why ABIZ is publicly traded. And it sold at some very high number.

OID: North of \$60 per share, it looks like — versus closer to 60¢ today.

Weitz: And on a per share basis for Adelphia, that was some significant number. But we never mentally gave the company much credit for that in our valuation. We really focused on the cable values. And we thought that was being conservative. But now, it turns out that it may have a *negative* value to Adelphia. And I think part of the confusion and fear on Wall Street is that some people are afraid that there might be some *growing* negative value.

But as we talk to the company, we think that there's about \$500 million of ABIZ debt that Adelphia is responsible for — which is about \$2.50 per share.

Lawson: More like \$2.00 on its fully-diluted shares.

OID: And presumably, it's not growing.

Lawson: Correct. ABIZ's debt may be growing, but the amount that Adelphia is responsible for is not.

OID: Gotcha.

Lawson: So if ABIZ were just to disappear from the face of the earth and Adelphia were to pay off the \$2.00 per share of debt, then the public wouldn't subtract any more than that for it.

But that's not the case today. And they've been under a lot of pressure from Wall Street to separate the two and

make it clear to shareholders that ABIZ is not an ongoing problem. And they're working on ways to isolate it. However, they haven't accomplished that yet.

IF YOU WANT TO UNDERSTAND ADELPHIA,
THE PLACE TO START ISN'T VALUE LINE.

Weitz: The only way to start talking about Adelphia is to start talking about the cable industry generally...

OID: The one-page summary in Value Line won't cut it?

Lawson: My guess is that you'll find that Value Line is not very helpful with a cable company.

Weitz: A common theme in our investments seems to be that we buy things that Value Line doesn't help you understand very much.

Lawson: There's a lot of stuff we could talk about in terms of the cable industry. But the short summary is that we think cable is a good business. And we think about how good a business is based on its cash flow, not on its reported earnings.

The cable industry is pretty much dominated by entrepreneurs who had it in their heads that they wanted to maximize value — and quickly understood that paying taxes was a bad way to maximize value.

OID: Albeit a good way to stay out of jail.

Lawson: They don't think it's *necessary* to pay a tax. And they go out of their way to make *sure* that's the case.

Weitz: Although with Adelphia, you might say that they haven't exactly ever faced a great *threat* of having a tax liability...

Lawson: [Laughing.] Well, that's true, too.

OID: Because they've never been in danger of earning any money.

Weitz: That's right. All of these cable companies spend up front and have high depreciation charges. But Adelphia's been more aggressive in terms of its leverage than some. So other cable companies have come closer to being taxpayers than it has.

OID: But how much of that is discretionary and how much of it is just the nature of the industry?

Lawson: I think the industry's accounting is fine. A cable company is made up of a bunch of cable operations. For example, there's a cable operation in Omaha that's run by Cox. Adelphia has operations in a number of cities on the East Coast and elsewhere across the country.

But if you think about any single cable operation and what that business is like and you go through the math of how much money you have to spend to build the system and upgrade it over time and how much cash flow it generates, the reported depreciation and amortization on a typical cable company's income statement overstate the true costs associated with running the business.

Cable companies become *more* valuable over time, not *less* valuable. So amortization of goodwill is really headed in the wrong direction. And depreciation I think, is also too high in many cases. The returns they get on their investment are very high.

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OID: You just can't see it for the accounting.

Lawson: Exactly. It represents another example of why the reported earnings are less important than the long-term cash generating ability of a business. Incidentally, one reason why depreciation is overstated is that the cost of upgrading goes down over time as technology improves.

OID: On the other hand, isn't it an open issue whether or not the need to stay up with changing technology ever ceases — or even slows down?

Weitz: It's true that cable companies over the years have thought that they had completed their final upgrade only to find that they needed to do another one. And that has been disappointing.

But if the industry had finished whatever level of upgrade they were doing in the early '90s and had never gone on to the next level of upgrade that was required for cable modems — digital and that sort of thing — they probably could have had a very good, positive-cash-flow-generating business. They just saw an additional opportunity to offer even more kinds of products.

So at some point, once capital expenditures eventually do level off and decline, the true earning power of these companies will eventually begin to show through.

OID: But it's not exactly like it's optional, is it?

Lawson: What's been happening is that they keep finding good, new things to invest in. The important distinction between this business and others that constantly have to upgrade is that there are not an infinite number of competitors in this business.

OID: Just an increasing number as technology advances...

Lawson: There really isn't even an increasing number. One can quibble about exactly how many there are. But if you're talking about video services, I can only think of three or four. And a couple of those aren't very strong. One possibility would be to try to provide video services through a telephone line — through the twisted pair that connects to your telephone.

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OID: Maybe. But let's leave my family out of it.

Lawson: The phone companies have talked about doing that for years — but they aren't doing it. And basically, they aren't doing it because they can't.

OID: Sounds like a good reason.

Lawson: Another possible competitor is satellite. That's the most real of their competitors. And we can talk about some of the strengths and weaknesses related to that.

Then, the third possibility is what we refer to as overbuilders — where somebody comes along and, in effect, builds a brand new cable system to compete with the cable system that's there. Sometimes that's done by a telephone company — or by somebody like an RCN.

OID: An RCN?

Lawson: RCN Corporation and other overbuilders go into areas where there's a cable provider already providing service and lay down totally new infrastructure.

OID: Laying down cable where there's already cable!?

Lawson: You've got it. It is happening some places. It's not happening everywhere. And it's unclear how well it's going to do — whether those systems will still be here 10 years from now. Their history's been very spotty so far. But they could represent real competition at some point.

OID: What can you tell us about how well they've done to date?

Lawson: They've been struggling. They've built out systems. They've signed up some customers. But thus far, there haven't been a lot of signs that they've been able to hurt the cable companies that they're competing with.

There was a period a couple of years ago when companies like RCN were finding it very easy to raise capital and were announcing bigger and bigger plans for all the places they were going to overbuild. But of course, that's no longer the case — because capital is no longer available. So if there ever was a window, it's closed. They'll continue to work on the places where they've already built. But those are few and far between.

OID: So you don't worry about the overbuilders.

Lawson: That's right. They're signing up some people. So you can't say they're not getting any customers. But it's real hard to see how it's having an effect in the cable systems' numbers.

OID: Interesting. Maybe that's because cable systems are almost like electronic newspapers — in effect, a natural monopoly.

Lawson: That's not a bad analogy.

TECHNICAL SUPERIORITY + DOMINANT SHARE
MEAN THAT CABLE'S AHEAD TO STAY.

Lawson: But it used to be a real natural monopoly. However, over the last 10 years, cracks have developed in that picture. On the other hand, it used to just be a television business. And now there's an awful lot of evidence that people can and will do a number of different,

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new things with that infrastructure.

OID: *Kind of like newspapers — where once they have the paper going to the home, things like sale circulars and coupons get added — only better. That cable into the home gives cable companies a natural advantage in a number of businesses.*

Lawson: Absolutely.

Weitz: Cable lost one of its advantages over satellite when the satellite companies were allowed to begin broadcasting local stations in local markets. That happened in the last year or so. When they couldn't do that, satellite subscribers couldn't get their local TV stations.

Lawson: But at the same time (also in the last year), the cable companies have rolled out digital cable — which requires a new box, but allows a number of new channels and basically provides a product that is fully competitive with satellite TV. In the old days, a typical cable system might offer 30 channels of programming. With digital cable from the cable companies — which is a product that requires both an upgrade of the cable plant and a new box in the subscriber's home — they're able to offer hundreds of channels. That package is effectively fully comparable with what the satellite companies are able to offer.

So I think there was a period of time a couple of years ago when you could argue that for some cable systems, the satellite offering was superior to the cable product. But that's no longer true.

OID: *Agreed. For whatever it may be worth, it's my impression that digital cable is now superior.*

Lawson: You can get arguments both ways. And I'm not suggesting that on a pure television basis, cable is a better product than satellite. There are enough subtle differences that reasonable people can differ.

OID: *Just out of curiosity, what are the arguments for satellite being superior to digital cable?*

Lawson: One of the arguments has to do with the nature of the digital that is being used. Some people argue that the satellite provides a better picture — because it uses an algorithm that captures more of the data.

OID: *Is that your perception?*

Lawson: No. But I can't totally discount it either. In any case, I haven't heard a lot of evidence that there are a lot of people who choose one or the other based on picture quality. But I do hear the satellite companies say that their picture quality is better.

Another argument is that there are some exclusive packages available on satellite that haven't been available on digital cable.

OID: *For example, sports packages.*

Lawson: Exactly. However, on the digital cable side, there are a number of potential advantages, too. One is this issue of local programming. Though satellite is offering more local programming in more places, it isn't as complete as you can get from cable. So if you're in Omaha,

I doubt very much that you can get all of the local stations on a satellite dish. In New York, you probably can. But it isn't ubiquitous yet. And it probably will be very difficult for it to become ubiquitous because it takes up so much satellite bandwidth.

OID: *Very interesting.*

Lawson: And to the extent that you want products that require interactivity — that require sending data back and forth between the home and the provider — cable will always have an advantage because they have a back channel that works easily. Satellite has tried to develop some back channels, but they are inherently more difficult to provide in the satellite architecture. As a result, the satellite companies often resort to using telephone lines for their back channel. But that's obviously less than ideal.

OID: *And doesn't cable enjoy an advantage in terms of total bandwidth?*

Lawson: It does from a *practical* standpoint because each cable system has what you might call a tree and branch architecture. So you can treat each node separately — and depending on how the architecture is built, there are between 250 and 1,000 homes per node. So basically, you're able to do something unique for those 500 homes on that node.

In the case of satellite, you're trying to cover the entire country. So there are several million subscribers who are all working off the same system.

OID: *So that relative to digital cable, at least, satellite has a stopped-up node.*

Lawson: If they're trying to show the same thing, satellite has plenty of capacity. In fact, satellite has an advantage where all you're doing is sending the same feed to lots of places.

OID: *In effect, broadcasting.*

Lawson: Absolutely. But once you start trying to send different things to different places or once you start to get into two-way interactivity or get into sending data back, satellite has a problem. In that area, satellite's at a tremendous disadvantage.

OID: *So satellite is competitive in terms of traditional cable service. But in terms of broadband internet and telephony...*

Lawson: It has much more of a problem. And even when it comes to traditional cable services, to the extent that you want to have your local television stations, it becomes an issue. They can handle the biggest cities pretty easily. But as you get further and further afield, there are hundreds of local TV stations in this country. And trying to broadcast all of them from one satellite...

OID: *Why can't they just put up more satellites?*

Lawson: Because they get in each other's way. There are only so many slots you can put a satellite up into in a geosynchronous orbit. If you put 'em too close, they interfere with each other's signals.

OID: *So it's a bandwidth issue.*

Lawson: That's right.

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(cont'd from preceding page)

OID: For whatever it's worth, what you describe is exactly the case in our area. Satellite seemed like a no-brainer. But digital cable came along and seems totally superior — except for uncomfortable delays waiting for the channels to change.

Lawson: Yeah. But a new, better digital cable box came out recently. So the risk from satellite is real in that it will take some of the subscriber growth away from the cable business that it otherwise would have gotten. But it won't have a big enough impact to make all that much of a difference in how cable looks going forward.

OID: So it won't reduce traditional cable systems' total number of subscribers.

Lawson: That's right. And given that most of the growth is coming from the addition of new services to existing subscribers, the presence of satellite competition won't really make the cable story any less powerful.

OID: And it sounds like a case of once you're ahead...

Lawson: Exactly. Because cable already has 65% of the available households as subscribers, it's a lot harder for satellite to make a dent.

OID: And it's those superior economies of scale and leverage that enable the cable systems to put together what represents a superior package from the consumer's perspective.

Lawson: That's right. That's the real issue here — plus the technological superiority via the back channel.

CABLE IS AN UNDER APPRECIATED INDUSTRY
WITH UNDER APPRECIATED CASH FLOW POTENTIAL.

OID: How do you expect to get paid in Adelphia — greater fool theory aside, of course.

Weitz: We don't count on that, but it often comes into play before the others do — like a couple of years ago.

Lawson: However, putting that one aside completely, there are two ways you get paid in this business: First, discounted cash flow analysis... Cash flow continues to go up. Cap-ex peaks out and goes back down. And as that dynamic plays out, lots of free cash gets generated and rational transactions reflect that free cash generation. So you're not counting on a greater fool coming along if somebody is paying a reasonable price for the company.

OID: Do you have any kind of time frame in mind?

Lawson: Lots of people look at the cable business and say that there'll never be free cash flow. And I think the reason that everyone is so skeptical is that there has been a major upgrade of the infrastructure.

OID: And here I thought it was just because there never has been any free cash flow in the past.

Lawson: No, that's not true. A number of cable companies *have* generated free cash flow in the past.

Some of them have even had *earnings*.

OID: I had no idea.

Lawson: But more often than not, those dynamics have been hidden — either by an aggressive willingness to make other acquisitions or to invest in new things or a balance sheet that reflects the underlying power of the business.

OID: Some would say "counts on" the underlying power of the business.

Lawson: But the problem the cable companies have had is that they've had to upgrade first and get paid later.

OID: That's going to change?

Lawson: I think so. As *this* upgrade is completed, it's going to be more of a sell the product and then spend a little bit of cap-ex and get cash flow at the same time. So this "waiting for tomorrow" problem will be much less of a problem going forward.

It looks to me like the expectation is that this year's cap-ex will be up slightly from last year's. Then it's supposed to begin dropping dramatically. Do you have those numbers, Wally?

Weitz: Yeah. I believe management has talked about \$1.8 billion in 2001 and 2002, \$500-700 million in 2003 (including their upgrades) and then \$150-200 million for maintenance annually thereafter.

OID: Wow.

Weitz: The idea is that once the upgrade is complete, if you're delivering the service over a fully upgraded system, the maintenance on that system on an ongoing basis should be *very* low. No cable company has ever gotten to that point *yet*. But that's what management expects.

Of course, that's just for pure *maintenance* cap-ex. When a cable system adds a new subscriber or when an existing subscriber signs up for a new service, there is a capital outlay involved. That's what some people call "success-based" cap-ex — because it's being spent to enable a given subscriber to pay you a monthly revenue stream.

OID: Which is good news.

Weitz: It's *great* news — because it's a relatively small outlay made to receive a high return annuity.

Lawson: Right. And that means Adelphia basically reaches break even cash flow in 2003 even when you consider interest expense. From there on, with an increase in cash flow and a continued moderation of cap-ex, it's pretty easy in our spreadsheets to get big numbers of free cash flow pretty quickly over the next few years past that. We realize that it's not here today. But it's not so far out that it's ridiculous.

OID: When you run your discounted cash flow analysis, what sort of numbers do you come up with? I suppose the assumptions are really anybody's guess.

Weitz: Yeah.

Lawson: You can come up with all *kinds* of things. We think about it more in terms of what generally makes sense. And combined with that, what's going on with the situation? Is this likely to be a place where you have a

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stock that is under appreciated? And if it happens to be an *industry* that's under appreciated, all the better.

And I think we probably have both of those things going on. There are too many reasons for people to not like cable — we've talked about a lot of 'em — and there are too many reasons for people to not like Adelphia for this *not* to be an interesting situation.

ADELPHIA'S LEVERAGE IS CERTAINLY A NEGATIVE.
BUT THERE ARE OVERWHELMING POSITIVES, TOO.

OID: *What could turn this one into a mistake — aside from a sustained horrible economic environment, technological developments that bypass cable or an overly harsh regulatory environment?*

Weitz: I don't view economic risk being as much of a risk here as I do in almost any other kind of business.

Lawson: Yeah, I would agree with that.

Weitz: It seems to me people *like* their television. They'll keep paying their cable bill. And that's what happened in the last recession.

Lawson: Also, the new products being rolled out are so compelling that I just don't see cable going away. They may come out more slowly. But they're not going to stop rolling out or shrink.

OID: *And you feel like the competitive advantage that they have technologically can withstand regulatory stupidity and new technology.*

Lawson: I do.

Weitz: Yes. I worry more about the absolute volume of debt and debt service — that because of their leverage, their expenses turn out to be higher and last longer and the take rate on new services turns out to be lower. If that happens, the positive spread that we think is going to get wider over time may not materialize in time to keep the lenders from taking it away. But maybe a more likely risk is that it could just lead to dilution of the equity — that they have to issue more shares before they reach the promised land. But that's the case anytime a company has a highly-leveraged balance sheet.

OID: *Is there anything else you worry about?*

Lawson: There's *another* dynamic in this industry that's either good or bad depending on how you think it all plays out. This is very much a consolidating industry. I'm quite comfortable that if there *weren't* family control, this company would be an acquisition target of a number of players in the business. So at one level, that gives me some comfort that if they get in trouble, there's somebody else out there who would be willing to step up and buy it.

The concern, I guess, would be if company management were to say, "We know that's out there, but we don't want to sell today because this isn't a good price" — and they do some interim things that, as Wally says, dilute the equity or let them get into a weaker position. My concern is just that over time, they make a number of

incremental steps that take away some value and end up having to sell at a price that is much more than where the stock was, but isn't much more than what we paid for it. To me, that's a more likely scenario of how this doesn't come out well.

OID: *And the huge debt levels could make relatively short-lived stupid regulation near fatal or fatal.*

Lawson: That's right.

Weitz: It's always fragile. And the more leverage there is, the more fragile it becomes.

Lawson: Yeah. We haven't talked about the regulatory environment. And that has at times been a real bugaboo for the cable industry. But I look around at the various kinds of forces that might lead us to think that it could be a problem. And I just have a hard time seeing a new set of regulations that would cause trouble for the industry — at least over the next few years.

Obviously, it's always a theoretical possibility. But it just doesn't look like it's anywhere close as we look today.

OID: *Based on consumer satisfaction, the availability of basic cable at very low rates, a relatively market-oriented administration and Republicans in the majority in the House of Representatives.*

Lawson: And the fact that there's an understanding that improving telecommunications connectivity and getting broadband access to the home is a good thing. There are a lot of different forces that suggest to me that taking away the cable business from the cable companies is not something that's on the mind of the regulators.

Weitz: And a healthy cable industry provides competition for the telecom industry — which the government seems to be interested in promoting.

And there's recurring revenue from the subscriptions, the churn is low and business changes from year to year are minor — all of which makes it less subject to a discontinuous event than someone with the best disk drive one year that gets eclipsed by a new product the next year. So we're more willing to accept a more leveraged balance sheet from a stable consumer products company like this.

WE EXPECT TO HAVE OUR SHARES TAKEN AWAY,
BUT WE'RE NOT WORRIED ABOUT THE PRICE.

OID: *Have you sold shares at higher prices?*

Lawson: Yes.

Weitz: We have.

OID: *Might you give us some idea of how many shares you sold and at what price?*

Weitz: Boy, I don't remember.

Lawson: Neither do I.

OID: *Just roughly speaking.*

Lawson: Well, I remember that I was selling when it was much closer to its peak. I'm sure I didn't top tick it — I never succeed in selling right at the top. But when the stock was in the \$70-80 range, it didn't feel to me like it was cheap enough to own as much of a position. But even

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at *that* point, it didn't feel like *overvalued* — at least to me. So I wasn't trying to get out completely. I just wanted to own less.

OID: What about you, Wally?

Weitz: I just did what I generally do — which was to add to the position as it went down and sell into the strength and continually pare the position as it went up. So I wouldn't be surprised if I was selling stock in the \$40s and \$50s and \$60s and \$70s — and probably starting to buy it back in the mid-\$30s. And of course, that stock would be underwater now.

Lawson: We might even have begun buying it back at higher prices.

Weitz: Yeah. But at the same time that Adelphia was going from \$5 to \$80...

OID: To \$87, but who's counting.

Weitz: ...Century and Comcast were doing the same thing as were TCI and MediaOne — and we owned 'em all. So from my point of view, I can remember having cable as a group starting to push 30% of the portfolio. And therefore, on general principle, we were selling some of *all* of 'em.

OID: So one negative is that if the stock were to go to \$87, you'd probably sell your position.

Lawson: I can live with that negative. [Laughing.]

Weitz: I don't think I'd still own it at \$80 — at least given the set of facts that we're looking at today.

Lawson: But I imagine the set of facts that the world would be looking at would be different.

Weitz: Yeah. Part of what was happening when the stock was in the \$70s and \$80s was that these companies got a little bit of internet fever. It was at the time when anything that could give somebody internet access or do telecommunication services got a little extra dose of hysteria.

OID: A little extra?!

Weitz: At least a little. I can remember when we were in the selling mode describing to clients how we were the beneficiary of people paying what seems to be the wrong price for the wrong reason — and, therefore, that we were going to accommodate 'em.

OID: Is there anything that we didn't talk about with respect to Adelphia that we should have?

Lawson: I think the only other point is that we believe the ultimate end to Adelphia is that it will be acquired by some other company. And that will not be a bad transaction for us — because I suspect they'll sell it at a good price. Although we can make all of the numbers work and we'd be perfectly happy to hold it forever, I'd be surprised if we're still holding it five years from now because I think it'll be sold by then.

OID: Which wouldn't be the worst news in the world — at least at the numbers you're talking about.

Lawson: That's right.

OID: At what price would you be indifferent between holding it and selling it given today's fundamentals?

Lawson: My sense is that what I'm willing to take will be less than what the controlling family is willing to take. [Laughing.] So I haven't tried too hard to figure out exactly what that number is.

OID: What do you think they'd be willing to take?

Lawson: I don't know. But I would be surprised if it weren't closer to \$80 than \$50.

Weitz: And it would have to be in a currency that they'd want to hold — because they'd be getting a *lot* of it and they wouldn't want a tax problem.

OID: Given your assessment of the likelihood of a transaction at some point, how much do you worry about there being two classes of shares?

Weitz: The extreme case that I remember well is Resorts International when the super-voting shares got a price that was something like two or three times what the other shareholders got.

OID: I remember. It was outrageous.

Weitz: It was *really* outrageous. I don't picture that kind of thing happening in today's world.

Lawson: In today's world, to feel like you're getting nicked is almost part of the picture. But there have been enough precedents where the premiums were 10% or 20% that I think it would be pretty hard for them to squeeze much more than that out of something like this.

OID: Given your fiduciary responsibility to your shareholders, given today's fact set and given that this is investment publishing, at what price would you think it would be a fair transaction?

Weitz: In part, it depends on the currency. If we could get \$60 worth of Comcast stock and we liked Comcast, we might be content taking \$60 — even though we might think it was worth more. And in part, it depends on the alternatives.

Lawson: If we felt like we could take the money and we thought that there were a bunch of other things that were worth buying, we might be happy to get the transaction done and go somewhere else.

OID: Would you be happy at \$60?

Weitz: I'd accept it.

Lawson: Probably...

Weitz: He'd sigh and fuss — and accept it. [Laughs.]

Lawson: [Laughs.]

LIBERTY MEDIA IS SIMILAR TO BERKSHIRE
AND SELLS WELL BELOW ADJUSTED BOOK.

OID: Are there any others you can tell us about?

Weitz: Liberty Media's definitely been on our buy list.

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OID: And you still think it's a bargain today?

Weitz: I *definitely* think it's still a bargain.

Lawson: Oh, yeah. That one's owned and believed in very much by both of us.

OID: Then time's 'a wastin'.

Weitz: Liberty Media [LMC.A/NYSE] is a portfolio of both public and non-publicly traded media and entertainment properties managed by the master of the media content industry with a small but growing European cable business. I think of it as a closed-end fund of media properties with a terrific portfolio manager, John Malone.

There's a lot of guesswork that goes into valuing all of the individual parts. You have public market values on some of them — that we usually don't really agree with. But I would say that the sum of the parts is still something in the high teens. And the stock trades at about \$13.

OID: What's so exciting about that?

Lawson: Well, if you do everything on the basis of the total market value of Liberty's publicly-traded holdings plus our best estimate of the value of their private pieces, as Wally said, we come up with \$18 per share total.

Weitz: About half public and half private. A little more than \$9.50 per share is comprised by publicly-traded pieces. Then we estimate that they own about \$9.00 per share of private assets. And from that, when we net out their pro forma cash, their pro forma option proceeds and other cash less pro forma debt, we get a negative 50¢. That's how we arrive at our \$18.00.

OID: My pulse has yet to quicken.

Lawson: However, there are two key questions: First, how do you look through to the public market value on all the pieces? If you simply take their public market value, something in the high teens is probably right. But if you believe the market is undervaluing things like News Corp. and Sprint PCS and USA Networks [three of Liberty Media's public holdings], then the discount is even larger.

OID: And you think the market is undervaluing them?

Lawson: We do.

Weitz: And if you want to dream about what Malone will do with Liberty's cable properties...

Lawson: ...in Germany...

Weitz: ...in Europe...

Lawson: Then you get an even *higher* number.

OID: Dream away, please. And remember that this is investment publishing. So be sure to round up.

Lawson: Sure. I don't have a hard time getting a valuation for Liberty in the mid-\$20s when I start looking through to the private market values of all the pieces. So that's probably the kind of number I would use.

BUT A COMPANY LIKE LIBERTY MEDIA
IS WORTH *MORE* THAN ADJUSTED BOOK.

Lawson: But there's another aspect here that's important, too. If you look at the history of this company, the value has grown at rates well in excess of normal discount rates. That's been a function of several things. One is the quality of the underlying businesses. The underlying value of the Discovery Channel, for example, has been growing very rapidly for a long time. Another has been Malone's ability to add value by buying and selling and otherwise doing things that make sense. And there's a long history of that.

So if you think about *those* factors, I think one could argue that the underlying value today is in a sense sort of like book value.

OID: In effect, adjusted book value.

Lawson: That's right. And if you have a business that's growing value rapidly, you should pay *more* than adjusted book value for it.

OID: Similar to Berkshire.

Lawson: Yeah. There are some similarities.

Weitz: Agreed.

Lawson: Wally started by describing Liberty as a closed-end fund. And you could argue that over the years, this has been *better* than a closed-end fund in that the manager has owned a lot of private, wholly-owned subsidiaries. And he's been able to do things with them that you couldn't do if you were just a portfolio manager.

Weitz: Yeah. I think Berkshire's a much better analogy than a closed-end fund.

OID: Less the insurance company wrapper.

Weitz: That's right. But it's like Berkshire in the sense that there are operating businesses that the management can add some value to and where the relationships of one company in the portfolio to another can add value as well.

OID: And although you don't get the very well run insurance wrapper and, therefore, the low-cost float, you do get somebody who's willing to discard...

Lawson: Right.

OID: ...and play a more active hand, if you will. So there would appear to be offsetting benefits.

Lawson: And from *my* perspective, at least, if you look at some of the businesses within Berkshire, you would conclude that they're high return, high-free-cash-flow-generating businesses, but that they don't necessarily have high return reinvestment opportunities for that cash flow.

OID: I think Buffett says as much.

Lawson: And that has definitely *not* been the history with Liberty Media. There have been *lots* of high return reinvestment opportunities — which is a clear advantage.

OID: That sounds like a very important point.

Lawson: Absolutely.

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ANYWHERE NEAR THESE PRICES,
THE ODDS ARE IN OUR FAVOR.

OID: *Rick, you mentioned earlier that when you look through to the underlying value, you have no trouble getting to a number somewhere in the mid-\$20s.*

Lawson: That's right.

OID: *Why are you more optimistic than Wally — congenital factors aside?*

Lawson: The way I round up here is more a function of how long you think they can grow underlying value at, 20% per year — and what do you pay for that?

OID: *I asked first.*

Lawson: It doesn't take many years of that kind of growth and very much in the way of a multiple to get a much bigger number than what we're talking about.

OID: *Yeah, 20% here, 20% there — before you know it, you're talking about real money.*

Lawson: Yeah. And I don't have those numbers in my head — because given Liberty's size, it's going to be harder to grow rapidly for a long time. But it gives me a lot of comfort that at anywhere near these prices, the odds are in our favor.

OID: *What's the current market cap?*

Weitz: It's \$35+ billion.

Lawson: Depending on exactly how you count them, there are something like 2.8 billion fully diluted shares outstanding. And it's trading at around \$13 today. So it's not a tiny company anymore.

OID: *It owns stakes in some not-so-tiny companies, too, I gather.*

Lawson: Right.

[Editor's note: The top three "available-for-sale" securities are AOL Time Warner, Sprint (PCS Group) and News Corp. The top three investments in affiliates (using the equity method) are Discovery Communications, USA Networks and QVC — all as of 9/30/01.]

OID: *Is there net cash or net debt in the parent?*

Lawson: There's been net debt. And it's been growing somewhat with the investment in Germany. It looks like there's roughly \$10 billion of debt and \$3 billion of cash. However, Liberty's debt is pretty small relative to its assets.

OID: *I guess that everything's relative.*

When in the cable industry...

Lawson: And a lot of the debt is directly related to individual assets on a non-recourse basis. But most of the value at Liberty is on the programming side, not on the cable system side.

IN EUROPEAN CABLE, THERE'S A LOT TO LIKE.
HOPEFULLY, MALONE WILL WORK HIS MAGIC.

Weitz: I don't really know how to put a number on Liberty Media's German cable assets. But one of the historical things about Liberty is that John Malone started off with TCI as a cable operator and got involved with the programming side. And he had subscribers to deliver to new programmers. So he could develop a close relationship with the new programming companies.

And that's how he got to control a long list of programming assets — which is what Liberty is now. But over the years, as he built up TCI and decided that other people were willing to pay a high enough price, he sold out the cable properties, split off the media properties — and that was Liberty.

Now it looks as if he is doing something akin to recreating a TCI over in Europe inside Liberty by paying very low prices per subscriber for cable assets over there. Mind you, to a certain degree, it is apples and oranges — they're not the same as American subscribers.

OID: *No. I imagine they watch a lot more soccer. And given how much cable companies are creatures of regulation, I imagine not.*

Weitz: And the prices that subscribers pay for the service is very low. I think Malone paid \$5 billion for something like 10 million subscribers — or \$500 per sub.

Lawson: That sounds right.

OID: *Or about 1/9th or so of what those assets would appear to trade for in the U.S.*

Weitz: Yeah. But it really is apples and oranges. You really can't say, "He's going to buy 'em at \$500 and sell 'em at \$4,500."

OID: *No problem. It's more convincing if you say it.*

Weitz: But over the course of 10 years or something like that, the European market may come to be more like the American market. There may be an arbitrage there.

OID: *Can you give us a sense of the cable business over there — just in passing, I mean?*

Weitz: [Laughs.]

Lawson: It really varies a lot from jurisdiction to jurisdiction. The German regulatory market has a weird regulatory structure with several levels of participants. And I don't want to even try to give you a full explanation of how it works — because I don't think I understand it completely myself.

But there is more available free TV. So the propensity to pay a lot to get more channels is less fully developed at this point. And I think that's partly a function of the regulatory structure and partly a function of the availability of free TV.

OID: *With much of that free TV being state owned or state sponsored...*

Lawson: That's right. It has been historically. And one of the things that's going on is that the governments are getting out of that business.

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OID: Which I imagine would be one reason among many to expect their industry to look more like ours over time.

Lawson: That's correct.

OID: Also, it seems logical to expect programming to develop.

Lawson: That's right. What tends to happen in various jurisdictions is that there's a little bit of a bootstrap between distribution and programming. At first, there's not much of either. But along comes somebody who wants to do more distribution — and they find that they need to help create more programming to drive more penetration of their distribution network.

OID: In effect, to give people a reason to subscribe to the cable service.

Lawson: Exactly. And once they've got more success in creating compelling programming, that then helps create more interest in distribution. So more programming leads to more distribution. And more distribution leads to more programming.

OID: Sure — just as more eggs create more chickens and more chickens create more eggs.

Lawson: Exactly. And it just takes awhile for all of that to work through the system...

OID: And thereby develop a more and more robust cable system — absolutely.

Lawson: What's a little different at *this point* is that if you've got a cable infrastructure that's not particularly upgraded, but that has some capabilities, you can begin to offer new services. So there's an expectation that Liberty will be quicker about offering cable modem services than the Germans have been up to this point.

OID: Because they've done it before, solved those technological problems, gotten practice doing it in the U.S. and so forth and so on.

Lawson: That's right. And as we've demonstrated around the world, there really is a demand for high-speed broadband data access.

OID: Absolutely. There's no question about it. (Remind me to ask you what that means later.)

Lawson: And as that process works out, it has the benefit of exposing the plant to more people — which helps further drive the video distribution.

OID: And in terms of public policy, it's logical that governmental/regulatory authorities will favor cable because that infrastructure gets built up without any expenditure on their part.

Lawson: That's right.

Weitz: On the other hand, if you think about Liberty in terms of a \$20 per share value on 2.8 billion shares, the value is roughly 85% programming, 10% German cable

and 5% other non-programming assets. So it's not a very significant part of Liberty overall at the moment.

Lawson: That's right. The non-programming assets only comprise about \$3 per share of Liberty's value today. Besides its German cable, its other primary non-programming-related asset is Sprint PCS. And it's worth about \$1.00 per Liberty share.

Included within the public pieces are AOL/Time Warner and News Corp. — both of which are programming. And then USA Networks has lots of pieces, but it's *mostly* programming. And then there are some small pieces that add up to well less than \$1.00 per share.

OID: In which case your enthusiasm for Liberty's German cable assets seems all out of proportion to their current contribution to Liberty's value.

Lawson: That's true.

OID: Is that because Malone is aggressively adding assets in that area or what?

Lawson: That's part of the reason. It's where they're making investments.

Weitz: Actually, of Liberty's \$9.50 or so per share of publicly-traded stocks, most of that is hedged out and will be turned into cash over the next year or two and be redeployed. Again, a primary part of the story in our view is trusting management to redeploy the capital well.

Lawson: So they're growing that portion. And the reason why we think that's good is that a lot of the value added that Malone has been able to generate over time has been from taking advantage of the synergies between programming and distribution.

Weitz: So the German cable is a potential extra if Malone can reproduce some of his past success in building a cable system and capturing value in programming assets that wind up getting built around those systems.

OID: The TCI model — and you're hoping he'll replicate it in Europe.

[Editor's note: Lawson informs us that during the final 15 years of its existence (ending in 1999), TCI's stock went from under \$2 to close to \$70 adjusted for splits. That works out to something north of 25% per year.]

Lawson: I think he's already *started* to replicate it internationally. He doesn't control the cable assets yet in Germany. So he hasn't been in a position where he can. But in England and Japan, he owns both programming *and* distribution. And he's been able to generate additional value out of the programming *because* he owns the distribution.

Weitz: And there's another wrinkle to the European cable, too. There are several cable companies in Europe that are *very* highly leveraged. Malone's made investments in them and joint ventures with them in recent months and quarters. And he's been careful to have Liberty's investment be high enough in the capital structure that he stands a chance as a creditor of ending up owning some of the properties.

At any rate, one way or another, Liberty stands to consolidate various European cable systems.

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WEITZ FUNDS'

WALLY WEITZ & RICK LAWSON
(cont'd from preceding page)

WHAT COULD TURN LIBERTY INTO A MISTAKE?
GOOD QUESTION. I DON'T HAVE A GOOD ANSWER.

OID: *With apologies in advance, I notice that you guys have paid well above today's price — at least up in the \$15 range, I believe.*

Lawson: Yep.

Weitz: We've paid all different prices over the years. It's something that we've held for years as a core position almost all the time.

Lawson: Since the early '90s. I think Wally has shares with a cost basis of \$1.45 that he purchased in 1991.

Weitz: That's right. And I paid in the high teens during the fall of 1999. Then I sold most of my stake at* much higher prices when it got a little dotcom fever in the spring of 2000 (in the high \$20s) and paid up again — up to something around the \$20 range — on its way down in the fall of 2000.

And Rick's timing has been even better than mine recently. He sold *all* of his shares — most of them in the spring of 2000.

OID: *Congratulations. But when you bought it up around \$20, what was your investment rationale? And might we ask whether your valuation then was similar or higher?*

Lawson: We were thinking of the valuation as \$25-30 — and we were still pretty happy with it.

Weitz: We must have had a number in the low \$30s. But it turned out not to be a sustainable number — at least in the short run.

OID: *What caused the decline in your valuation?*

Lawson: Well, in a company like Liberty, we're trying to guesstimate value by guesstimating the value of a long list of companies that includes News Corp., AOL and others. And we've never been huge fans of AOL. So we've never given it a huge premium. Therefore, we've tended to think more in terms of market value on that piece. And that market value, of course, has come down considerably, as have the values of pretty much all the public pieces. But interestingly, we believe that the value of the private pieces has held up pretty well.

(continued in next column)

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OID: *If Liberty Media doesn't work out, what do you think the reason is likely to be?*

Lawson: Good question. [Pauses.] Frankly, I'm struggling to come up with a good answer. The only way I can even *try* to answer that question is to suggest the possibility that the underlying assets, because they're getting bigger and bigger and face a slower growth world, may prove to be less valuable or grow more slowly than we expect.

OID: *But you think that's highly unlikely.*

Lawson: I do.

OID: *Anything else?*

Lawson: The investment track record that Malone's had the last couple of years has been mixed. There have been investments in things that haven't worked.

Weitz: He strayed into the telecom world a bit.

Lawson: None of them have been particularly large. And none have had a major effect on the overall value. But people look at 'em at say, "Well, he got that one wrong."

OID: *The concern being that he's lost his touch.*

Lawson: Exactly. So another possibility would be that Germany just doesn't work out and that a *lot* of things he does just don't work.

Weitz: If you want to think dire thoughts, you could imagine him borrowing a whole lot of money and doing a *very* large acquisition in Europe that ended up failing. That's not something *we* expect. I think some other cable companies have taken on a lot of debt and are struggling. But Malone is pretty coldhearted about making sure that he doesn't bet the entire farm.

OID: *So you don't worry about that either.*

Lawson: We really don't.

Weitz: That's right. Malone is somebody we trust to allocate the capital and build the assets over time.

PROGRAMMERS ARE MISUNDERSTOOD BY INVESTORS.
THEY'VE ALWAYS BEEN CHEAPER THAN THEY LOOK.

OID: *Why then is Liberty Media cheap?*

Lawson: I think there are several reasons. First, it did get painted with the dotcom brush. And as that's gone from being a very good thing to a very bad thing, I think that there's been an overreaction. And there is a concern that Malone has lost his touch.

I think that there's also been a lot of skepticism about Germany. There's a tendency for Wall Street to believe that Liberty's German cable properties are a bad thing rather than a good thing.

OID: *Wow. The Street views it as a liability and you view it as a wonderful asset. One of you is right.*

Of course, since you're not paying for it...

Lawson: That's right. Of course, none of us are experts in German cable — because we're not there.

OID: *Feel free to call anytime.*

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WEITZ FUNDS'
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Lawson: Also, this company is *complicated*. And it's *always* been relatively complicated. You don't have earnings that you can simplistically apply a multiple to.

OID: Now there's a negative.

Lawson: Also, for years, Liberty Media has been a tracking stock of one company or another. And I think that there's been a tendency for it to get discounted for that reason. Those are the reasons that come to my mind.

Weitz: Also, there are a lot of developing companies in there — like the Discovery Channel. And as they get to the point where they're generating free cash, that free cash gets reinvested into other new things like Animal Planet, the Learning Channel [TLC] and so on and so on.

[Editor's note: A press release from Liberty Media dated November 13th provides some idea of their position in programming generally and in the position of its 50%-owned Discovery subsidiary in particular:

"In October ... the Discovery Channel (became) the world's most widely distributed television brand, now reaching over 400 million households worldwide in 155 countries and territories."

"For the 10th year in a row, Discovery Channel is the #1 major cable network in which nonsubscribers are most interested — sweeping all demographic categories measured (in a Beta Research study). Among emerging networks, Discovery Health Channel, in only its second year measured in the study, ranks #1 in all demographic categories and #1 (for the second year in a row) in interest.

"For the ninth consecutive year, Discovery Channel is the #1 Television Network Brand in Overall Quality, according to results released recently in the Equitrend 2001 Study. Bolstered by the strength of the Discovery brand, Discovery Science Channel debuts in this year's study as the #2 Television Network Brand in Overall Quality, followed by TLC at #3.]

Weitz: So there aren't any GAAP earnings. Therefore, for traditional growth stock investors, it doesn't have earnings that you can point to. And traditional value people can't point to its low P/E or low price to stated book.

Therefore, you have to believe that the value of Liberty's media properties is real and that it's growing — and that Malone will continue to hatch more of 'em.

Lawson: Going back almost 10 years, when I first started to try to understand this company in the form that it took at that point, the main assets were really developing programmers such as Discovery. And I remember thinking, "Geez! The multiple that people are ascribing to this business is *huge*! How can they give this company such a big multiple?!" (It was a mid-20s kind of multiple or something like that.)

OID: And the answer?

Lawson: It took me a while to realize that it really wasn't nearly as bad as it looked. What tends to go on in these businesses is that at any point in time, you have a channel that is actually making money — that has positive

cash flow — but they're also working on something new that hasn't yet reached that point. So the total cash flow is the sum of a positive number and a negative number.

Well, the positive number can continue to grow with virtually no reinvestment of capital required. And the negative number has to be fed for awhile. But then it eventually turns positive. So there's value on both sides.

And if you apply some multiple to the positive number and some positive value to the negative number, suddenly the overall multiple really isn't that large. I think people still don't understand that dynamic by and large. And I think that misunderstanding causes them to just conclude that something's too expensive when it really isn't.

[Editor's note: According to Portfolio Reports, besides Weitz Partners Fund and Weitz Value Fund, five other managers who we currently monitor — Delphi Mgm't, Nicholas Co., Oakmark Fund, Roxbury Capital Mgm't and Errol M. Rudman — had Liberty Media among their top 10 purchases for the quarter ended 9/30/01.]

OID: Wally, would you like to explain why Rick's wrong?

Weitz: No. I think somebody who *did* disagree — or who was being skeptical — would say that if you keep having new negative projects, you'll never get out of the hole. So it is important that you have a high success ratio. And Liberty Media has had a high success ratio.

Lawson: They sure have. Somebody did an analysis that looked at all of the investments that Liberty's made in its various forms over the last 15 years. And they concluded that those investments had a weighted average internal rate of return of 31%.

OID: Wow!

Lawson: That'll work.

OID: It certainly works for me.

Lawson: It works for me, too. But I would argue that it's *very* unlikely that they'll get the same kinds of returns going forward that they've managed in the past. And I say that partly because of their size and partly because they're no longer feeding off the largest cable system in the U.S. That gave them the ability to do all kinds of interesting things that were value-creating. However, the basic underlying value of these businesses is likely to continue to grow very nicely.

OID: So despite a few apparent recent missteps, Malone seems to know what he's doing.

Lawson: Absolutely. He understands his businesses. He knows what makes 'em tick and how to get the most out of 'em. He cares very deeply about creating and maximizing value. He really does think many steps ahead. And he's *very* good at creating value.

In fact, aside from Warren Buffett, I can't think of anyone I'd rather have allocating my assets than Malone. Certainly, there's no one in *this* area I'd rather be with.

LESS EXPOSURE TO ADVERTISING DOWNTURN
 AND GREAT RETURN/GROWTH DYNAMIC BOTH.

OID: I suppose another reason why Liberty is cheap —

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assuming it is — is that media companies in general aren't exactly in great favor today.

Lawson: Well, the advertising business is definitely challenging right now. And yes, that does make people question anything that has an advertising component. So I think it's fair to say that media companies in general have fallen out of favor.

Weitz: That's right.

Lawson: I can't do numbers off the top of my head, but Liberty Media is less dependent on advertising than many of its media peers. And that's just a function of the mix of its businesses and where their revenues come from. A typical cable channel gets roughly half of its revenue from subscription fees. That, in and of itself, makes the cable programmers less sensitive to advertising than radio where *all* of the revenue is advertising based.

In addition, Liberty has stakes in businesses like QVC that are not advertising-based businesses. So the mix is less sensitive than that of many media properties.

OID: But what's likely to happen to programmers' subscription and advertising revenues in the future is an interesting, if complicated, question. Could you tell us a little bit about the way that deal works today and your thoughts about how it's likely to change?

Lawson: Well, generally speaking, the cable system pays the programmer — Discovery, for example — on a per subscriber basis for everyone who gets to see its channel. Then the programmer gives the cable system the right to sell a portion of the advertising minutes available. But most of the advertising is sold by the programmer — and that revenue goes directly to them.

So the question of what happens to that subscription revenue over time is really a complicated question of what happens to media businesses generally and what happens to television and whether people will continue to desire to see *Discovery* and whether, in effect, they'll be willing to pay for the right to see *Discovery* by paying to get cable.

OID: And the relative bargaining power of the programmers versus the cable systems. It sounds like it would be similar to the relationship/struggle between ever-evolving distribution channels and branded product companies.

Lawson: There are some similarities. And as the distribution becomes able to handle more and more individual channels, you fragment the market across more possibilities. So it's a little unclear — at least to me — who ends up with more power over time.

OID: But you wouldn't have gone broke historically investing in Wal-Mart or Coca-Cola.

Lawson: That's right. And I don't see anything that's likely to quickly change the basic balance of power. I don't see the subscription fees that *Discovery* is able to garner drying up anytime soon. Their growth rate may slow down. But they're not going away.

Weitz: But let me add a couple of wrinkles to that.

There are more and more channels. So the bull case for the programmers is a shortage of quality programming. That could be a plus for the Liberty Medias of the world.

Also, some kinds of programming have gotten a lot more expensive — whether it's because of sports salaries or the cost of producing movies. And that could be a negative because the buyers could begin to balk at the price.

OID: On the other hand, it sounds like a case of what Buffett means when he says, "Once you're ahead, they're not going to catch you."

Lawson: I think there are some of those dynamics here, with some of those businesses. Once you're the *Discovery Channel* and you have the share of mind they do and their programming capability, you benefit from a virtuous circle. You can produce better programming which means that more people watch it which leads to more revenue which leads to better programming and so on and so on.

Weitz: And you get spin-offs like *Animal Planet*.

Lawson: And then they expand it around the world so that they can reuse the programming in many places and continue to create a higher quality experience for more and more people. So it really does feed on itself. And it is hard to imagine how anybody catches 'em at this point.

Also, these are very high return businesses. They tend to have very little need for capital expenditures — reinvestment or whatever you want to call it — to support their *existing* cash flow streams. Yet the cash flow streams have a natural tendency to grow pretty fast.

And again, on top of everything else, you have reinvestment opportunities in equally attractive businesses.

OID: Not to mention that these businesses are a play on rising standards of living — although I imagine that you can probably say that about most businesses.

Lawson: But there are some businesses that do that better than others. And I think leisure businesses tend to do that better than lots of others because rising standards of living get multiplied into more leisure dollars.

OID: Whereas you're only going to buy so much food.

Lawson: That's right.

WE LIKE THIS DICTATOR JUST FINE
— AND HE LIKES THIS STOCK.

OID: All of the preceding positives aside, I gather that there are two classes of shares at Liberty Media.

Lawson: That's right — and super-voting control.

OID: And the super-voting shares are owned by...

Lawson: Malone. However, as I mentioned earlier, that's a very common setup in cable and media businesses.

OID: Yeah. I see that you guys seem to be willing to live with that same problem in Washington Post.

Lawson: Yeah. There are *lots* of examples. You can point to a number of companies where that's going on. And when you have that situation, we just think that you have to recognize that that's the reality and ask yourself whether you like the management. Is it one you

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understand where you trust that management well enough to be comfortable with that situation?

If you can answer those questions in a positive manner, then you go ahead. And Malone in particular has a very good, long-term track record of creating value. We also have an example of how he used the super-voting shares that he owned with TCI. And the answer is that he got a premium for them — but it wasn't an egregious premium.

OID: How much of a premium was it?

Lawson: As I recall, it was something like 10% or 15%. It certainly wasn't 50%. It was in the same zip code. So yes, having two classes of shares is a potential disadvantage. But at the same time, I think it really does free up management to truly think about the long term if that's what they want to do. And I think this is a management that wants to do exactly that. So it's my sense, on balance, that it's not a bad thing.

OID: An enlightened dictatorship, if you will.

Lawson: Exactly. So if you don't like the dictator, then forget it. But we like him just fine. We're comfortable that it's a reasonable trade-off in this case.

OID: Finally, what can you tell us about insider ownership at Liberty Media?

Lawson: It's very large. He's been transferring his assets from AT&T stock to Liberty Media.

OID: And I believe that I noticed insider buying...

Lawson: Yeah. There has *definitely* been insider buying at Liberty Media — and it's been large.

MAIL-WELL HAS DISAPPOINTED — A LOT.
BUT AT 4 TIMES RECOVERY EARNINGS...

OID: What about Mail-Well [MWL/NYSE]?

[Prolonged silence.]

OID: There's no need for you guys to fight each other to take credit for it.

Weitz: You want to tell him about Mail-Well, Rick?

Lawson: Well, Wally and I both own a lot of Mail-Well. But I don't know how much we want to dwell on it.

OID: That bad, huh?

Lawson: It's one of those companies that has been hurt by the economic environment. And I'm pretty comfortable that it gets better again. But it's sorta hard to put numbers around it to prove it.

Mail-Well has a lot of potential once the economy turns. Right now, its business is weak. But I think its valuation is just fine. And I think that it will prove to be very cheap as the economy turns.

OID: With our apologies in advance, might we ask

your average cost?

Lawson: Oh, it's *much* higher than the current price.

OID: That's a good start.

Lawson: Yes, it is. It's probably *really* cheap today.

OID: Can you give us a thumbnail?

Weitz: I'll take a crack at it. We first got interested in Mail-Well when it was a growth stock that had disappointed growth investors and had come down a lot — like from the \$20s to the \$10-12 range, I think.

OID: Versus something like \$4.50 today.

Lawson: That's right.

OID: I feel your pain.

Weitz: At that time, it was a consolidation story. Here was a company that was in a very prosaic industry — envelope and commercial printing — that was buying a lot of its competitors, streamlining its operations, cutting costs and capturing a growing share of the market. And as I see it, some combination of having underestimated their problems when we bought it — involving integration and so on — and worsening conditions after that made the disappointments continue.

So at each step along the way, we sorta reassessed and decided that at \$8 and \$6 and \$4, it still seemed to be worth a lot more than that new price. So we stuck with it. And we added to it down in the \$4s and \$3s.

OID: Boy can I relate.

But it sounds like you didn't foresee the whole anthrax thing coming...

Weitz: [Laughs.]

Lawson: Definitely not. It's not *totally* clear to me whether that's going to wind up being a negative or a positive for Mail-Well. That very sad event for America could result in people being willing to pay more to buy envelopes that are clearly machine processed and not somebody's handwritten note. It just depends on how that all develops over time.

OID: Do they offer see-through envelopes?

Lawson: In fact, they *do*.

Weitz: Mail-Well representatives were in the news just recently talking about them.

Lawson: We don't have TV here. So we don't see those things.

Weitz: Yeah. We don't watch that stuff.

OID: No wonder you've done so well.

Weitz: I suppose that'll be a factor in the short run. More importantly though, under previous management, they borrowed a lot of money to make a lot of acquisitions. They had been *very* aggressive about going out and buying other companies that make envelopes, do commercial printing and so on and they took on a lot of debt to do that. Their idea was that by being big, achieving economies of scale, eliminating some competition and so on, they could be a survivor — the champion — over the long run.

However, in the meantime, with the economy having slowed, that cyclical has hurt their earnings. And that's

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been compounded by the debt that they've taken on in the process of making all these acquisitions — including a *huge* acquisition they made a little over a year ago.

But fortunately, now there's new management that has religion.

OID: *And presumably, that religion doesn't promise a place in paradise for managers who ratchet up debt and blow up their balance sheets.*

Weitz: No. They want to rationalize their operations, get out of a couple of the businesses, sell assets and pay down their debt. And they have a plan that they've laid out for Wall Street that shows them getting back to earnings of \$1.00 or more in a few years. And they've indicated that they think that's very *conservative*.

OID: *Yeah. But I thought publishing five times a year was very conservative, too.*

Weitz: And we think that it's all very plausible, too. We just don't know if it's going to *happen*.

Lawson: And we could easily argue that they're being *overly* conservative.

OID: *Argue away, please.*

Weitz: It could be \$1.50 or \$2.00.

Lawson: They could get to those kinds of numbers without a major improvement in the economy. And sometime in the next few years, I suspect the economy will be doing better than it is now.

Weitz: Yeah. And they do know that they have a balance sheet issue. But I think that we both believe that it'll work out. And we own so much of it — around 25% — that we're going to *have* to own it for awhile. [Chuckles.]

OID: *Whether you like it or not.*

Weitz: Right. But I wouldn't be a bit surprised to eventually get \$8 or \$12 per share instead of \$4. And that'll turn out to have been an unsatisfying round trip. But it'll be a nice change from here.

OID: *Everything's relative.*

Lawson: I agree with Wally on all counts. And I think there's a chance that the economy turns and that Mail-Well gets higher margins and higher earnings than we're talking about here a lot faster.

IF MAIL-WELL JUST GETS BACK TO WHERE IT WAS,
IT'S A TRIPLE FROM TODAY'S STOCK PRICE.

OID: *So you wish you hadn't bought it. But would you buy it today if you didn't already own it?*

Weitz: [Laughs.]

OID: *Or is this more like the one Walter and Edwin Schloss talk about where the broker keeps calling and calling — and just to get rid of the guy, they say, "Buy us 100 shares and sell 'em when we get to break even."*

Weitz: [Laughs.] We *did* buy more of it [sighs] at the end of last year when there were several big sellers that we accommodated. We'd prefer to have a good business. And this isn't really a good business. This is really more of a cigar butt kind of a thing in a way — at *this* point. Actually, I shouldn't say that — because it's not *that* bad. It does have potential earning power.

Lawson: I think it has the potential to be a reasonably good business. They're basically making a bet that you can consolidate the industry and that if you own 30% of the envelope business that you'll be able to make high returns. They've proven that in a small way in Canada — and they've proven that over time in this country. So it *will* be a good business.

It will still be a *cyclical* business. But on average, over time, I think they can earn pretty reasonable returns. However, that's all in the future. That's not where they are right now.

OID: *But, of course, that assumes people continue to use envelopes, send mail to each other and so forth.*

Lawson: That's right. And bill presentment and bill pay is going to go away over some undefined period of time. So the envelope business is going to grow very slowly. But management understands that. Therefore, they've never been very buoyant in their forecasts for growth in their envelope segment. And I think that's a good assumption.

At the same time, it's hard for me to believe it shrinks rapidly because there are way more users of direct mail. And they make enough kinds of specialty envelopes that I think they're going to be making envelopes for a long time.

OID: *Reading between the lines, I get the impression that you've recategorized Mail-Well in your own mind from a fairly decent business to a not-so-great one that's very, very cheap.*

Lawson: [No response.]

Weitz: [No response.]

OID: *Otherwise, with Mail-Well's price down so much, I'd expect you to be pounding the table.*

Weitz: I'm not sure our opinion of what kind of business it is has changed that much. But we were clearly wrong about the current earning power.

Lawson: Yeah. The earning power collapsed to a much greater extent than we predicted.

Weitz: We never thought it was glamorous — and we still don't. But it's not like we suddenly discovered that it was a very different kind of a business. Their execution and the conditions around them just turned out to be a lot worse than we expected.

OID: *Do you have a valuation on Mail-Well that you'd be willing to share with us?*

Weitz: Well, [laughing] I could make up a number for you.

OID: *It's that uncertain?*

Weitz: We believe that they can get back to some normal margins and earning power. And that means \$1.00 or more. And at 10 times earnings, that would be \$10.

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OID: *What is a normal profit margin for these guys? It looks like they got their net profit margins up above 3% for three years in a row from 1997 through 1999. And with their revenues per share up around \$35, that would imply earning power of \$1.00+ per share.*

Lawson: I think that's right.

OID: *But looking out three to five years, Value Line is projecting a net profit margin of only 1.3%.*

Weitz: Yeah. They're projecting razor-thin margins.

OID: *Paper thin. But feel free to give us your own back-of-the-envelope analysis.*

Lawson: I don't think the operating margins they reached were onetime achievements never to be attained again. I think they were still in the process of getting the synergies and benefits of scale developed. And they really haven't fully integrated things yet. So I think there's an argument that normal is even *higher* than 3% — in the long run. I really do suspect that. But I'm not sure that I want to try to make that argument right now. That's not a limb that I necessarily want to go out on.

However, what I am willing to say is that I just think it's a question of how *long* it takes them to get back to those levels. Their business is going to be different. They're selling off some of their business lines. So I think that you shouldn't expect the same kind of revenue growth. But I don't think that kind of margin is crazy at *all*.

And that gets you to earnings somewhere north of \$1 pretty easily — even with a restructured mix of business.

OID: *And it looks like Mail-Well's P/E averaged something around 15 from 1997-'99...*

Weitz: [Laughs.]

Lawson: Yeah. But you're not going to get back to that level for quite awhile.

OID: *Until people forget about this recent experience.*

Weitz: Right.

Lawson: But who knows? We may get back there sooner than we expect. If they get to the point where they're earning higher returns on invested capital and they're growing slowly, just from a free cash flow perspective, you won't be doing too badly.

OID: *Yeah. And from today's price, 12 times earnings of \$1.00 would give you a triple.*

Lawson: Yep. And we could still be conservative in talking about a double or triple.

MAIL-WELL ISN'T SUCH A LOUSY BUSINESS.
AND MANAGEMENT'S MAKING IT BETTER.

Lawson: This isn't a heavily capital intensive business. Historically, they've spent most of their money buying businesses. But if you look at how much cap-ex you really have to put back into the business to sustain it,

it's not that big a number.

OID: *That's surprising to hear. I would think that manufacturing envelopes and being a printer would inherently be relatively capital intensive.*

Lawson: You can keep equipment for a long time. If you're trying to *grow* a lot, then you might need to buy a lot of new stuff. But your equipment doesn't wear out on you in the short run.

OID: *Gotcha.*

Lawson: So I think you wind up with an actual need for maintenance cap-ex that's relatively modest.

OID: *What about technological obsolescence?*

Lawson: This isn't rocket science. There are changes, but they happen slowly.

Weitz: They talk about rationalizing their capacity over in the commercial printing side. They've made acquisitions, so they have a different kind of presence in different places. And as I understand it, they can make more efficient use of the presses if they redirect where it's done so they use the most efficient kinds of equipment in the best way. Also, they're still experimenting with their equipment and learning about it and so forth. That kind of thing can help their margins without them purchasing any new equipment.

OID: *So at 4 times recovery-level earnings, it sounds incredibly cheap. And if it doubles or triples, you'll be happy to cash out and never see it again.*

Weitz: Yeah, I'd say that.

Lawson: [Laughs.] And watching what the management is doing, they're focusing on the right issues, they're delivering on what they say they're going to do and they're working *very* hard to squeeze out excess cash.

Weitz: They say they're going to pull out \$100 million this year — which is \$2 per share.

Lawson: That's right — which is a big number.

OID: *Big?! That's a huge number on a \$4 stock.*

Lawson: That's not a sustainable free cash flow number because there are some onetime working capital reductions involved.

Weitz: And they'll be using it to pay down debt. They've got a *lot* of debt.

OID: *Although it doesn't look that much higher relative to sales than it was even in 1997 — when they managed a 3%+ net profit margin.*

Lawson: That's right. So we feel like management is doing the right things. They understand the situation. And they're slogging their way through it.

OID: *I didn't ask you what could turn Mail-Well into a mistake, but it sounds like buying it early...*

Lawson: Buying it early is clearly a good answer. [Laughing.] And we *have* done that.

Weitz: Yeah. We've already made *that* mistake.

OID: *Please understand that I'm not laughing at you.*

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(cont'd from preceding page)

I'm laughing with you.

Lawson: That's reassuring.

Weitz: Yeah. That makes me feel a lot better.

OID: But aside from buying it early and a prolonged lousy environment, what could turn it into a mistake?

Weitz: This company does have leverage. So I think there is a risk of substandard returns from exactly what you've described — a poor business environment for them. But I don't think either of us is particularly concerned about the risk of permanent capital loss in Mail-Well so much as that it just takes too long to realize its value.

Lawson: Agreed.

OID: There's no killer competitor on the horizon threatening to come in and take market share?

Weitz: It's a very competitive world.

Lawson: This isn't the type of business where you can point to a huge moat. It's *already* brutally competitive in that business.

Weitz: But they're the biggest at some of the things that they do and they're *among* the biggest in other things. It's a highly fragmented business that's not particularly subject to technological obsolescence — but again, without any apparent moat.

OID: But you have no reason to believe that it's going to get more competitive. And nobody does what they do better than they do it?

Lawson: That's right. And we believe and think that they have some advantages in that environment — based on their scale.

OID: They're the largest in terms of share.

Lawson: In the envelope business, certainly. And while they're still very small in the kind of commercial printing they do, they're working very hard to develop scale in each of the local markets that they participate in...

Weitz: ...or get out of some of the smaller markets. They're trying to focus more on a few markets where they're already important.

OID: So it sounds like competitively, their situation is stable or improving.

Lawson: It certainly looks that way to us.

[Editor's note: Shortly before we were going to press, we noticed what looked like an important omission and undertook a quick follow-up:]

OID: I understand you may be holding out on us again — that the earnings figures and net profit margin guesstimates are before adding back Mail-Well's goodwill amortization?

Lawson: You got me. I was using *reported* earnings. And Mail-Well's had considerable goodwill amortization — about 27¢ per share — which, frankly, I neglected to factor into its earning power or its net profit margins earlier.

OID: We'll forgive you this time, but don't let it happen again...

Lawson: But going forward, their amortization should be somewhat lower — because of the operations that they'll be selling. But exactly what it'll be, I can't tell you.

OID: Because it depends on what they sell.

Lawson: That's right. However, going forward, with the new accounting rules, they'll no longer have to amortize their goodwill. So there won't be an ongoing difference between cash earnings and reported earnings.

OID: What about the existing goodwill that Mail-Well has on its balance sheet? Will they have to continue amortizing it?

Weitz: Nope. Historical goodwill will sit on the books. It won't be amortized going forward.

OID: So that Mail-Well, other things being equal, will all of a sudden start reporting more earnings?

Weitz: That's right. Cash earnings won't change. But Mail-Well will suddenly start reporting more earnings.

OID: That's an important point, too — isn't it?

Lawson: Given the way most people think about it, sure. From our perspective, it won't make a difference — because we only pay attention to cash earnings anyway. That's what matters most in thinking about the kind of long-term cash flow that a company can generate. However, you're right — that's important, too, because it represents another important source of potential upside.

OID: Because it suggests that Mail-Well's historical and prospective earning power has been — and is — somewhat greater than it appears.

Lawson: Exactly.

THE BIGGEST THRIFT IN THE COUNTRY
WITH A HIGH TEENS ROE AT 8 TIMES EARNINGS.

OID: Any other bargains you can tell us about?

Weitz: We haven't talked about the things like Washington Mutual which I believe to be very comfortable, if not exciting.

OID: To hell with comfortable. Have you bought more Washington Mutual [WM/NYSE] at its current price?

Weitz: I have.

OID: Lately?

Weitz: Yep. Since their last earnings announcement.

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

Weitz: It's around \$32. And the consensus earnings are in the neighborhood of \$4.00.

OID: Reported earnings, cash earnings or what?

Weitz: Theoretically, they're going to converge in 2002. But I *always* think economic earnings. That's one that I bought a lot of in '99. And I took some profits on it

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WEITZ FUNDS'
WALLY WEITZ & RICK LAWSON
(cont'd from preceding page)

later on, but I held onto some. And now I'm adding to it again — coming back to it.

OID: At 8 times earnings, it sounds like it might be worth a look.

Weitz: You bet. Washington Mutual is a very large thrift/commercial bank focused on mortgage lending. I'm pretty sure that they're the biggest in the country by a factor of three or so because out of the top 10 thrifts from 10 years ago, they probably own five of 'em.

OID: That should do it. But what makes it a bargain at prices you've been paying lately? And don't tell me that it's money in the bank.

Weitz: Washington Mutual is very large and fairly predictable. Its management is a known quantity. And I've been comfortable with the way that they've allocated capital and run the business over the years.

Whenever you buy a financial company, you have to take some sort of risk or you're not likely to earn much of a return. And with a financial company, you can take liquidity risk. In other words, you can buy a company that's on the verge of bankruptcy. And if it survives, you can make a huge score. Well, I don't want to do that.

OID: I'll certainly second that emotion.

Weitz: You can take credit risk. Or you can take interest-rate risk — where changes in the interest rate will affect your result. And in different environments, it seems like it makes sense to take — or refuse to take — more or less of each of those risks.

OID: You sound like Wally Gaye. He says, "Here are the rules, but you have to know when to break 'em, too." I hate it when judgement is required...

Weitz: When I was buying Washington Mutual and other mortgage lenders/S&Ls in 1999, the Fed was raising rates — and they were perceived to have huge interest rate risk. So that risk was coming into play. And no matter how much you're dealing with variable rate assets and variable rate liabilities, there's usually an element of borrowing short to lend long in the S&L business. And with rates going in the wrong direction, people thought that spreads would be depressed and that interest rate risk would hurt them.

I didn't know it *wouldn't* particularly. It's just that I figured it wouldn't for very long — at least not more than a year or two. So I was thinking of Washington Mutual as a way of isolating the interest rate risk variable and not taking credit risk — because it's dealing with single family mortgages for the most part. And I didn't feel like I was taking liquidity risk because the company has almost endless access to capital.

I deny being a theme investor, but that was a theme, I guess — where my perception of risk was different from other people's.

OID: And today?

Weitz: Today, I'm not starting with a theme that people are misjudging what's going on in the whole industry.

It's just that Washington Mutual is trading at 8 times earnings. And I trust them to slowly grow and, if the stock doesn't go up, to buy back a lot of stock. It just seems to me that it's very likely that it'll sell at some higher multiple of some higher earnings per share at some point.

They've been earning a high teens return on equity. And they're paying out a little under \$1.00 per share now. So I get a dividend yield of about 3% while I wait. And they're reinvesting the retained earnings. So I think I have a real good chance of earning better than a 15% return.

THIS IS A SOLID, NOT GREAT, BUSINESS.
BUT 10%/YEAR EARNINGS GROWTH IS FINE.

OID: At 8 times earnings, it doesn't exactly sound like Washington Mutual has a lot of downside — unless its profits are above normalized levels. And it doesn't sound like you're worried about that.

Weitz: Well, I always worry a little bit about that. It's a recession. So there should be higher credit losses. That's one reason why the stock dropped from the mid \$40s to the low \$30s. When it announced its earnings, they raised their provision from some pretty small number to a slightly larger, pretty small number. But the direction reminded people that credit losses can get larger in a recession. However, again, it went from a very small number to another very small number.

That's one of the recurring themes on Wall Street — people in the short run get very hung up on the direction of change and not the absolute level.

OID: Why don't you worry about the level getting bigger later?

Weitz: Well, I think it *could* get bigger later. But I don't picture it getting to a problem level.

OID: Why not? Isn't Washington Mutual leveraged something like 94%?

Weitz: Nearly all banks have borrowings of 15 times or so their equity.

OID: So it wouldn't take a very big bump in the road to put a serious hurt on shareholders, would it?

Weitz: No. But I think they raised their loan loss provision from \$130 million to \$200 million in the quarter. And to put that in perspective, Washington Mutual has 880 million shares outstanding. So we're only talking about something like an additional 8¢ per share.

And we're talking about single family mortgages. We're now at an annualized rate for loss provisions of about \$800 million — or a little under \$1.00 per share. And it's not the kind of lending that is subject to a sudden dramatic increase in losses. That is more of a threat in commercial lending.

OID: On the other hand, this doesn't sound like one of the world's great businesses.

Weitz: No. But I'm not counting on them being able to continue earning the same ROE on reinvested funds — because they're awfully big and it's hard to keep reinvesting that much. The S&L business isn't that great. Freddie Mac and Fannie have a better cost structure and can earn more

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WEITZ FUNDS'
WALLY WEITZ & RICK LAWSON
 (cont'd from preceding page)

investing in mortgages. Countrywide can originate and service better. It's a highly competitive world.

Plus, although their ROE is up around 20%, the bulk of their reinvested capital is deployed via acquisition. And, they're not making those acquisitions at book, but at a *multiple* of book. Also, they've *already* bought almost everybody in California. So now they've had to go to the East coast.

OID: So they may run out of targets — and, therefore, attractive reinvestment alternatives.

Weitz: The prices of potential targets rise and fall. But they are fairly disciplined about the prices they pay. So I don't worry that they'll overpay just to keep growing. When reinvestment opportunities are scarce and their stock price is reasonable, they can buy back their own stock.

Something else that distorts Washington Mutual's ROE is that when it buys in its stock at 2-3 times book, equity disappears. So you have to be careful about attributing too much significance there — because there's a gigantic difference in some companies between their economic equity and book equity. And I think if you're just looking at GAAP statistics, you're likely to get off base.

On the other hand, there's always been a lot of skepticism about their skills as an acquirer, about them being too big to grow fast and about management having too many mortgage-backed securities on the balance sheet when they're underwater.

But you're right. This isn't a great, exciting business. Just the same, if they can even do a mediocre job of reinvesting retained earnings, it seems to me 10% earnings growth ought to be realistic — and that it ought to be worth 10-11 times earnings and sell there periodically.

And it's available at 8 times earnings in an environment where I don't see a lot of great alternatives.

[Editor's note: Understatement alert: In 1997 and 1998, Washington Mutual looks like it sold for an *average* of 14-1/2 to 18-1/2 times earnings — topping out at something north of 20 times earnings. And it's reached a price of 10 times earnings or more in every year shown in *Value Line* (back to 1991).]

IF YOU EXPECT THE WORST AND INVEST THAT WAY,
 YOU PROBABLY WON'T BE DISAPPOINTED.

OID: Wally really does tend to understate, doesn't he?

Lawson: Oh, absolutely.

OID: Where do you think that comes from?

Lawson: Wally is somebody who doesn't want to put himself in a position where he can be disappointed. He wants to believe in stuff that's very likely to happen. And if his expectations are low enough, he won't be disappointed. Obviously, that's been a very successful approach for him.

For example, I've learned that when I'm trying to make a case for something with Wally, it's better to try to build a low-end case — a case that's hard to argue with where something is still interesting. I've learned over time

that that's a better way to get him interested in something than showing him how huge the upside is.

OID: In other words, that the near-worst case scenario is still pretty good.

Lawson: Right.

OID: Wally, where do you think your practice of understating comes from? And how can we keep it from catching on with other contributors?

Weitz: [Laughs.] I don't know. I've just always liked to set low expectations — both for myself and my clients. That way, if they turn out to be too low, everybody's happy.

But I don't know where it came from. I'm not trying to kid anybody. It's not a conscious effort to downplay or anything...

OID: It's just a function of your temperament.

Weitz: I think so. A lot of things go wrong in companies and in the economy and in investing.

OID: Yeah — in publishing, too.

Weitz: Maybe it's a product of having started in the early '70s and having spent '73-74 having to mark down expectations day after day after day. I saw the stocks of companies, even if they were doing well, go down what seemed like every day for two years. And I've seen the market environment where nothing goes right price-wise even though the companies are doing well.

In the last 10-20 years, we've had the reverse of that — where stocks have done *very* well even when their companies *haven't* been doing so well. I just remember when it was the other way.

But it's a matter of temperament that makes me remember the old bear market, not the bear market that warped my temperament.

OID: So you were already warped?

Weitz: I don't want to get into childhood traumas and family stuff [laughs] and all of that...

OID: Yeah, please don't. We're rated PG.

Weitz: But I think I probably grew up not wanting to count on everything working out.

OID: Well, I don't know about everything working out. But these ideas sound like they'll work out just fine.

Thanks for sharing 'em with us.

Weitz: We enjoyed it.

Lawson: Our pleasure.

—OID

For additional information
 you may contact:

WEITZ FUNDS
 1125 S. 103RD ST., SUITE 600
 OMAHA, NE 68124-6008

(800) 232-4161
 (402) 391-1980

BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
(cont'd from page 1)

Incredibly, even those figures understate Buffett's feat — because, believe it or not, before fees, but after all taxes, that \$10,000 would have grown to close to \$500 million.

Of course, the manner in which Buffett and his long-time partner and straight-man, Charlie Munger, achieved those results is no less remarkable. But rather than utilize scarce space to recount it here, we'll simply allow them to speak for themselves.

However, we will take a moment to mention that we don't think it's a coincidence that one after another of the most successful managers we can find tell us that they model themselves and what they do after Buffett and Munger and/or that there's no one else they'd rather have manage their own money than those two.

In any case, without further ado, we'll simply tell you that we're very pleased to bring you selected excerpts from their answers to shareholder questions at this year's annual meeting. And as always, we highly recommend that you give them a careful reading, (re-reading, etc.).

IF YOU PROTECT AND ENLARGE THE MOAT,
THEN EVERYTHING ELSE FOLLOWS.

One difference between publishing and investing....

George Brumley III: We often consider evaluating companies in the context of Michael Porter's model of position relative to competitors, customers, suppliers and substitute products. You state that much more simply when you say you seek companies with the protection of wide and deep moats.

To complete the valuation of a company, we all seek to choose the appropriate future cash flow coupons. A qualitative assessment of the protected competitive position is required to precisely forecast those future coupons. In your opinion, are the dynamic changes in the nature of competition, distribution systems, technology and even changes in customers making it more difficult to accurately forecast those future cash flow coupons?

Are good protected businesses going to be more rare going forward than they have been in the past? And if so, does that make the few that do exist more valuable?

[Editor's note: George Brumley III is a past *OID* contributor and co-manager of Oak Value Fund.]

Warren Buffett: Well, you've really described the investment process well. The questions you ask are right on the mark. To the extent I've read or understand what Porter's written, we basically think alike in terms of businesses. We call it a moat and he makes it into a book. But that's the difference between the businesses we're in.

Unanimity at Berkshire....

Buffett: Charlie may have a different view on this, but I don't think that the quantity or sustainability of moats in American business has changed that dramatically

over the last 30 or 40 years. You can say that Sears, General Motors and companies like that thought there were some very wide moats around their businesses — and it turned out otherwise when, in the case of Sears for example, Wal-Mart came along. But with the businesses we think about, I think the moats that I see now seem as sustainable to me as the moats that I saw 30 years ago.

But I think there are many businesses and industries where it's very hard to evaluate their moats. Those are the businesses of rapid change. And are there fewer businesses around where change is going to be relatively slow than previously? I don't think so, but maybe Charlie does.

Charlie Munger: No. I'd argue that the old moats — at least some of them — are getting filled in. And the new moats are harder to predict than some of the old moats. So I would say it's getting harder.

Buffett: [Chuckling] Well, there you have it — unanimity at Berkshire.

If you protect and enlarge the moat, everything else follows.

Buffett: I think it's a very good question. And Charlie may be right or I may be right. That's a *very* tough one to figure. But regardless of whether there are fewer businesses with wide, reliable moats or whether they're harder to find, that's *still* what we're trying to do at Berkshire. That's what it's all about.

We don't give a lot of instructions to our managers. We don't have budgets. And we don't have all kinds of reporting systems or anything else. But we do tell 'em to try and not only protect, but *enlarge* the moat. And if you enlarge the moat, everything else follows.

SOME FRANCHISES ARE WEAKER THAN OTHERS.
TAKE CAMPBELL AND KELLOGG, PLEASE.

Kellogg & Campbell have been casualties for a reason....

Shareholder: Mr. Buffett, you've talked about the importance of franchise in sustainable competitive advantage. Companies like Kellogg and Campbell's Soup are companies most people would say had those qualities. But over time, those qualities were lost as a result of changing consumer tastes. What gives you confidence the same thing won't happen to Coke or Gillette?

Buffett: That's an interesting question. I'm no expert on Campbell's Soup and Kellogg, but I would say that just based on my general observation over the years, the problems there came from two different things: I think that the problems with ready-to-eat cereal were not so much changes in taste or consumption patterns. I think they may have just pushed their pricing too far to the point that they lost market share without having the moat that they thought they had vis-a-vis the General Mills cereals and the General Foods cereals and all of that sort of thing. If your pricing really gets out of whack and people regard Wheaties or Grape Nuts in the same category as they regard Kellogg's Cornflakes, you're going to lose share. And once you start losing share, it's hard to get it back.

The problems with soup, I think, relate more to life-style. I think that it ... fits in a little less well with people's current life-styles, maybe, than it did 40 years ago.

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

Coke's a different animal altogether — like night and day.

Buffett: What gives us confidence the same thing won't happen to Coke? Well, I don't have the figures here, but I would wager that during the last 110 years, the per capita consumption of soft drinks has gone up virtually every year — to the point that it's now grown to close to 30% of U.S. consumption of liquids. So if the average American consumes about 64 ounces of liquids a day, you're talking about 18 ounces of that being soft drinks — and 43% of that 18 ounces, or almost 8 ounces a day, being Coca-Cola products. In other words, nearly 1/8th of all the liquids consumed by men, women and children in the United States are Coca-Cola products.

And that's not only the case in the U.S., but throughout the world. It's gone up on a per capita basis almost since soft drinks were discovered. And I would say that that trend is almost impossible to reverse on a worldwide basis. There is so much potential in countries where per capita consumption of Coke products is maybe 64 ounces a year. So you have 1/50th of the consumption per capita in some important countries that you have here.

And it's interesting — coffee's gone down every year. People talk about Starbucks and all of that. But if you look at per capita coffee consumption in this country and per capita milk consumption, it just continues to go down, down, down, year after year after year after year.

So I think it's pretty clear what people like to drink once they get used to it.

And then there's the issue of pricing. That's a big plus, too.

Buffett: But it has to be priced right, too. You can push pricing too far. There comes a point... And of course, it depends on the country in which you're doing it and even on areas *within* the country in which you do it.... But if you were to establish too wide a differential in the pricing between Coke and a private label product, you'd change consumption patterns somewhat — not a *huge* amount, but enough so that you don't want to do it....

And an interesting thing about Coca-Cola is that when I was born in 1930, a 6-1/2 ounce Coke cost a nickel — and you put a 2¢ deposit on the bottle. But forget about the deposit — just take the nickel. Today, when you buy a 12 ounce can or a larger product (and you can buy it on the weekends during a supermarket special or something for even less) you're paying maybe a little more than twice per ounce what you were paying in 1930 — 70 years ago.

Compare that to the price behavior of almost any product that you can find — except raw commodities. But compare it to cars, housing — *anything*. There's been *very* little price inflation in there. And that's contributed, of course, to the growth in per capita consumption over time.

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RETAILER/BRAND BATTLE ISN'T NEW.
THE ADVANTAGE FLOWS BACK AND FORTH.

Kellogg faces a much different — much tougher — world.

Buffett: Charlie, how about cereal and soup?

Munger: Well, I think those are examples where the moats got less hostile for the competitors. Part of the trouble was the buying power got more concentrated — and tougher. The big grocery chains now have a lot of clout. And then you add the Wal-Marts and the Costcos and the Sam's... It's a different world faced by the Kelloggs than the one they had 30 or 40 years ago.

And the battle between retailers and brands isn't new.

Buffett: Yeah. There will always be a battle between brands and retailers — because the retailer wants his name to be the brand. And to the extent that people trust Costco or Wal-Mart as much or more than they trust the brand, the value of the brand moves over to the retailer from the product. And that's gone on for a long, long time.

The first case I know about in any real quantity was with A&P back during the '30s. A&P, I believe, was the largest food retailer in this country — and they were also a big promoter of private labels. Ann Page, I think, was a big private label with them, for example. And they felt that they could convince the consumer back in the '30s that their brand meant more than having Del Monte or Campbell's or whatever it might be in the different categories. And people thought they were going to *win* that war for awhile.

And who knows? I don't know all the variables that went into A&P's decline, but it was dramatic. It was a great American success story for awhile — and then it was a great American failure. Charlie?

Powerful brands are doing things they wouldn't have before.

Munger: The muscle power of the Sam's Clubs and the Costcos has gotten very extreme. Earlier this morning when I was autographing books, a very good-looking woman came up to me and said she wanted to thank me. I said, "For what?" And she said, "You told me to buy this pantyhose I'm wearing from Costco."

I'd evidently made some comment about how amazing it was that Costco could get Hanes, of all people, to allow a co-branded pantyhose — Hanes-Kirkland — in Costco's stores. That wouldn't have happened 20 years ago.

Buffett: She must've been pretty *desperate* if she was consulting with you on where to buy pantyhose.

CORPORATE PROFITS? THEY'LL DECLINE —
AND THEN THEY'LL GO BACK UP....

In accounting, dreams often take precedence over reality.

Shareholder: Mr. Buffett, your 1999 article in Fortune was excellent. I'm wondering what your thoughts are on American business profit margins and return on equity in the future? Also, I'd like your thoughts about the huge inventory write-offs at some businesses today....

Buffett: Your question about inventory write-offs gets into the category of "big bath" charges which are the

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BERKSHIRE HATHAWAY'S
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(cont'd from preceding page)

tendencies for management when some bad news is coming along to try and put *all* the bad news that's happened into a single quarter or a single year — and even to put the bad news that they are worried about happening in the *future*, into that year. It leads to real deception in accounting. The SEC has tried to get quite tough on that. But my experience has been that managements that want to do it usually can find some way to do it.

And managements frequently are more conscious of what numbers they *want* to report than they are of what has actually *transpired* in a given quarter or a given year.

Corporate profits? They'll decline — and then go back up.

Buffett: In the *Fortune* article, I talked about the unlikelihood of corporate profits in the U.S. getting much larger than 6% of GDP. And historically, the band has been between 4% and 6% — and we've been up at 6% recently. So unless you think that profits as a part of the whole country's economic output are going to become a bigger slice of the pie... And bear in mind they can only become a bigger slice of the pie if other slices get diminished to some extent (personal income and items like that).

So I think it's perfectly rational and reasonable that in a capitalistic society, corporate profits are something like 6% of GDP. That does not strike me as outlandish in either direction. It attracts *massive* amounts of capital because returns on equity will be very good if you earn that sort of money. And on the other hand, I think it would be very difficult to get where corporate profits would be 10% or 12% — or something of that sort — of GDP because it would look like an unfair division of the pie to the populace.

The future? Pretty much more of the same...

Buffett: Corporate profits are going to be down in the near future as a percentage of GDP from recently. But then they'll go back up at some point. So I think 10 years from now, you'll be looking at a very similar picture.

Now if that's your assumption and if you're already capitalizing those profits at a pretty good multiple, then you have to come to the conclusion that the value of American business will grow in a relationship that's not much greater than the growth in GDP. And, probably, most of you would estimate that as being maybe 5% a year if you expect a couple percent a year of inflation.

So I wouldn't change my thoughts about the profitability of American business over time. And I wouldn't change my thoughts much about the relationship of stock prices over time to those profits. So I would come down very similarly....

Anyone expecting 15%/year is living in a dream world.

Buffett: Interestingly enough, some of those same relationships prevailed decades ago. But you were buying stocks that were *yielding* perhaps 5%. So you were getting 5% in your pocket *plus* that growth as you went along. And of course, now if you buy stocks, you get 1.5% if you're the American public — before frictional costs. So the same rate of growth produces a way smaller aggregate return.

So I think stocks are a perfectly decent way to make

6-7% per year over the next 15 or 20 years. But I think anybody who expects to make 15% per year — or expects their broker or investment adviser to make that kind of money — is living in a dream world.

PENSION ACCOUNTING IS DUMB AND IMPROPER
— BUT OTHER THAN THAT, IT'S JUST FINE.

Understated pension contributions = Overstated earnings.

Buffett: And it's particularly interesting to me that back when the prospects for stocks were far better — I even wrote something about this in the late '70s — pension funds were using investment rate assumptions that were often in the 6% range. Now when the prospects are way poorer, most pension funds are building into their calculations returns of 9% or better on investments.

I don't know how they're going to get 9% or better on investments. But I also know that if they change the investment assumption down, it would change the charge to earnings substantially — and they don't want to do that. So they continue to use assumptions which I think are quite unrealistic. And for companies with a big pension component in their financial situation and, therefore, in their income statement, that can be quite significant.

So it'll be interesting to me, where pension funds are experiencing significant shortfalls from their assumptions in the next couple of years, to see how quickly they change the assumptions. And the consulting firms are not pushing them to do that at all. The consulting firms are telling them what they want to hear — which is hardly news to any of us. But that's what's taking place. Charlie?

It's human nature to extrapolate the recent past.

Munger: Pension fund accounting is drifting into scandal by making these unreasonable investment assumptions. Evidently, it's part of the human condition that people extrapolate the recent past. And therefore, since returns from common stocks have been high for quite a long period, they extrapolate that they'll continue to be very high into the future. And that creates a lot of reported earnings in terms of pension benefits that aren't available in cash — or likely won't be available at all.

This is not a good idea. And it's interesting how few corporate managements have responded like Sam Goldwyn: "Include me *out*." You'd think more people would just say, "This is a scummy way to keep the books — and I will not participate in it." Instead, everybody just drifts along with the tide — assisted by all of these wonderful consultants.

It's not GAAP accounting: It's HITS (Head in the Sand).

Buffett: Except for the pension funds that we take over, I don't know of any case in the U.S. right now — and I'm sure there are some — where people are reducing their assumed investment return.

Now you'd think if interest rates drifted down several percentage points, that might affect what you would think would be earned with money. It certainly is to bondholders or to us with float or something of the sort. But most major corporations, I believe, are using an investment return assumption of 9% or higher. That's with long-term governments below 6% and maybe high-grade corporates at 7%. They don't know how to get it in the bond market. They don't know how to get it in the mortgage market. And

(continued on next page)

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

I don't think they know how to get it in the stock market. But it would cause their earnings to go down if they were to change their investment assumption.

And like I say, I don't know of a major company that's thinking about it. And I don't know of a major actuarial consultant suggesting it to the managements. They'd just rather not think about it.

The current practice is dumb and improper.

Munger: The way they're doing things would be like living right on an earthquake fault that was building up stress every year and projecting that the longer it's been without an earthquake, the less likely an earthquake is to occur. That is a dumb way to write earthquake insurance. And the current practice is a dumb way to do pension fund planning and accounting. It's dumb and improper.

Buffett: If you talk to a management or a board of directors about that, you'll get absolutely no place.

Munger: Their eyes would glaze over before the hostility came.

DON'T ASK YOUR ADVISOR (OR CONSULTANT)
ABOUT THE ODDS OF ACHIEVING HIGH RETURNS.

The probability of us achieving 15% growth? Virtually zero.

Shareholder: In order for Berkshire to have an opportunity to grow its earnings by about 15% per year for the next few years, it's obvious that because of the redeployment of earnings and float, the existing businesses don't need to grow at 15%. At what rate would you expect the existing businesses to grow in order to achieve an aggregate rate close to what I'm describing? And what do you think the probability is of achieving that?

Buffett: Well, I think the probability of us achieving 15% growth in earnings over an extended period of years is so close to zero that it's not worth calculating. I mean we'll do our best. And we have a lot of *fun* doing it. So it's not something where we have to do things that are boring to us or anything of the sort. Our inclination is very much to do everything we can legitimately to add to Berkshire's earnings — in things we can understand. But 15% a year — that can't happen over time.

We'll have years when we *do* achieve 15% growth. And you're quite correct in pointing out that we don't need to do it from the present businesses any more than we needed to do it from the current business back in 1965 with the textile business. We will add things all the time. We have to improvise as we go along — and we *will*.

Only a select few of the Fortune 500 are likely to do it.

Buffett: The businesses we have are good businesses in aggregate. They will do well. But they won't do anything like 15% growth per annum. So we will take a good rate of progress from those businesses and we'll superimpose acquisitions upon that which will add to that. But we can't do 15% over time — nor, incidentally, do we think any large company in the U.S. is likely to do it.

There will be a couple that do it for a long period of time. But to predict which of the Fortune 500 will end up being the one or two or three would be very hard to do. And it won't be more than a couple of the Fortune 500 if you take large companies not working from a deflated base year.

Extrapolating the past is stupid — and not slightly stupid.

Buffett: I think our method is a pretty good one. I think the idea of having a group of good businesses that throw off cash in aggregate in a big way, that themselves grow and are run by terrific people, and then adding onto those — sometimes at a slow rate, but every now and then at a good clip — more businesses of the same kind without increasing outstanding shares is about as good a business model as you can *have* for a company our size. But we'll have to see what it produces. **Charlie?**

Munger: I certainly agree that 15% per annum progress extrapolated way forward is virtually impossible. I think generally the shareholding class in America should reduce its expectations a *lot*.

Buffett: Including the pension funds.

Munger: Including the pension funds — you bet. It's stupid the way that people are extrapolating the past — not *slightly* stupid, but *massively* stupid.

It's almost impossible for advisors to be intellectually honest.

Buffett: Incidentally, if you think about it, this is a message that nobody has any financial interest in saying — whereas people have all *kinds* of financial interests in saying just the opposite. Therefore, if you listen to the financial world or read the financial press, you do not get an information flow that is balanced in any way in terms of looking at the problem — because the money is in believing something different. And money's what causes people to become prominent — or it flows from becoming prominent in the investment world — in terms of whether you go on television shows or whether you manage money or you're trying to attract it through funds or whatever it may be.

If you're an actuarial consultant and you insisted that the companies that you gave your actuarial report to use a 6% investment rate, I don't think you'd have a client. So it's almost *impossible*, in my view, for the advisors, in effect, to be intellectually honest on that score. Don't you think so, **Charlie?**

It's crazy for this group to have very high expectations.

Munger: Yeah. There's a very smart investment advisor in my town. And he said, "Years ago, some risk arbitrage firm would tell its clients, 'We know how to make 15% per annum year in and year out.' And everybody said, 'That's impossible.'" He said, "Now, in this climate, they say, 'So what? Who's interested in a lousy 15%?'"

Buffett: It was easier in the earlier time, obviously...

Munger: Yes.

Buffett: ...because the money hadn't been attracted into it.

Munger: Generally speaking, there's more felicity to be gained from reducing expectations than any other way. It's *crazy* for this group to have very high expectations. Moderate expectations will do fine for all of us.

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

UNREALISTIC TARGETS LEAD TO BAD BEHAVIOR.
BUT DON'T COUNT ON THEM GOING AWAY.

It's a mistake for any company to predict 15%/year growth.

Shareholder: Do you think that Gillette's goal of trying to grow earnings at 15%+ per year got them into their current inventory problems with the trade? And neither of you were the biggest fans of the Duracell acquisition. How do you feel about it now?

Buffett: As I've said, I think it's a mistake for *any* company to predict 15%-a-year growth. But plenty of them do. For one thing, unless the U.S. economy grows at 15% a year, eventually any 15% number catches up with you. It just doesn't make sense.

Very, very few large companies can compound their earnings at 15%. It just isn't going to happen.... If you pick any company in the Fortune 500 that currently has record earnings and you want to pick out 10 of them that over the next 20 years will average 15% or greater, I will bet you that more than half of your list will not make it.

So I think it's a mistake.... I think it leads people to stretch on the accounting. I think it tends to make 'em change trade practices. And I'm not singling out Gillette in the least. But I can tell you that if you look at the companies that have done it, you will find plenty of examples of people that have made those sort of mistakes.

Don't count on unrealistic expectations to disappear....

Buffett: Obviously, Duracell hasn't turned out the way the management of Gillette at the time hoped it would. The investment bankers who came and made those presentations would look pretty silly now. Charlie?

Munger: I think that kind of stuff happens all the time. It will continue to happen. It's just built into the system. I see *more* predictions of future earnings growth at high rates, not less. A few people have taken the abstinence pledge, but it's *very* few. It's what the analysts want to hear.

Buffett: And it's what the investor relations departments want the managements to say....

The implications of unrealistic growth are unreal....

Buffett: If we were to predict 15% annual growth from Berkshire, assuming the same multiples, that would imply a market cap of \$200 billion in five years, \$400 billion in 10 years, \$800 billion in 15 years, \$1.6 trillion in 20 years, etc. So the values get to be crazy.

If you have a business with a market value of \$400-500 billion — and we had a few of those not so long ago — just think of what it takes to deliver in the way of future cash at a 15% discount rate to justify that. If you've got a business that's delivering you no cash today and it's selling for \$500 billion, in order to give you 15% on your money, it'd have to be giving you \$75 billion this year. But if it doesn't give you \$75 billion this year, it has to give you \$86.25 billion next year. And if it doesn't do it next year, it'd have to give you almost \$100 billion in the third year. Those numbers are *staggering*.

The implications involved in certain market valuations

really belong in *Gulliver's Travels* or something. But people take them very seriously. And when people were valuing businesses at \$500 billion a year-and-a-half ago, ... if you demanded something like 15% on your money, there's almost no mathematical calculation you could make that would possibly lead you to justify those valuations.

When valuations get irrational, crazy things can happen.

Munger: Well, I said on another occasion that to some extent, stocks sell like Rembrandts. They don't sell based on the value that people are going to get from looking at the picture; they sell based on the fact that Rembrandts have gone up in value in the past. And when you get that kind of valuation in stocks, crazy things can happen. Bonds are way more rational because nobody can believe that a bond paying a fixed rate of modest interest could go to the sky. However, stocks behave partly like Rembrandts.

So I said, "Suppose you filled every pension fund in America with nothing but Rembrandts." And, of course, Rembrandts would keep going up and up as people bought more and more Rembrandts — or pieces of Rembrandts — at higher and higher prices. I said, "Wouldn't that create a hell of a mess after 20 years of buying Rembrandts?"

To the extent stock prices generally become irrational, isn't it sort of like filling half the pension funds with Rembrandts? I think those are good questions.

Buffett: Once it gets going, though, people have an enormous interest in pushing Rembrandts. It creates its own constituency.

RECENT U.S. PROFITS HAVE BEEN OVERSTATED,
BUT THEY'VE TRULY BEEN HIGH NONETHELESS.

Accounting helps, but American returns have been higher.

Shareholder: If you believe accounting statements as published in annual reports, the returns on equity for U.S. businesses are amazingly high — higher than in Europe, higher than they've been historically and higher than Japan. Do you think these highs are completely attributable to accounting shenanigans or are there any fundamental reasons in addition that might make U.S. returns higher than in Europe or higher than they've been historically?

Buffett: Well, to the extent that American returns have been higher than those around the world — at least in developed countries — I would say that they are not solely due to accounting shenanigans. I think the absence of honest accounting for option costs has been a factor. But American business has done *very* well *excluding* any accounting activities that Charlie and I might differ with.

I'm no expert on exactly what returns have been around the world in developed countries. But my impression definitely is that American business profitability is *well* above average for the developed world. And I don't have the answers as to why that's occurred.

Meritocracies work best....

Buffett: I think that American business — and I think the whole American *system* — has reflected more of a meritocracy than exists in many countries. And I think that a meritocracy works best.

And I think that mobility between classes, which

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BERKSHIRE HATHAWAY'S
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[goes hand in hand with] a meritocracy, does tend to get a Jack Welch into a position where he runs a General Electric, or an Andy Grove where he runs an Intel or a Sam Walton where he runs a Wal-Mart. If you'd taken those same individuals and dropped them down in most countries, I think they would've done very well, but I don't think they would have done quite as well as they've done here. And I think that what they've done well has spilled over in a *big* way to benefit the American economy. So I wouldn't blame it all on the accounting shenanigans.

Pension fund accounting's less relevant at younger firms....

Buffett: The pension funds' accounting ... applies very heavily at some companies. But of course, most newer companies don't have pensions. Companies that were started in the last 20 or 30 years are much more inclined to have various kinds of profit sharing or 401-Ks.

It's the older industries that took on pensions spurred to a great degree, I think, by World War II when excess profits taxes ran to 90%. As a result, there was a huge incentive to start pension plans and fund them heavily because the government, in effect, was funding 90% of your pension obligation. So there was a great boom in the inauguration of pension funds — and of course, that meant steel, auto and all those big industries of that time. Charlie?

Returns are higher in part because mgt's want it that way.

Munger: It isn't so much accounting shenanigans as it is deliberate financial practice. Take General Electric: There's been a deliberate increase in financial leverage which was made possible by their wonderful and deserved reputation. There's been a deliberate increase in repurchase of stock which General Electric has done even when paying huge multiples of book value.

That sort of thing does wonders for returns on equity as reported, as does the process of writing off everything in sight and various extraordinary charges, thereby removing the burden of past costs from future earnings.

If you put all those things together, American returns on equity are higher in part because the managements have deliberately set out to paint the company as unusually efficient in their use of capital — meaning that they earn a high return on shareholders' equity.

We haven't been managing Berkshire to report a high ROE.

Munger: Just think how high we could drive our return on equity at Berkshire. We could make it almost any number you want if we just used enough leverage.

Buffett: Yeah, we could run it without stock....

Munger: We could run Berkshire with no equity. And then people could say, "Gosh, these guys have finally learned how to manage the damn thing."

It's not been an objective around here to reduce the equity to zero. But at other places, in order to make the reported return on equity good, they deliberately pound down the net worth as much as they can.

Managers like to write things off and say they don't count.

Buffett: The S&P figures of the last 15 years are

reported both before and after special charges. And there's been a very significant difference between those two figures. American business likes to write off things and say that doesn't count. Of course, that takes the equity down and it frequently benefits future earnings because you remove costs that would otherwise hit the income statement in future years.

Munger: The truth of the matter is that part of this is shrewd and correct management of the company's financial structure and operations — and part of it drifts into gamesmanship.

OUR HANDS AREN'T TIED IN INSURANCE.
ON THE OTHER HAND, IN THE UTILITY AREA...

We're not really hindered in any way by insurance statutes.

Shareholder: As an insurance holding company, Berkshire Hathaway is subject to regulation by insurance departments in every state in which GEICO or the other insurance subsidiaries do business. Has that handicapped or affected your operations in any way?

Buffett: We really haven't been impeded in any way.... Berkshire itself is not an insurance company, but it owns various insurance companies.... In the insurance business, there's relatively little in the way of regulation or oversight that extends up to the holding company. So it hasn't slowed us down *there*.

On the other hand, PUHCA...

Buffett: But as has been reported recently, in the electric utility business, there is a statute from 1935 — the Public Utility Holding Company Act. The acronym is that euphonious term "PUHCA" [pronounced puke-uh]. It has a lot of rules about what the parent company can do. That act was put on the books because there were many abuses in the holding companies of the '20s — most particularly ones formed by Sam Insull, but there were others. So it was quite understandable that the act was passed in the '30s. And it achieved a pro-social purpose at the time.

But I don't think there's anything, frankly, pro-social about limiting Berkshire's ability to buy into other utilities. We can buy up to 5% of the stock. But we might *well* in the last year or two have bought an entire utility business if that statute weren't present. So we are handicapped by PUHCA.

However, we're not handicapped, in my view, by any state insurance statutes.

Congress has become more receptive to the repeal of PUHCA.

Shareholder: What's your expectation for passage of the repeal of PUHCA? I know that there was some recent activity in the Senate Subcommittee.

Buffett: With respect to PUHCA, it's hard for me to know. I have no great record of handicapping legislative action. But I would say that the awareness of the public problems in the electric utility industry under current circumstances has mushroomed. It's ballooned. So I think it's likely that Congress is more receptive to the idea that they need to do something that insures that the power supply is adequate.

And I think that there's probably a number of 'em that

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would think that PUHCA is a barrier to capital entering the industry from a lot of sources where capital is available — and that it's going to take capital to solve this problem.

Now, they don't have to solve it by letting Berkshire do more things. But it's not a crazy approach to say that if Berkshire has billions of dollars to invest that it might be a net plus for the availability of electricity down the road. So I think certainly the chances of repeal, or major change, are *far* higher today than they were a couple of years ago.

Public will hold politicians accountable for brownouts.

Buffett: Politicians don't like to face major brownouts. They can try and blame it on someone else — and they may well be *accurate* in blaming it on someone else. But the public is going to, at least partially, blame political leaders if this country runs out of electricity — because it hasn't run out of the ability to build generators. We could create all the generators we need to have plenty of electricity — and we could create the transmission lines and all of that.

But you do need a flow of capital to the industry. And PUHCA restricts that flow to quite a degree, I would say.

CALIFORNIA REGULATION *DISCOURAGED* CAPACITY
— WHICH WAS A VERY, VERY BASIC MISTAKE.

In California, they ignored the single most important factor.

Shareholder: Considering the political climate and what seems to be a more regulated environment than not in the electric utilities market — and politicians that seem to be pacifying their constituents rather than [relying on] the common sense of price and supply and demand — isn't it a risky venture to participate in these markets (more than what's already been done with MidAmerican) considering that even with a possible repeal of the PUHCA laws that they may be reinstated some years later with the addition or subtraction of any other legislation that a politician may dream up and thereby put the investment at risk?

Buffett: Charlie, you're a resident of California.

Munger: Well, the production of electricity, of course, is an enormous business — and it's not going away. And the thought that there might be something additional that we might do in that field is not at all inconceivable. It's a

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very fundamental business.

You're certainly right in that we have an unholy mess in California in terms of electricity. It reflects, I'd say, a fundamental flaw in the education system of the country: that so many smart people of all kinds — utility executives, governors, legislators, journalistic leaders — seemingly had difficulty recognizing that the most important thing with a power system is to have a surplus of capacity. Is that a very difficult concept?

Everybody understands that if you're building a bridge, you don't want a bridge that will handle exactly the maximum likely load and no more. You want a bridge that will handle a lot *more* than the maximum likely load. And that margin of safety is just enormously important in bridge-building.

Well, a power system is a similar thing. Why do all of these intelligent people ignore the single most obvious and important factor — and just screw it up to a fair-thee-well? So I'm giving you a response which is another question. As my old professor used to say, "Let me know what your problem is and I'll try and make it more difficult for you."

If you want ample capacity, then regulate accordingly.

Buffett: Charlie's obviously right in that from a societal standpoint, you've got perhaps three goals in what you would like your electric utility business to be. One is that you would like it to be reasonably efficiently operated. Secondly, since it does tend to have in many situations monopoly characteristics, you would want something that produced a *fair* return, but not a *great* return, on capital — enough to attract new capital. And then third, you'd want this margin of safety — this ample supply.

When you've got a long lead time to creation of supply — which is the nature of putting on generation capacity — you need a system that *rewards* people for fulfilling that obligation to maintain extra capacity. A regulated system can do that. If you give people a return on capital employed so that if they keep a little too much capital employed they get *paid* for it, then they'll stay ahead of the curve — they'll always have 15-20% more generating capacity than needed.

The cost of insufficient capacity dwarfs any inefficiencies.

Buffett: One of the *disadvantages* of that regulation and the monopoly nature is that it doesn't have the spur to efficiency. They try to build it in various ways, but it's difficult to have a spur to great efficiency if somebody can get a return on any capital they spend. Therefore, utility regulators have always been worried about somebody just building *any* damn thing and getting whatever the state-allowed return is.

But I'd say that the problems that would arise from, say, a little bit of sloppy management are *nothing* compared to the problems that arise from inadequate generation.

The new regulatory scheme discouraged new capacity....

Buffett: So in California, in my view speaking as an outsider, utilities had the *incentive* at one time to maintain a little extra generating capacity because they were allowed to earn a decent return on it — a return sufficient to attract capital.

But then you had, I think, the forced sell-off of something like half of their generating capacity. And they sold it at multiples of book value to a bunch of people who

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became generators who are deregulated and don't have an interest in having too much supply. They've got an interest in having too *little* supply. So they *totally* changed the equation — because the fellow with the deregulated asset, for which he paid 3 times book now has to earn a return on that 3 times book what the fellow was formerly earning under the regulated environment at 1 times book.

So he's not going to build extra generating capacity. All that does is bring down the price of electricity. He *hopes* things are tight. If you've got a utility plant that was put in place at X and then you go out and encourage entrepreneurs to buy it at 3X, you can't expect electricity prices to fall. So you've created a situation, in my view, where the interests of the utility companies have diverged in a significant way from the interests of society. And that was a very, very basic mistake. It just doesn't make any sense to me — but maybe I don't understand it fully.

The old regulatory scheme made more sense....

Buffett: I really think that the old system made more societal sense: Let people earn a *good* return (not a great return, but a return that attracts capital) on investment that has built into it incentives to keep ahead of the game on capacity because you can't fine-tune it that carefully. And you do have this long lead time.

Now, what you do with the scrambled eggs now — with all the political forces back and forth... I think that you better have a system that encourages building extra capacity because you don't know how much rainfall there will be in the Pacific Northwest and, therefore, how much hydro will be available. And you don't know what natural gas prices will do and, therefore, whether it's advantageous for a gas-fired turbine to be operating.

The old system really strikes me as somewhat better than this semi-deregulated environment that we have more or less stumbled into. Charlie, what do you think?

We may enjoy the California Experience in oil refineries....

Munger: Of course, even the old system got in some troubles. Everybody had the NIMBY syndrome — "Not In My Back Yard". Everybody wanted new power plants to be anyplace not near me. If everybody feels that way and if the political system means that the obstructionists are always going to rule — which is true in some places in terms of zoning and other matters — you're in deep trouble. If you let the unreasonable, self-centered people make all of the decisions of that kind, you may well get so that you just run out of power. That was a mistake.

And we may make that mistake with the oil refineries. We haven't had many new big oil refineries in the last period. So you may get to do this all over again.

We wouldn't expect great returns on capital — which is fine.

Buffett: All of that being said, there *will* be a need for more generation capacity. The electric utility industry will grow. It will need lots of capital. And there should be ways to participate in that where we get reasonable returns on capital. We would *not* expect to get great returns on capital. But we'd be happy to do that. We generate a lot of capital.

And we'd be comfortable in that business. We would not feel the risks were undue as long as we didn't go around paying incredible prices for somebody else's capacity and then have people get very upset at what that meant in terms of their electric rates.

YOU CAN SPOT TROUBLE EARLY IN MOST BUSINESSES.
IN FINANCIAL INSTITUTIONS, YOU SPOT IT LATE.

We felt the risk profile changed for the worse at Freddie.

Shareholder: I noticed that you sold our position in Freddie Mac. What risks do you see in that industry?...

Buffett: It's true — we sold the Freddie Mac stock last year. There were certain aspects of the business that we felt less comfortable with as they unfolded — at Fannie Mae, too. And the consequences of what we saw may not hurt the companies at all. But they made us less comfortable than we were when those practices or activities didn't exist.

I would stress that we did *not* sell it because we were worried about more government regulation of Freddie and Fannie. If anything, it's just the opposite. Wall Street will occasionally react negatively to the prospect of more government regulation — and the stocks will react, sometimes short-term, for that reason. But that was not our reason. We felt the risk profile had changed somewhat.

There is so much at a financial institution you don't know.

Munger: But that may be just a peculiarity of ours. We're especially prone to get uncomfortable around financial institutions.

Buffett: We're *quite* sensitive to risk — whether it's in banks, insurance companies or in what they call GSEs [Government Sponsored Enterprises] here in the case of Freddie and Fannie. We feel that there is so much about a financial institution that you *don't* know just by looking at the figures that if anything bothers us a *little* bit, we're never sure whether it's an iceberg situation or not. And that doesn't mean it is an iceberg situation in the least at banks or insurance companies that we review.

But we have seen enough of what happens with financial institutions that push one way or another that if we get some feeling that that's going on, we just figure that we'll never see it until it's too late anyway. So we bid *adieu* and wish 'em the best without any implication that they're doing anything wrong. It's just that we can't be 100% sure of the fact that they're doing things that we like.

And they make us nervous when they try to do well....

Buffett: And when we get to that situation, it's different than buying into a company with a product or a retail operation. You can spot troubles, usually, fairly early in those businesses. You spot troubles in financial institutions late. It's just the nature of the beast. Charlie?

Munger: Financial institutions tend to make us nervous when they're trying to do well. It sounds paradoxical, but that's the way it is.

Buffett: Financial institutions don't get in trouble by running out of *cash* in most cases. You can spot other businesses that way. But financial institutions can go

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beyond the point ... of *solvency* while they still have plenty of money around — and we had banks that did that *en masse* 10 years ago.

DEALS THAT ARE GOOD EXCEPT FOR ASBESTOS
ARE LIKE BEING FINE EXCEPT FOR BEING DEAD.

We don't go near asbestos.

Shareholder: I believe that you're willing to write larger policies of reinsurance than anyone else, but that you still insist on the amount of your liability being capped. I'm wondering with your investments in companies that have exposure to asbestos, have you capped that or is that unlimited — especially given joint and several liability? *

Buffett: We haven't put any significant money, to our knowledge, in any company with asbestos exposure now. We have a small amount of money in USG where the subsidiary of United States Gypsum has a *major* asbestos exposure. But that's a very, very minor investment. It's 1/10th of 1% of Berkshire, roughly. And that's the only one that I can think of.

We've walked away from several deals that were quite attractive in every respect except for asbestos. But that's like saying to a 120-year old, "You're in good health except for the fact that you're dead." So we don't go near asbestos.

We write bigger than anyone. But we don't write unlimited.

Buffett: In our retroactive insurance policies, we're taking over the liabilities of companies with lots of asbestos exposure. And in that case, we assume that those contracts will be paid in full. We make no assumption of any reduction in asbestos costs. But we do cap them.

There are a couple of things you *can't* cap in insurance. You can't cap worker's compensation losses. You can as a reinsurer, but the primary insurer can't do that. I believe auto, for example, is uncapped in the U.K. And nobody thought that was very serious until they had a recent accident that I think involved a car doing something to a train that was unbelievable. So there are a few areas where insurance is written on an uncapped basis. And in our case, we write some auto insurance in the U.K. — and some worker's compensation, primarily in California.

But generally in reinsurance, you are capping the liabilities you take on. Obviously, when we bought it, General Re had asbestos liabilities from reinsurance contracts they'd written. However, reinsurance companies are pretty careful about writing unlimited policies.

But we write huge limits. If somebody wants to write a huge limit or an unusual limit, they should call us — because there's no one else in the world that will act as big or as promptly as we will. But we don't write things that are unlimited....

The biggest exposures are the inadvertent ones.

Buffett: The biggest exposures, in our view, are those of companies writing a lot of primary business who don't have the catastrophe cover they need. If you write 10-15% of all the homeowners' business on Long Island or Florida,

then you're writing a catastrophe cover that would blow your mind.

If you're Freddie Mac or Fannie Mae and you're guaranteeing mortgages for millions of people in areas like that and they don't have insurance — earthquake in California or the proper insurance in Florida (they'd be less likely to have earthquakes there) — then you're taking on enormous risks, *huge* risks, *far* beyond what we'd ever take on because you don't get paid for it, unfortunately.

In insurance, the unthinkable always happens.

Buffett: Just take the New Madrid section of Missouri down in the corner. That was the area of three of the greatest quakes in the U.S. — certainly in *recorded* history. How much homeowner's business and commercial property business did somebody have in that huge territory which supposedly caused church bells to ring in Boston when it happened back in whenever it was — 1811 or something like that? So all *kinds* of risks can aggregate in huge ways that companies aren't thinking about at all.

For example, I don't know whether Freddie Mac or Fannie Mae demands that all the homes they insure in a 300-mile radius of New Madrid have earthquake insurance. That sort of thing never comes to mind until the unthinkable happens. But in insurance, the unthinkable *always* happens.

WE BUILD IN A MARGIN OF SAFETY FOR LEGAL.
BUT SUGAR LITIGATION ISN'T ONE OF OUR FEARS.

Sugar's in practically everything. We don't worry about it.

Shareholder: In recent years, tobacco companies have been compelled to pay large damages for marketing their unhealthy, but discretionary, products. My question has two parts: First, does the potential for similar damage liabilities reduce the intrinsic value of Coca-Cola, See's Candy, Dairy Queen or any other business which sells discretionary products of questionable healthfulness? (Not that I don't *like* these products...)

And second, are either of you concerned that a possible erosion in the principle of *caveat emptor* is undermining the legal basis of contracts in general?

Buffett: Well, I've been living on the products that you describe for 70 years. So they'll probably haul me in as a witness that they don't do much damage....

I think the average human being eats something like 550 pounds dry weight of food per year. And I think 125 pounds or thereabouts of it consists of sugar in one form or another. It's in practically every product that you have. And it happens to be in Coca-Cola and it happens to be in See's Candy. But it's in practically everything.... It's over 20% of what Americans are consuming one way or another. Yet the average life span of Americans keeps going up.

So I wouldn't be worried at *all* about product liability in connection with those companies.

The lottery ticket aspect of the legal system is irresistible.

Buffett: But product liability *generally* is an area that is a fertile field for the plaintiff's bar. We are conscious of it in buying the businesses. And we've passed up some businesses because we were worried about the product liability potential. Unless there is some legislative solution,

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

I think you'll see more and more of the GDP going into liability awards. And whether there will be any change by legislation, I don't know. But it's a big field.

And the lottery ticket aspect of it is so attractive — because if an attorney can gamble a modest amount of time (or even a *reasonable* amount of time) and have a potential payoff of 10 or 20 or maybe in some cases hundreds of millions of dollars, that's a decent lottery ticket.

And you don't have to fool all of the people...

Buffett: Who knows what 12 people are going to be on a jury? As one of my friends who's a lawyer said, "Lincoln said, 'You can fool some of the people all of the time, all of the people some of the time, but not all of them all of the time.' Well," he says, "I'm just looking for 12 that you can fool *all* of the time." That's virtually all you have to do to get an award.

And the odds are fairly favorable in a nation where lots of zeros have sort of lost meaning to people. So it's a very real concern in any business we get into in terms of trying to evaluate product liability. Charlie?

It's bad now. And I see few signs of it getting better.

Munger: What's particularly pernicious is the increasing political power of the plaintiff's contingency fee bar. If you're on a state supreme court, in most places you're on for life — at least, you're on for life if you want to stay for life. And the one thing that could get you *off* would be for the court to really irritate some important group. I think that greatly helps a lot of abusive conduct in the courts. I think that judges in the country haven't been *nearly* as tough as they should be on junk science, junk economic testimony and trashy lawyers.

And I don't see many signs that it's getting better. In Texas, they actually improved their supreme court — which really needed it. So there are occasional glimmers of light.

Buffett: We make our decisions in insurance and in buying businesses with a very pessimistic attitude towards the chances of that particular ill that Charlie described being even moderated. We would project out that the trend would *accelerate*. That's just our natural way of building in a margin of safety in decisions.

I don't know what the answer is, but I feel terrific.

Buffett: But don't worry about eating the See's Candy or the Dairy Queen or the Coke. If you read the papers long enough... I use a lot of salt. I was always being warned about that. But then a few years ago, they started saying you can't get *enough* salt and all of that. So I don't know what the answer is, but I feel terrific.

I VIEW THE INTERNET AS LESS OF A THREAT,
BUT AS NO LESS OF AN OPPORTUNITY....

The internet looks like less of a threat today.

Shareholder: ...Last year, I asked how the internet

might affect some of your holdings. Since a lot of the internet companies have gone out of business, has your view of the internet changed?

Buffett: That's a good question. The internet probably looks to most retailers like less of a competitive threat than it did a couple of years ago. For example, jewelers on the internet — in several cases, at least — had very large valuations a couple of years ago. So the world was betting that they'd be very effective competitors against brick and mortar jewelry retailers. I think that that threat has diminished substantially. And I think that's been true in the furniture business. In both of those industries, very prominent dot-coms that had aggregate valuations in the hundreds of millions have vanished in short order.

But we still regard it as a huge opportunity...

Buffett: We continue to think that the internet is a *huge* opportunity for certain of our businesses. GEICO continues to grow at a significant rate in internet business. See's Candy's internet business is up 40% this year. Last year, it was up a much larger percent than the year before. It grows — and it'll *continue* to grow. So the internet's an opportunity.

But I think the idea that you could take almost any business idea and turn it into wealth on the internet... Many were turned into wealth by promoting them to the public, but very few have been turned into wealth by actually producing cash results over time.

So I think there's been a significant change in the degree to which I foresee the internet as a possible threat to our retail businesses. There has been *no* change in the degree to which I regard it as an opportunity for other of our businesses. Charlie?

The internet bubble has been a huge trap to the public.

Munger: Well, Warren, you and I were once engaged in the credit and delivery grocery business. And it was a *terrible* business. It barely supported a single family for 100 years with all of them working 90 hours a week.

And somebody actually got the idea that that was the wave of the future and turned it into a great internet idea. That can only be described as a mania. And it sucked in a lot of intelligent people.

Buffett: Yeah, Charlie is talking about the infamous Buffett & Son grocery store which did barely support the family for 100 years. And then we could support the family only by hiring guys like Charlie for slave wages.

I used to go out on those delivery trucks. And it was pretty damned inefficient. People would phone their orders in. And I'm sure we took 'em down with a pencil and an order pad instead of punching them into a computer. But when you start driving around the trucks and hauling the stuff off and everything, we ran into the same costs that Webvan is running into now.

What the internet offered was a chance for people to monetize the *hopes* of others. You were able to capture the greed and dreams of millions of people and turn that into instant cash, in effect, via venture capital and the markets. And there was a lot of money *transferred* in the process from the gullible to the promoters, but there's been very little net money created by pure internet businesses so far. It's been a *huge* trap to the public....

—OID

GABELLI FUNDS'
MARIO GABELLI & TIM O'BRIEN
(cont'd from page 1)

the *Ibbotson* Small Company Index for the 12 years ended December 31, 2000. So, obviously, the man knows whereof he speaks.

And as we've learned over the years, few observers bring Gabelli's unique blend of cutting edge insights into the latest media developments — both from the perspective of new technological developments, colorful personalities and good old human interplay. We never fail to pick up a new insight or two and usually a few interesting ideas, too.

We're therefore very pleased to bring you the excerpts which follow which were taken from the remarks of Gabelli and Gabelli utility expert Tim O'Brien and their answers to shareholder questions during their Gabelli Equity Trust, Gabelli Global Multimedia Trust and Gabelli Utility Trust annual meetings held May 14th. In this instance, being late appears to have been good timing — because most of the ideas discussed appear cheaper today than the day that they were first mentioned.

As always, we found their comments enlightening and valuable and hope that you will, too.

EVERYTHING'S GONE WRONG IN MEDIA LATELY.
BUT THAT'S BEEN THE BEST TIME TO BUY.

Internet advertising's still the fastest growing segment....

Gabelli: In January through April of last year, you still had dot com advertising. In 2000, you also had political advertising and some other events like the Olympics. In 2001, you don't have any of that. So the comparisons for broadcast media are terrible year-to-year. And that's caused the stocks of great companies to get hurt.

The total amount of advertising [done by] Coca-Cola, Procter & Gamble, etc. in the U.S. — all sources, all advertising — is \$236 billion. How does that break down within what we call the media pie — television, radio, cable, newspapers, magazines, direct mail, outdoor, internet and other? Of the \$236 billion spent, about 2.5% of that was on the internet — about \$5-6 billion. That's going to be up this year at least 40% — not for Petsmart.com, but for companies like IBM advertising on the internet. So that's still the fastest growing portion of the media pie....

Everything's going wrong in media. We like that....

Gabelli: Back in 1971, we had tobacco on the air.... Marlboro used to be able to advertise on television. Then the government said you couldn't do that. They pulled 6% of what the TV stations were getting off the air. And it happened at the same time that you had no Olympics and no election and an economic slowdown. So advertising dropped sharply. Well, that's exactly what's happened in 2001. About 5% of the advertising in 2000 was from the Petsmart.coms — and that's gone....

TV advertising in 1966-1975 kind of reminds me of this period.... I was the analyst covering broadcast stocks at Loeb Rhoades during that period of time. That was also [when] the accounting industry introduced APB [Accounting

Principle Bulletin] #17 for amortization of goodwill in business combinations. So you had *everything* go wrong. And it was the best time to buy those stocks.

Now's the time to own advertiser-supported companies....

Gabelli: Fast forward — instead of Marlboro, you had Petsmart as a surrogate for the internet-related dotcommer's spending on television. That's gone....

So you have a glitch down [in 2001]. But a year from now, we'll [see the effects of the] tax cut. We'll have oil prices hopefully stabilized. We'll have interest rates helping. And we'll have a consumer-led economic recovery.

We'll also have another election. They're going to spend and spend — whether it's in New York, New York City or California with Davis. That's going to be terrific for the advertising media pie. We'll have another Olympics. And the comparisons will be very easy year-to-year.

So you want to own advertiser-supported companies. We believe that for the next 10 years, advertising's going to ramp up dramatically....

TWO GREAT CATALYSTS IN THE MEDIA AREA:
APB #16 AND A MORE MARKET-ORIENTED FCC.

Changes at the FCC and FTC are extraordinarily important.

Gabelli: The second reason you want to own them is because of what's going on at the Federal Communications Commission [FCC]. You're going to have a more open playing field with regard to transactions.... Bill Kennard at the FCC, [former FTC Commissioner Robert] Pitofsky and Joel Klein [former Justice Department Antitrust Division head] basically were the gatekeepers of transactions. [So instead of] creating a gateway, they were the gatekeepers.

But the Department of Justice is changing, the Federal Trade Commission is changing and we have Michael Powell [and a Republican majority] at the FCC. This is all *extraordinarily* important for transactions in media and entertainment....

Michael Powell is going to do a fabulous job as the individual at the FCC who's going to change the rules to let the free market work. [He's going to] reposition the system.

Raising of ownership limits will cause a round of mergers....

Gabelli: Let me go through what he's going to do: Cross-ownership.... *The New York Times* can't own a television station in New York. When that rule is changed, they will be able to own a TV station in New York. That means if I own a TV station in St. Louis like Gannett or Belo does, I'll want to buy the newspaper. Right now, a television station can only have approximately 35% of the U.S. population under its control.... That'll be raised. The cap for cable is 30%. And wireless ... will also be changed — where you'll go from having a cap to an unlimited cap on spectrum. And that will cause a round of mergers and consolidations in the wireless telephone business....

Accounting changes are a powerful incentive to do deals.

Gabelli: There's one other element that we have to talk about. It's an element that I wrote about back in 1971 when I started following Taft Broadcasting, Cap Cities and Lin Broadcasting. What happened is that after that wave of acquisitions in the '60s [and after] Saul Steinberg attacked Chemical Bank, the business community reacted. As an outcome of that, the government issued the Williams Act.

(continued on next page)

GABELLI FUNDS'
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(cont'd from preceding page)

The accounting industry also woke up and issued APB #16, which was a methodology of poolings, and APB #17, on the amortization of goodwill — so that any company that bought another company that wanted to follow a certain accounting treatment had to amortize the goodwill [associated with that transaction].

Today, 30 years later, they're going to eliminate this. If I'm [running] General Electric and I'm driving my company based on earnings per share and Bob Wright, who runs NBC, wants to buy a movie company, I tell him, "Hey Bob, you can't do that because it creates an earnings dilution". In the future, Bob Wright at NBC is going to go in and say, "We're going to buy — and it *won't* create an earnings dilution." So the change in the accounting rules where amortization of goodwill will be eliminated is going to be a *powerful* incentive for companies to have a greater propensity to do deals.

Everybody will say that's nonsense. But I sit on enough boards and I listen to enough meetings that I think this will be a great catalyst....

A whole lot of companies will be taken over. For example....

Gabelli: You put all of this together and you're going to see an *incredible* number of mergers in the next 12 months in the media area — newspaper companies like Journal Register. It's a \$16 stock that's worth \$30. They're the operator of newspapers in New Haven and the Philadelphia suburbs — and they'll sell.

Pulitzer, a long-time favorite of ours, owns the St. Louis newspaper, one in Tucson and a whole bunch of local [community newspapers]. They're selling at \$50, worth \$75 — and they'll sell. Gannett or Belo would like to buy them.

In broadcasting stations, [there's] Young Broadcasting. It's selling for around \$35. We think they're worth \$70. The family probably wants \$100. They have LA and San Francisco. NBC wants those [markets]. Lots of companies want 'em. Paxson at \$11 — NBC already has their arms around them. So there's a whole bunch of companies like this that can be taken over....

[Editor's note: According to SEC filings, Gabelli-related entities purchased 164,400 shares of Young Broadcasting between June 27th and August 24th at an average cost of \$30.66, and an additional 162,981 shares at an average cost of \$20.40 between August 28th and October 15th.]

But you need a tour guide — like us....

Gabelli: Now, some companies are smart like Herb Siegel [at Chris-Craft] and they negotiate up. Some companies are really dumb like Granite and they destroy shareholder value. So you have to be careful with it. That's why you need a tour guide like us — because even we make mistakes.

Let me give you Scripps Howard — because I want you to own this one. Scripps is located in Cincinnati. They have two wonderful cable networks: Home & Garden and The Food Network. And I think those are going to become magnets that attract attention.

The company sells at \$63.... I think we're going to get \$120 in two or three years. So you're going to start seeing that in the portfolio. They're a great cash generator with a good balance sheet and newspapers.... And they just

settled a newspaper war in Denver with the Denver Post....

IT'S TRUE THAT NEWSPAPERS FACE CHALLENGES,
BUT THE POSITIVES OUTWEIGH THE NEGATIVES.

Newspapers definitely face challenges and uncertainty.

Shareholder: At the Berkshire shareholder meeting, Buffett said he thought newspaper stocks were overvalued because you could get the stuff free on the internet — and that they had a bleak future. Do you have a retort to that?

Gabelli: No. As we've said in the past, the internet is changing everyone's life. If you own a newspaper — and Warren owns one in Buffalo — you see the following: readership, circulation, [advertising revenue, etc.] And only one quarter of the New York Times' revenues comes from circulation. The rest comes from advertising. And of the advertising, you have retail and classified — which breaks into three parts: help wanted, houses and autos. And the technology is such that putting those classifieds on the internet is very cost effective — and very effective generally.

So as you're looking out, you're fragmenting the share of a local market by radio and others in advertising. Your cost for newsprint goes up. Yet you can distribute that same information for free. On top of that, your classifieds — which are part of your business model — are getting marginalized by dot coms. So where's the value?

But the positives, if correctly exploited, are even greater.

Gabelli: But I still think it's a global local business. In 1967, I wrote a research report as a rookie analyst on the checkless society. I projected out what was going to happen in 20 years. And one of the great stocks that's *still* a great stock — and everything I projected was correct — was Deluxe Check Printers [now Deluxe Corp.]....

What I'm getting at is that newspapers will have a declining value of their business, but it will still be a terrific local business. And if Gannett can buy Pulitzer — if the family says, "I don't want to fight the holy war" and bites it... If you and I were running Pulitzer, what would happen is that we would (1) try to sell the company because we don't want to fight it or (2) try to keep the economic value of the enterprise by taking on a premier competitor in the market [as a partner] to handle the internet-based [retail and classified].

But I believe even in today's world, *that* business is worth more than the economic value of the business the newspapers have lost. So if you were active and did (1) [and stayed with the old newspaper business model], it would decline in value. But if you did (2), it would *increase* in value. The sum of the two would be a higher valuation.

I have a friend that publishes The Boston Herald — and he did exactly that. And it's worth a lot more today....

THERE'S LOTS OF UPSIDE IN CABLEVISION
AND A POT OF GOLD AT THE END OF THE RAINBOW.

Rainbow is extraordinarily attractive....

Gabelli: Let's go through some of the other stocks you own.... Cablevision — Chuck Dolan. Cablevision closed at \$59 — so let's call it \$60. There's 170± million shares.... So \$60 x 170 is about \$10 billion. There's approximately \$5 billion of net debt and preferred. So you're paying \$15 billion for the company. And what Dolan has done

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 (cont'd from preceding page)

is dominate the New York market by concentrating all of his cable assets there....

A couple of months ago, you received a half a share of Rainbow for every share of Cablevision. Rainbow is Bravo; it's American Movie Classics; it's what was formerly Romance — now WE (Women's Entertainment). And that is an *extraordinarily* attractive company. So we think there's a pot of gold at the end of that rainbow.... AT&T owns a piece. And they're going to sell that off because they're dismantling their assets. NBC owns about 25% of Chuck Dolan. And we, as your surrogate, own a fairly large piece of Rainbow.

So I want you to buy Rainbow in your own accounts. The stock's around \$22. Over the next five or 10 years, I think you'll make close to 20% a year. We have a research report on Rainbow ... on our website.... So put a little romance in your life by buying a little bit of Rainbow.

Changes at the FCC bode well for Cablevision.

Gabelli: As for Cablevision, the short-term concern is capital expenditures — like rolling out digital [cable boxes]. And that's a fairly heavy capital-expenditure-type item.

You have to step back though [and consider what's happening at the FCC].... Michael Powell is free market — and he'll change the rules of the road.... And there are other dynamics in place. For example, the Federal Court of Appeals has remanded back to the FCC certain questions driven in part by the first amendment. Those questions deal with how many cable subscribers you can have in the United States. [As I mentioned earlier,] they're going to change the cap on the [percentage of the] ... population you can own.... And they're going to change the caps on cable and ... on spectrum.

[Editor's note: On September 13, an open meeting was held at the FCC where they discussed their thoughts on revising the caps and solicited public comments. Gabelli & Company expect a new ownership ruling by the commission in mid to late 2002.]

Gabelli: The second thing that they're doing is asking the FCC to re-examine whether a cable company can also own programming — and to what extent. It's called vertical integration. And then there are other elements that come into play called rules of attribution....

But they need [a few] more months to get the [new commissioners at the] FCC in place. And after that happens, we think we can get close to \$100 a share. But we won't get the money for about two years.... So that's why we own Cablevision. That's probably why at a certain price we'll buy more....

[Editor's note: According to SEC filings, Gabelli-related entities purchased 969,215 shares of CVC at an average cost of \$37.26 between September 10th and November 9th.]

(continued in next column)

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**LIBERTY CORP & LIBERTY MEDIA TRADE AT 50% OFF
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The best investment Liberty can make is its own stock.

Gabelli: Liberty Corp: The stock is selling at \$38. There are 20 million shares outstanding. So we're talking about a \$760 million market cap. And they have no debt. Liberty sold off its insurance company to a Canadian group. In the process, I said that they should've bought back more stock. Their stock was trading at \$50 and they shouldn't have done what they did. So we're suing them in South Carolina on behalf of our clients.... But there's an old concept in litigation called "homering" — the home court advantage. And we don't have one in South Carolina.

What we hope to do is to have the company become a lot more shareholder sensitive and buy back a lot more stock. We think they can easily borrow three or four times their close-to-\$100 million in cash flow and buy back stock. The company's worth about \$75 today.

I think they want to grow by buying some TV stations in Atlanta, the Southeast and then Texas. And depending on the price they pay, they could buy back their own stock at 7 times cash flow. So why would we want them to pay 12 times cash flow for someone else's stock...?

We think Gaylord could be awfully intriguing....

Gabelli: Gaylord is located in Nashville. If you think about Gaylord Entertainment, you have to think about country & western music: Loretta Lynn, the Grand Ole Opry and Ryman Auditorium. And they have a hotel that has 2,971 rooms — call it 3,000 rooms — down there. The cash flow's about \$80 million a year. At one time, this company was the dominant factor in country & western music, bass fishing — fishing is the largest sport in the U.S. — NASCAR racing (they had a lock on NASCAR), and line dancing at the ... Wild Horse Saloon.

They then proceeded to screw up this great franchise. This guy, Terry London, ... must have been a cousin of the Carters — not Jimmy Carter, the Carter-Wallace family — and they fired him. They just brought in ... Colin Reed, who worked for Harrah's, and his boss, Michael Rose, who's a very good hotel person that ran ... Promus.

I think the stock at \$28 could be *awfully* intriguing. No analyst follows it. We think the hotel alone is worth the whole company. And we get the genre of music for free. We think country & western — Garth Brooks and that group — has a very good position. And they're very profitable....

[Editor's note: According to SEC filings, Gabelli-related entities purchased 111,200 shares of Gaylord between October 8th and December 7th at an average cost of \$22.56.]

And Liberty Media looks like a two-year double....

Gabelli: Liberty Media [no relation to Liberty Corp] is my favorite surrogate for us to own. It trades at \$16 — and we're buying it. Liberty Media is about half the price [of what it's worth]. And as we look forward in an environment [with] AOL Time Warner, Viacom ... and Disney, all of these other companies are small....

There are cable companies coming together. So what we see over the next five years is that companies that have content — or content packages like the Discovery Channel — will do quite well.

John Malone made a lot of mistakes last year, but I think he's back on track. He'll unleash a series of

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GABELLI FUNDS'
MARIO GABELLI & TIM O'BRIEN
(cont'd from preceding page)

acquisitions with his financial resources. He's got a big ownership in AOL Time Warner's entertainment unit — and he'll use that as a currency.... Over the next couple of years, I expect that stock to double.... So we intend to add to it....

Vivendi, we're holding. We think the sum of the parts is worth north of \$100. This is the company that brought you "The Mummy". You didn't see it? Well, they have some wonderful assets....

THE FUTURE IS NOW, AT&T WIRELESS IS PART OF IT,
AND YOU SHOULD OWN IT. PLUS, IT'S A BARGAIN.

With wireless, you ain't seen nuthin' yet.

Gabelli: AT&T Wireless is a world class company. Wireless has been driven in its first wave by voice. Nobody that's smart goes into a hotel room any more and uses the hotel's phone service. They take their AT&T phone out and they dial because it only costs whatever your bucket plan is.... That's voice.

The next step is data. In Japan, i-mode is the brand name of DoCoMo. All the next generation of users are using their phones [to get] everything.... And then with the next generation down the road, if you want anything... Let's say I want to leave the Greenwich library and go to a French restaurant in the area with a \$30 price tab and make reservations. The phone will say, "Are you crazy? Eat at McDonald's. You can't eat for \$30 in Greenwich." But they'll recommend Jean Louis. If you're on a budget, you'll go to the Homestead.

The future is now — and AT&T Wireless is a bargain.

Gabelli: Then we go to the next logical step. I want the best possible price for my new refrigerator.... They'll search and find the price. I'll say, "Charge it to my American Express card." AT&T Wireless is going to get a piece of that transaction in some form. It's down the road, but it's going to happen.

You're already seeing these ads with kids ... dialing in and saying, "Give me that Coke because I'm at a vending machine and I don't have any coins". They just dial a number on the phone, put it in and get their Coke.... So the future is now, AT&T Wireless is part of the future and you should own AT&T Wireless. It's an undervalued stock at \$19-20, it's cheap and it's a bargain.

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What went bust were the equipment companies...

Gabelli: And the Japanese [NTT DoCoMo] were willing to pay \$28-30. If Mike Armstrong had negotiated better, he would have gotten a higher price.

Then you have a global consolidation in this business. And it's unlike [other areas of] telecom which people say are ugly. What went bust were the equipment companies. I can go into the horrors of Nortel....

TWO TELECOM BARGAINS, ONE TELECOM CYCLICAL
AND ONE TELECOM BARGAIN HUNTER.

Our TDS sells at 50¢ on the dollar.

Gabelli: We have a research report on Telephone & Data Systems. It sells at \$103. They own U.S. Cellular. We like the wireless telephone part of that business.... When you're in the wireless telephone business, it's huge growth and technology driven. However, there's one thing — you need a license to get into the business. And that's fundamentally good. So that's why we own that.

[They've] become a very major holder of Deutsche Telekom. We're buying that for free — and we like that. TDS today is worth in excess of \$200, so we continue to hold it....

And then there's Leap Wireless — among others...

Gabelli: In fact, we like wireless around the world.... And we include NTT DoCoMo in that category. You'll see an announcement that Telefonica — the Spanish telephone company — is attempting to buy into the Mexican wireless industry. And one of the ways they'll buy in is by negotiating to buy Pegaso. Pegaso is 20%-owned by Leap Wireless which is a Qualcomm spinoff. And we've been accumulating Leap Wireless....

[Editor's note: According to SEC filings, Gabelli-related entities purchased 828,100 shares of Leap Wireless between June 20th and August 9th at an average cost of \$24.50 and an additional 526,300 shares between July 25th and September 4th at an average cost of \$17.84.]

We like people who buy things for a penny on the dollar....

Shareholder: Are you involved with IDT?

Gabelli: Howard Jonas is a terrific guy. He's one of the great creative geniuses in the telephone business. Darwin said it best. He said it's not the smartest or strongest guys who survive. It's the ones that adapt to change. And Howard Jonas has adapted to change. He's terrific.

This is a company in Hackensack, New Jersey.... What he's buying right now are remnants of all of these companies. Winstar, which was trading at \$50 a share, is trading at 2¢ a year later. Teligent [run by] Alex Mandl was selling probably at \$100 and is now down at 16¢. So he's buying that with John Malone. I can't tell you whether it's a transaction that's driven by taxes or a transaction to buy assets cheap, but Howard has it figured out. And he seems to have a good enough currency to do these things.

So I think he's a terrific operating engineer. And we'll see how he can make money. I like individuals that are bargain hunters buying things for a penny on the dollar....

We like cyclicals — at least we do when nobody else does.

Shareholder: Do you follow Corning?

Gabelli: ...We bought a little bit of Corning in the

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GABELLI FUNDS'
MARIO GABELLI & TIM O'BRIEN
(cont'd from preceding page)

last couple of months just because we wanted to own fiber optics. The stock dropped from \$100 to \$22.... The market has thrown out the Cornings and EMCs of the world — which are great companies — because of cyclicity. Cyclical stocks are fairly simple. You buy 'em when nobody wants 'em. If they have cash to survive, that's nice. And then you try to sell 'em when everybody wants 'em. What people forgot was that there are cycles. They are high growth cyclicals — and some of them are very attractive.

One good thing about technology — rapid obsolescence....

Gabelli: And the one good thing about technology is that the obsolescence factor is a lot faster. If I build a car factory or a steel mill, I'm stuck with it for 20-30 years. But technology will obsolete a lot of the incremental capacity that came on too fast when it was in a high growth mode. So some of the capacity from the telecoms — some of which should never have been built — will be used up quickly.

SEQUA'S CHEAP AND WELL-POSITIONED.
WORLDCOM IS ANOTHER STORY.

Sequa's still trading at 50¢ on the dollar.

Shareholder: Were there any positives in the results coming from the Sequa meeting [earlier this year]?

Gabelli: Our analyst went to the meeting — and [Sequa's 87-year old Chairman and CEO] Norman [Alexander] looked good. Well, I'm delighted to hear that.... The stock's \$50. There are about 11 million shares outstanding. So we're talking about \$550 million market value for the equity. And we still think it's worth \$100.

Airplane engine components could be a strong propellant.

Gabelli: Norman is Norman.... He's got a *tuxedo* company — After Six. It makes tuxedos — you know, the things you rent. But when you think about the business they should be in and which they're migrating into... Chromalloy is their crown jewel. Let me describe it: every time an airplane flies X miles, it has to have its engines overhauled or repaired. Chromalloy makes components for that — and they do a good job.

Think about the shortage of electricity. Imagine that the U.S. is going to have a shortage of power — rolling brownouts [like in] California, the sixth largest country in the world. How do we solve that problem? We've been bringing on an enormous amount of capacity in what are called industrial gas turbines. These are very efficient engines — like jet engines.... And companies that make parts for those, and that overhaul those parts, will be very attractive.... So that could be a strong propellant.

Plus, the other thing that's happening is that we're starting to see mergers accelerating in the defense area. But did anything else happen? No. Norman is Norman. He's been running it the same way for 50 years....

The long distance business is like an oil well....

Shareholder: How about Worldcom?

Gabelli: We don't own Worldcom. Bernie Ebbers is going to try to sell the company. We've been buying Sprint

instead. We think Sprint will be sold this cycle. At \$22, we've done some work that indicates we could make 50% on it. And I think they're for sale. Bernie is for sale. All the long distance companies are for sale. But I think Sprint is more easily sold.

Long distance became a commodity. Everybody saw it. [The question is] can you buy the synergies faster than... It's like an oil well. It's a depleting asset with great cash flow. But what's the residual value — and how fast will [it deteriorate]? So that's how you have to look at the long distance part of its business in light of what's going on.

It's possible that the FCC will change the rules. And if they do, ... it'll either slow down the rate of decline in the value of long distance or make it easier for a Bellsouth to come in and buy one of these — which is probably the way it *should* go as far as I can tell....

GAS AND ELECTRIC WASN'T A POPULAR FOCUS;
BUT SO FAR, IT'S BEEN A PROFITABLE ONE.

The gas and electric power industry....

Gabelli: Henry Kravis, Mario Gabelli, Warren Buffett — why do they all want gas and electric? Why does California have a problem? Will we have a brownout in New York? Do we want to own the gas companies or the water companies? Within the electrics, do we want to own the manufacturers — the companies that *produce* the power — or do we want to have those that *transport* the power? Or do we want to own the ones that distribute the power locally? How do we make money in this area?

We saw bankruptcies of electric companies. We saw Con Edison trying to buy Northeast Utilities — and we saw that deal break. We saw ... DTE renegotiate the transaction with MCN.... So how do we earn a return? And why did we as an organization ask you two years ago to spin-off the Utility Trust? Why did we hire Tim O'Brien who spent 10 years covering that industry?

We don't mind cat calls if they're followed by high returns.

Gabelli: Two years ago, everybody got up and said, "Gabelli, you need [internet analysts] Mary Meeker and [Henry] Blodget on your team. You've gotta go dot com." Well, we ... hired Tim O'Brien. And to do what? Utilities! Well, everybody booted us. However, utilities were the best performing group in 2000.

Warren Buffett bought a utility. And Buffett right now — and this is important — wants to change ... the Public Utility Holding Company Act [PUHCA].... If he changes that, he's going to go out and buy a whole *bunch* of utilities. So we see another catalyst for the utilities industry....

Look for further consolidation of the U.S. power industry.

Tim O'Brien: I'd like to go over the top holdings of the Fund.... Niagara Mohawk is an arbitrage situation — although we had a position in it before the deal was announced. In August of last year, they agreed to be acquired for \$19 by National Grid of the U.K. The acquisition of Niagara Mohawk by National Grid was the fourth acquisition of a U.S. utility company by a foreign utility company. And I don't think it will be the last by any stretch of the imagination.

Several foreign utilities have made acquisitions in the

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GABELLI FUNDS'
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(cont'd from preceding page)

U.S. — including Scottish Power, Powergen and the Grid itself — that indicate that this is only the first of what we anticipate will be further consolidation within the U.S....

We like the RGS/Energy East deal a lot.

O'Brien: RGS Energy is another arbitrage situation. It's a bolt-on or tuck-in acquisition being acquired by Energy East — a large upstate New York utility.... Rochester Gas & Electric, which is the utility subsidiary of RGS Energy, really fits into Energy East like a hand in a glove. So they should be able to take substantial costs out — even beyond the identified synergies that they mentioned when they announced the deal.

The deal is accretive to Energy East's earnings from the first year — and I think it's pretty clear that they're lowballing on the synergies. So we like this deal a lot. There's a nice spread that we can pick up by owning the stock to the deal close. And it wouldn't surprise me if we kept it after the deal closes — because Energy East itself is also pretty cheap.

We see a lot to like in El Paso Electric....

O'Brien: El Paso Electric is an acquisition target. It's a small west Texas utility that also serves a small piece of eastern New Mexico. They just got a potentially major transmission and generation play into Mexico where demand is growing 7% a year.

It's cheap relative to cash flow. It's got a management that is substantially incented to get the stock price up. And management owns a lot of stock. So a lot of the things that we like to see in a utility, we see in El Paso Electric....

Northeast Utilities is a logical target.

O'Brien: Northeast Utilities is a busted arb situation. They had a deal on the table to merge with Con Ed. But for a variety of reasons, the deal fell apart — somewhat acrimoniously. The two companies are suing each other.

But at some point, I think Northeast Utilities is a logical target, either to get back together with Con Ed (although I think the social issues make that somewhat problematical) or to combine with another large regional player. I don't look at that as a near-term likelihood, but in the next year or two I think it's something that you're likely to see....

PUHCA'S PROBABLY HEADED OUT TO PASTURE —
GOOD NEWS FOR INVESTOR & CONSUMER ALIKE.

Repeal of PUHCA could be a significant catalyst for change.

O'Brien: [It was] a pretty active year for acquisitions last year. It slowed down a little bit this year. But I think that's attributable to California in part and to the [wait for the] repeal of PUHCA, among other reasons. And once that law gets passed, the acquisition activity is going to pick up again....

We're always interested in finding catalysts for significant change here at Gabelli — particularly those that lead to consolidation — and PUHCA has the potential to be one of those. The Public Utility Holding Company Act was a law that was passed in 1935 in response to financial abuses

that occurred in the utility industry in the 1920s.

Today, PUHCA helps keep rates artificially high.

O'Brien: And PUHCA was not a bad law for its time. However, its time has passed. Basically what PUHCA did ... was to keep financial and industrial companies out of the utility industry, and keep the utilities relatively small, fragmented, and easy to control. It also kept the capital structures from being too highly leveraged. Not all of those are bad things. And all of them were good things in 1935. But a lot has changed since 1935.

It's clear that the fragmented nature of the utility industry keeps costs artificially high. And since it's the customers who pay those costs, that means that it keeps rates artificially high. And as rates have gone up, things that keep rates artificially high for no good reason have come under scrutiny. And PUHCA is one of those things.

PUHCA keeps Buffett from investing needed capital....

O'Brien: In addition, non-utility companies want to be able to invest in the utility industry as they're able to do in many other countries around the world with no harm being done to the consumer. They're being prevented from doing that by PUHCA. PUHCA basically says that if you're a multi-state holding company, you must be a pure utility. You can't be a financial or industrial company.

Now, Warren Buffett ... is interested in investing in the utility industry — and the utility industry needs new investment. Buffett, as part of a consortium, acquired an Iowa utility last year — MidAmerican Energy. But if he goes multi-state, because Berkshire Hathaway is a holding company, he would fall under PUHCA — from which he's currently exempt. He would then have to get out of the insurance business and all his other non-utility businesses — which, of course, he's not going to do.

And Berkshire Hathaway has indicated that, given the opportunity from the repeal of PUHCA, they'd be interested in investing another \$10-15 billion in the utility industry — which the utility industry could use because it needs new capacity and new capacity requires capital.

Berkshire has more money than reinvestment opportunity.

O'Brien: Why does Warren Buffett want to own a utility company? Well, think about this: Berkshire generates substantial free capital. Their combined ratio is 106%, which by insurance standards is very good. That basically means the cost of generating the float (the money that Berkshire has available for investment until it needs to be paid out in the form of claims to policyholders) is about 6%.

The problem is he can't reinvest that float at what his current assets are generating since, although he owns a lot of very profitable assets, they're not growing rapidly....

The utility industry offers lots of investment opportunity....

O'Brien: Meanwhile, the utility industry is about a \$300 billion industry with a regulated rate of return of between 9% and 11% — and it's highly fragmented. So given the opportunity, Berkshire could take its 6% cost of capital and reinvest it in the utility industry at 9-11% ... giving them an unleveraged return on assets of 4-5%.... And utilizing only *modest* leverage (which the industry could easily support) you can see the financial returns to a company like Berkshire Hathaway in the high teens or even the low 20s.

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Again, there's not a lot of growth there. But because the industry is so ... fragmented, there's an opportunity for Buffett to put capital to work that would not only benefit Berkshire, but that would benefit the consumer as well by providing the capital needed to expand the industry. So the repeal of PUHCA would provide that opportunity for Berkshire and companies like it.

In 1935, PUHCA benefited the consumer. It doesn't today.

O'Brien: Now, why should we repeal a law which has stood the test of time purely to benefit the Berkshire Hathaways of the world? In 1935, there really was not the regulatory infrastructure in place to protect the consumer. State regulatory commissions were either nonexistent or undeveloped. The accounting standards were not in place for you to really know what was going on in the utilities.

But all of that's changed. Today, state PUCs [Public Utility Commissions] are very sophisticated. They now have the ability to examine utility companies' books and records. They have all kinds of accounting safeguards and separations to keep the non-utility operations segregated from the utility operations.

So the ability financial operators had in the 1920s to use the utility to gouge the customer is not there today — which means that PUHCA creates a separate layer of regulation on top of these holding companies that keeps them from doing things that make great economic sense and provide benefits to the consumer. So it's time for PUHCA to go.

PUHCA's probably headed out. So we should do quite well.

O'Brien: And the repeal of PUHCA passed the Senate Banking and Commerce Committee 19 to 1, indicating that there's not a great deal of opposition. What little opposition to the repeal of PUHCA there is basically comes from the public power guys — the 25% of the electric power industry in the U.S. which is either municipal or co-op. And for historical reasons I won't bore you with, basically they're against anything the investor-owned utilities are for. That's more or less pro forma.

And opposition is also coming from the labor unions who perceive — and *correctly* so, I might add — that the consolidation of the utility industry will lead to more efficient operation which will lead to fewer jobs needed to do the same amount of work. So that's serious opposition, but it's hardly insurmountable — and I think, compared to the forces favoring PUHCA's repeal, it's relatively weak.

So the odds are that PUHCA is on the way out. And that means non-utility companies are on their way into this industry — which, I think, means that a lot of the utility companies close to a deal are going to get bought. And we should be able to make a great deal of money....

EXPECT MORE EUROPEAN BUYERS OF U.S. ASSETS
AND MORE GLOBALIZATION IN ENERGY SERVICES.

Europeans see the opportunity in American energy service.

Shareholder: The dollar has been strong versus the euro. But at the same time, you said European companies have been buying energy companies in the U.S. What is it

that American capital doesn't see that the Europeans see at a premium?

O'Brien: ...First of all, my experience in talking to the European companies is that they don't spend a great deal of time agonizing about fluctuations in currency — and they don't hedge. What they do see in Europe are low and declining rates of return and rates of return in the U.S. which, while capped and regulated, are still significantly higher than they can earn in Europe.

In addition, there are some tax advantages to a European company acquiring utilities in the U.S. Some of those may be going away. But as it stands right now, they have the opportunity to leverage an already superior rate of return in the U.S. through tax benefits.

The nature of the energy services business is changing....

O'Brien: And we've talked about European companies expanding in the U.S. — and we've seen a lot of that and we'll see more. But I should point out that this started with several years of American utilities expanding abroad. American utilities have substantial investments — particularly in the U.K., but to a lesser extent in continental Europe and in other parts of the world like Australia. So what's really going on is that the energy services business is increasingly changing from a local and regional business to a globalized business....

For several reasons, expect more European buying.

Gabelli: Clearly, if I have \$100 million and it costs me 120 million euros to buy it, it's not as favorable as if it only costs me 80 million euros to buy it. The euro is trading at 88 on the dollar. When it first started trading in January of 1999, it was at 120.

Given what I see in Europe — in terms of taxes coming down, like the Germans ... eliminating a double tax in 2002 (Company A can sell shares of Company B and not pay a tax), and what I see the economies of those countries doing (you can drive a truck from Budapest to the south of Wales to the north of Scotland, or from Hamburg down to Sicily) — that is very [encouraging].

And over time, you'll see a lot more consolidation. There are approximately 85 million people in Germany, 65 million in France, 65 million in Italy, and 65 million in the U.K. And as they come together, that is a very powerful, well-educated bunch of consumers. So I think the currency gets stronger. Therefore, they'll be buying more U.S. assets....

OUR PATIENCE SHOULD PAY OFF AT SOUTHWEST GAS.
IT'S ONLY GOING TO GET BETTER.

I can't understand the math at Southwest Gas.

Shareholder: How do you see a road map out of the morass at Southwest Gas?

Gabelli: A year ago, Southwest Gas had a deal on the table at \$30 from Oneok. George Lindemann came along in the free market system — and through a company that he controls called Southern Union bid, I believe, \$33.50. But for whatever reason, the board of Southwest Gas said, "\$30 is better than \$33.50."

For the love of me, I could never understand the math because Lindemann could write a personal check to pay for the company. At the time, it was a \$1 billion deal — which

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(cont'd from preceding page)

is not a big number. They're the gas company in Las Vegas and Phoenix — which are the fastest growing communities....

I can't tell you why they took to Oneok. They have some crazy arguments.... And all of a sudden, before I knew it, George was suing them, someone from Oneok was accused of doing lots of nasty things, and so they've been suing each other now for two years.

We're constrained by PUHCA, too. But that may change....

Gabelli: So a year ago, on your behalf, under the state of Nevada rules, we got what's called "cumulative voting". It [means that] we, with almost 10% ownership, can't own much more of the company because of certain PUHCA rules [that state that] money managers can't buy over 10%. So Fidelity, Gabelli and all of those entities that want to own over 10% of a utility company can't do it. (But that nearly 10% did allow us [to] elect one director....)

If this rule changes and allows that, that's *another* element to drive the prices up....

So far, so good. And it's only going to get better....

Gabelli: How do we get disengaged from the transaction?... How do you get out of this? Company A's suing Company B, and B is suing A, and B is suing C. So the lawyers are making money. They *love* this.

Western Resources, which is [trying to merge] with Public Service of New Mexico, controls Oneok. And since they're in the process of unwinding their company, it's possible that Oneok, too, will have a change in management. They could come back and pay up for Southwest Gas, settle up with George and vice versa. So there are a lot of ways to do deals.

George is a pretty savvy guy — and money talks. Somebody's got to come to the table and make these litigations end. Meanwhile, Southwest Gas was up from \$20 to \$21. And you've gotten paid a nice dividend. So you've made 13%. And in relationship to Nasdaq down 39%, that's a swing of 52%. But you're waiting for an event that *will* happen. And you'll get a price 50% higher. So I think it's a win/win. You just have to be patient....

And in theory, its value should rise. But only time will tell.

Shareholder: But will the value rise as we wait?

Gabelli: That's a good question. I can't answer that — because they've been drifting stock out and made some acquisitions that haven't been very smart. I can't ever understand why they [acquired] Northern Telecom's equipment construction company two or three years ago.

Phoenix — good city, lousy regulation. Las Vegas — good city, lousy regulation. The question then is, will the problems of California, where they regulated it poorly, influence the public service commissions in these various states to reexamine how they're regulating utilities? I'm in the camp that believes that that *will* happen. That's the good news.

So in *theory*, the value should rise. But you're also getting a dividend that is improving.... It's like any other company. You've got to make a certain return. And then you have the event — and the event is what really makes

your return. And you hope to have that done within two or three years.

[Editor's note: According to SEC filings, Gabelli-related entities purchased 96,400 shares of Southwest Gas between July 16th and August 31st at an average cost of \$23.74.]

There are lots of opportunities — on both sides of the table.

Gabelli: And there are other companies that are easy to identify.... Florida Power & Light [FPL Group] was going to merge with Entergy.... However, that deal didn't close. But we clearly think they'll do something.... And it's a great company — extraordinarily well-managed....

* [Teco's also] in Florida. Where does that one sell?

O'Brien: \$29.

Gabelli: And it's worth?

O'Brien: \$45. I think Teco looks very attractive. It would fit very well with Florida Progress. That's a logical acquisition....

Gabelli: So there are a lot of opportunities.... There are those of us, on this side of the table, who like takeout power. And there are those of us on that side of the table who like growth power. I'm a takeout power guy....

TODAY'S INVESTMENT QUESTION IS FAIRLY SIMPLE.
I'M TRYING TO GET A FOCUS ON TOMORROW'S....

The investment question yesterday and today....

Gabelli: Okay, let me summarize.... Where do we see the world? In the stock market two years ago, the investment question was, "Would the American consumer continue to be the engine of global growth or would the rest of the world's economic malaise drag us down?" A year ago, the investment question was fairly simple: "Would Greenspan, coming off Y2K, be able to cut back on liquidity, tighten rates and have a 'Soft Landing Part II'?"

Today, the investment question is also fairly simple: "Will interest rate cuts and tax cuts give us enough ballast to overcome the three bubbles that are breaking: two that already broke — the wealth effect and the Nasdaq (the technology capital expenditures) — and the dollar?"

But once the tax cut takes effect, expect a strong recovery.

Gabelli: However, as ... the tax cut [begins to take effect,] I think it will lead to a strong economic recovery.... When we're here next year, the investment question will be, "How will we sustain this? Will Europe do well? How will we handle the dollar? And how will we handle perhaps some incipient elements?" So the investment question a year from now is what I'm trying to get a focus on....

—OID

For additional information
you may contact:

GABELLI FUNDS
ONE CORPORATE CENTER
RYE, NY 10580-1434

(800) 422-3554
(914) 921-5100

CHRISTOPHER C. STAVROU, STAVROU PARTNERS

"...The stock market decline after the tragedy of September 11th was the worst since the defeat of France in 1940. The Twin Towers may have fallen, but our Republic still stands. The long-term earning power of the companies we own, when you add up all the pluses and minuses, is no worse this month than last, and it may be better.

"To me the terrorist attack looks like a once-in-a-generation super attack, not the start of many similar ones. The attack took years of planning. It depended almost entirely on an all-important element of surprise. They had to catch us asleep. Since 9/11, U.S. vigilance and security measures have skyrocketed. We are on alert, and are likely to remain so for years. (I'd guess Americans will again fly a lot and use hotels more, albeit with heightened security, just as, say, the English do.)

"I think the war against the terrorists will heat up enormously. Nineteen terrorists — on a 3rd class budget and led from a country with a gross domestic product of \$20 billion — just inflicted \$40 billion of damage on a country with a \$10 trillion GDP. Now there are 275 million angry Americans looking for the people responsible. For openers, Congress has already earmarked \$40 billion to shore things up and will spend no telling how much to find the culprits.

"Regarding the earning power of our portfolio: Recall that we are heavily in insurance. I would assume that since 9/11, every single Fortune 500 company has thought about increasing insurance coverage; every top primary insurance company that uses reinsurance has thought about using more or facing higher risk: Berkshire Hathaway, which owns General Re, is the 4th largest reinsurer in the world, and arguably the strongest. I assume that every company owning a jet plane has thought about flight safety: Berkshire owns Flight Safety International, the largest independent jet pilot training company. And I would think that every corporate executive or person of means who has been frustrated with airport delays has thought about buying a share of a private jet. Berkshire owns Executive Jet, the largest executive jet time-sharing company. I'd infer that Berkshire is getting lots of calls these days.

"Berkshire estimates its insurance loss from the tragedy at \$2.2 billion pretax and significantly less after tax refunds and credits. This is at most several percent of its equity capital and, in any event, is likely to be fully recovered from perhaps two quarters of cash flow. Possibly insurance rate increases in the next 12 months alone will cover that loss.

"It is worth quoting Warren Buffett on the stock market. What he says matches my sentiments, only he says it better. As quoted in *Fortune*, he said: 'Whatever you thought about the stock market before the attack on the World Trade Center is what you should be thinking today. I don't have any feeling that this will cause the market to behave much differently from how it would have behaved without this disaster. It's a market that has been through a bubble. If you think the market was too high to start with, that's what you should still be thinking. What happened doesn't change the productivity of the American worker. It doesn't change my feeling about what to pay for a business I've been negotiating to buy.'

"And according to *The Wall Street Journal*, Buffett also said: 'There's nothing dumber than betting against America. It hasn't worked since 1776.'

Letter to Partners — October 1, 2001

Dear Subscriber,

Like all Americans, we're deeply saddened by the events of September 11th. But for a variety of reasons, we're heartened as well. First and foremost, it could have been so much worse. Those who died did not die in vain. Rather, the event served as a sorely needed wake-up call to the rest of us. May we now and forever remember that the price of freedom is eternal vigilance.

Because our offices were within 12 blocks or so of Ground Zero and within the area shut down to allow trucks and emergency personnel in and out of the area, they were closed briefly. As a result, your editor was reported missing by an overly concerned family friend. And if it weren't a family friend of long-standing who did it, we would suspect that it was actually a comment about our editorial productivity (to use the term loosely).

Between 9/11 and the aforementioned productivity, it's probably no wonder that there was apparently a rumor floating around to the effect that your editor had passed away. Let's you wonder, we'll tell you an easy way to know when that happens: We'll publish much more frequently.

Meanwhile, we'd like to make a few observations:

- (1) The world's in much better shape geopolitically than it's been at any time since the end of World War II.
- (2) As Buffett says, behavior that made sense and behavior that didn't prior to 9/11 has not changed.
- (3) We believe that this edition includes at least three or four very nifty bargains.

Until next edition,



Your Editor

P.S. Happy Holidays to you and yours.

P.P.S. Thank you for your patience and your support.

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