Outstanding Investor Digest

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

Investors featured in this Edition:

Other Investors in this Edition:

Companies & Investments in this Edition:

Volume XVII Numbers 3 & 4 December 31, 2002

THIRD AVENUE VALUE FUND'S MARTY WHITMAN
"I COULDN'T BE MORE PLEASED WITH OUR PORTFOLIO — FOUR THAT COULD BE FIVE OR EVEN 10-BAGGERS."

Despite the fact that the Russell 2000 declined in three of the 11 calendar years ending December 31st, 2001, Marty Whitman's Third Avenue Value Fund failed to at least break even in only one year of the three — and in that year, declined only 1.5%. However, 2002 has been another matter entirely — with the Fund down 15.2% through year end.

But while Whitman isn't happy about that performance, he says that he couldn't be more pleased with the resulting

(continued on page 2)

LONGLEAF PARTNERS FUNDS' MASON HAWKINS, STALEY CATES ET AL.
"A NUMBER OF GREAT BUSINESS FRANCHISES THAT WE'VE YEARNED TO OWN HAVE SHOWN UP."

Southeastern Asset Mgm't's Mason Hawkins and his associates have been consistently outstanding stockpickers over the years — with emphasis on the word "consistently". Just *how* consistent? According to Callan Associates, Southeastern's equity-only returns rank them among the top 1% of all large-cap managers for the last 20, 10, five, three and one-year periods ended September 30th, 2002.

Incredibly, that's despite the fact that their equity-only

(continued on page 3)

WESCO FINANCIAL'S CHARLIE MUNGER
"SHAREHOLDER DEMOCRACY? THAT'S A FICTION. AND ANALYSTS WERE *ALWAYS* SHILLS TO SOME DEGREE."

In the foreword to Janet Lowe's excellent biography — *Damn Right! Behind the Scenes with Billionaire Charlie Munger* — long-time partner Warren Buffett observes: "I've had an enormous amount of fun in my business life — and far more than if I hadn't partnered with Charlie. With his 'Mungerisms', he's been highly entertaining, and he's shaped my thinking in a major way. Though many would label Charlie a businessman or philanthropist, I would opt for teacher.

(continued on page 23)

OAKMARK FUND'S BILL NYGREN AND HENRY BERGHOEF
"*MANY* QUALITY, LARGE-CAP GROWTH IDEAS ARE CHEAP. THEY SELL AT DISCOUNTS, BUT DESERVE PREMIUMS."

Bill Nygren says the genesis of Oakmark Select was his desire to invest his own money in a more concentrated way than he would be able to do otherwise. However, he could hardly be accused of overselling the idea to his partners at Harris Associates. In 1996, he told them that in the first five years, they should probably expect one exceptional year, that there hopefully wouldn't be a horrible year and that the rest would probably be mediocre.

(continued on page 39)

THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
(cont'd from page 1)

opportunities. And in his latest letter to shareholders dated on or around December 16th, he explains why:

My worst performance since I entered the mutual fund area.

The 11.4% decline in per share value for fiscal 2002 was, I believe, the worst performance for any mutual fund I've managed since I entered the mutual fund management business in 1984. The fact that TAVF's performance was less worse than [the S&P 500 and the Russell 2000 return] is small comfort.

[Editor's note: For the year ended October 31, 2002, the S&P 500 and the Russell 2000 were down 15.1% and 11.6%, respectively. By comparison, in the two other years since 1985 when both indices declined, Whitman managed a return in excess of 20%. In 1990, while the S&P 500 and Russell 2000 were down 3.2% and 19.5%, respectively, Whitman's Equity Strategies Fund was up 22.5%. And in 2000, when the S&P 500 and Russell 2000 lost 9.1% and 3.0%, respectively, Third Avenue Value Fund was up 20.8%. (Market data and manager performance data provided by *Morningstar* and Third Avenue Funds, respectively.)]

After all, the Fund is supposed to be market neutral. For example, according to *Barron's*, the S&P 500 Index at November 1, 2002 was priced at 4.15 times book value, while the Third Avenue portfolio[1] at October 31, 2002 is estimated to have been priced at about 1 times book.

I couldn't be more pleased with our portfolio quality today.

What kind of weight ought an investor give to past performance, especially one-year performance? In general, I think investors ought to consider two factors in deciding how attractive, or unattractive, a particular mutual fund investment is: Factor one is past performance. Factor two is the quality of the portfolio that exists currently.

How does one measure portfolio quality? I measure it by assessing the probability permanent impairments of the businesses in which the Fund has invested on a long-term basis will or will not occur. Permanent impairments occur when a company dissipates a strong financial position without materially improving its long-term earnings power; when a company loses its competitive position; when an industry becomes obsolete; or when a management shows signs that it is incompetent, crooked, or both.

[1] The weighted average of the top 41 holdings representing 62.5% of the Fund's assets.

(continued in next column)

PORTFOLIO REPORTS estimates the following were Third Avenue Value Fund's largest equity purchases during the 3 months ended 10/31/02:

1. RADIAN GROUP INC
2. INVESTOR AB CL A
3. AQUILA INC
4. APPLIED MATERIALS INC
5. AVX CORP
6. TXU CORP
7. CIT GROUP INC
8. KEMET CORP
9. ALLEGHENY ENERGY INC
10. TOYOTA INDS CORP

Very few permanent impairments seem to have occurred within the TAVF portfolio historically. And in the very few instances where we believe they have occurred, they seem mostly to have been attributable to management shortcomings. What about today? Today, I couldn't be more pleased with the present quality of our portfolio.

Our debt positions were acquired yielding 25% to maturity.

During the quarter, new positions were established in three high-yield debt positions and in three common stock positions; Eleven common stock positions were increased during the quarter largely reflecting my belief that these issues were even more attractive than when first acquired because their prices were lower....

The AES Notes [AES Corp Senior Notes 8.75% due 6/15/08], the Aquila Notes [Aquila (Utilicorp United) 7.00% due 7/15/04] and the Adelphia Bank Debt [Century Cable Bank Debt (restricted)] were acquired at yields-to-maturity averaging around 25%. All are likely to remain performing loans except, perhaps, the AES Notes. Even though Adelphia Communications Corporation is in Chapter 11, monthly interest payments are being made on Adelphia Bank Debt pursuant to the "Adequate Protection" provisions of the Bankruptcy Code.

The AES Notes could prove to be a problem if AES succeeds in issuing large amounts of secured debt at the holding company level. At some point, TAVF might swap its AES Notes into AES Secured Notes. But meanwhile, the interest payments on the AES Notes seem fairly safe. If AES seeks Chapter 11 relief, interest payments would cease. However, our analysis indicates that the AES Notes probably would fare reasonably well in a Chapter 11 reorganization — probably receiving common stock in a reorganized AES.

We returned to a familiar, successful theme....

Over the years, the Fund has done very well buying into the common stocks of well-capitalized financial institutions at prices representing meaningful discounts from adjusted book values. CIT and Brookline qualify on this score. RS Equity [Convertible Pfd Cl A (restricted)], while priced near book, is a start-up financial institution with a venture capital flavor.

Electric utilities seem to be an interesting speculation.

The investments in the common of Allegheny, TXU, Aquila and Quanta are a bit aberrational for the Fund in terms of our "safe and cheap" investment philosophy — because while these securities do seem to be dirt cheap, they are far from as safe as the other common stocks in the Third Avenue portfolio.

All four are electric utility related. Three — Allegheny, Aquila and TXU — are regulated electric utilities. And one — Quanta — is a service company. Electric utilities need almost continuous access to capital markets. And they particularly need access at this time. If the companies cannot get new financing from credit and equity markets, it will have been proven that it was ill-advised for the Fund to have owned electric utility common stocks.

Yet, if things go OK, these four could turn out to be five-baggers, seven-baggers, or even ten-baggers over the next three to five years. On balance, electric utility and electric utility related common stocks seem to be an interesting speculation for Third Avenue.

—OID

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from page 1)

returns lagged the S&P 500 for three out of five years during the go-go years 1995 through 1999. How is that possible? Very simply, in 2000 and 2001, they outlegged the S&P 500 by an incredible 31.3% and 25.5%, respectively. (Equity only returns are for all discretionary, domestic, equity-oriented, tax-free accounts of $10 million or more excluding small cap. All performance figures were provided by Callan Associates and Longleaf.) And according to *Morningstar*, their flagship fund — Longleaf Partners — was down only 8.3% through December 31st of this year, which was ahead of that same index by an additional 13.9%.

We consider ourselves privileged to be able to sit in on their events and, even moreso, to be able to share their insights with you. We find that their comments about their investment process never fail to refocus our minds on what's important. And we find their comments about individual securities rewarding and enlightening, too.

The excerpts which follow were selected from the prepared remarks of Hawkins, Staley Cates, John Buford, Andrew McDermott and Lee Harper and their answers to client questions at their Longleaf Partners Luncheons for Advisors which took place in New York on September 23rd and in Boston on October 9th and conference calls that were held on July 25th and October 24th. We hope that you find them as valuable as we do.

IN EARLY 2000, THE SPECULATORS WERE THE RAGE.
TODAY, IT'S FIXED INCOME AND FORENSIC SHORTS.

Not long ago, there weren't a lot of rational investors.

Mason Hawkins: In our 30 years of experience, we've not seen perception deviate so radically from reality on both ends of the spectrum as we've seen recently going back to early 2000. Up until March 10th of 2000, speculators had a voracious appetite for IPOs of almost any description — and in the main wanted tech, telecom and internet new world companies. Most had few customers, much less solid revenues or the reasonable prospect of profits to support their stock prices.

Wall Street analysts were renowned for promoting their underwritings. And corporate America's stock options-incented CEOs were considered almost godlike. And that wasn't that long ago.

No rational investor participated at that point in time. And yet almost everybody did. So I guess the corollary is that there weren't a lot of rational investors.

When the rage is forensic shorts, that tells you something.

Hawkins: The pendulum has radically swung from one where greed drove perception dramatically *above* corporate value to today where fear has pushed prices *below* thoughtful corporate valuations. Now every CEO is considered almost a villain. News holes overflow with stories of how managements are victimizing their owners. Managers of tech funds were speculators' heroes up until the bubble burst on March 10th, 2000. As Lee Harper has observed, PIMCO's now become the nation's largest fund. And everyone seems to be putting their money into bonds.

Today, all the rage seems to be about participating in hedge funds with "forensic shorts". It all seems so easy: Find a stock that's rolling over, plant a story in the media that seeds doubt, call in a plaintiff's lawyer, the SEC or even a politically motivated U.S. Attorney, and take turns piling on the short interest. It's almost the reverse of the stock promotion days of the '20s....

OUR LARGER MARGIN OF SAFETY TODAY
ALSO IMPLIES HIGHER FUTURE RETURNS.

We had lots of cash earlier this year. We don't now.

Hawkins: ...In the first quarter of this year, we were having a real struggle — a real hard go of it — finding *any* qualifiers.... At March 31st, cash in our funds was as follows: Longleaf Partners 20%, Longleaf Small-Cap 8% and Longleaf International 31%. And many shareholders were saying, "Don't you know that equities outperform Treasury bills? Why aren't you more invested?"

Since then, a number of great business franchises that we've yearned to own have shown up. And we've acted aggressively to buy them. As a result, today, we're fully invested. So that represents quite a change.

We've laid a solid foundation for terrific performance.

Hawkins: The *bad* news? We've not made you any money over the past six plus months. And we've not made any money for ourselves.... And we're not happy with that.

However, over the last two quarters, we've aggressively committed our cash reserves to dramatically mispriced existing *and* new positions — companies like Disney, Comcast and Vivendi. Importantly, we bought companies which we feel will grow their values. For example, in the Partners Fund, today over two thirds of our assets are invested in what Staley's termed "perma holdings" — companies with dominant, low-cost, competitively entrenched businesses which almost guarantee large and growing free cash flow streams.

To give you examples, Waste Management, FedEx, Hilton and Marriott, Yum Brands, Comcast, Knight-Ridder, Disney and Aon would fit that description. And those kinds of businesses comprise more than two thirds of Longleaf Partners Fund. And I think it's also probably important for you to know that your managers added meaningfully to *their* holdings in each of the three Longleaf funds during the third quarter.... We're highly confident that these positions will provide us with the foundation for above average returns going forward. In fact, we believe they'll produce *terrific* risk-adjusted results.

So far, so good.

Hawkins: For those of you who don't have a perspective on Southeastern and the Longleaf Funds, we thought we'd go through a quick historical review. As someone said, "Here's the good news." SAM's [Southeastern Asset Management's] equities have compounded at approximately 21% per year over the last 20 years — which is roughly 6% north of the S&P 500. Over the last decade, we exceeded the market by about 8%. Incidentally, according to Callan Associates, those returns place

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

Southeastern in the top 1% of all large-cap managers for the last 20, 10, five and one-year periods. [All performance figures are before fees through June 30th, 2002.]

More discounted portfolios imply higher future returns.

Hawkins: Historically, our price-to-value relationships have averaged about 68% of appraisal. Today, the P-to-V ratios of the Longleaf Partners and Longleaf Small-Cap Fund are in the mid-50s. And Longleaf International is around 50. All three are near their most attractive relationship to our appraisals of corporate intrinsic value in our history.

Again, from our price-to-value average of 68%, we've managed to crank out 20% kinds of numbers. Thus, with more discounted portfolios, I think that two things should be self-evident. First, it's clear that we have a larger margin of safety of value over price than we've had historically. And second, given the more discounted portfolios, the implication is for higher returns than the average that we've managed historically....

Do we eat our own cooking? That's *all* we eat.

Hawkins: In any case, the Longleaf Partners Funds receive our investment along with yours. Your managers are the largest shareholder group across the three funds. We treat everyone like family — to keep expenses down, maximize return, and hopefully minimize risk. All three of our funds, as you know, are no load, no 12b-1, no exit fees and no performance fees. And, let me add, SAM, not our shareholders, pays for extravagances like this lunch.

Another thing that we do differently at Southeastern Asset Management is that we insist, if you work here, that you put all your equity savings in Longleaf Partners Funds. Additionally, 100% of our retirement plan and 100% of our private foundation is invested in Longleaf.

IF YOU JUST GET A FEW THINGS RIGHT, THE REST WILL TAKE CARE OF ITSELF.

We spend about 90% of our time on corporate appraisals....

Hawkins: Investing, as we've said, is the arbitraging of perception to reality in the hope that reality will grow. We strive to own competitively entrenched businesses managed by honorable, capable and properly incented management teams, when their stocks sell for less than 60% of our conservative appraisals. *Barron's* has described the way we think about investing as "businesses, people and price". I think that's an apt summary.

About 90% of our time's spent on corporate appraisals and assessing managements. And as we've told you before, our appraisals are done by discounting free cash flows — gross cash flow streams minus required cap-ex or maintenance cap-ex and working capital needs — back to the present and, secondly, by figuring out the net liquidation value of a company that might have a group of assets that doesn't necessarily produce any free cash.

(continued in next column)

So in both our free cash flow appraisal method and in our net balance sheet value method, we compare each of those appraisal conclusions with a database of comparable business transactions that we've maintained for over 20 years. And we always look at each comparable sale carefully and weigh it within the context of the interest rate environment in which it occurred. Finally, we take the lesser of the long-hand appraisal and the comparable sale measurement.

Wide diversification doesn't pay — whatever may be taught.

Hawkins: Our portfolios are concentrated in our top 20 or so selections. We believe very, very strongly that over-diversification drives you to higher price-to-value relationships and to situations where you have less and less knowledge. Therefore, we believe very strongly that over-diversification produces *more* total investment risk.

That flies in the face of a lot of the academic thinking in various colleges and universities today. But there's been almost no great record created — where investors have added big premiums to the market and created huge absolute returns with what we'd consider to be low risk — by owning large numbers of companies.

If you get a few things right, the rest takes care of itself.

Hawkins: We believe that there are three prerequisites to successful equity investing. First, you need sufficient information to understand the business. Second, you have to get your appraisal right. And third, you must act with great alacrity and conviction to purchase a stock when it sells for less than 60% of value in the market and ignore the majority view on Wall Street. So in our shop in Memphis, we really try *not* to listen to outside influences....

Quoting Warren Buffett from the 1987 Berkshire annual report: "If you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game."

I think that absolutely summarizes our view. We have been surprised by how people manage huge sums of money without having appraisals. There are multitudes of ways that people can try to invest. But it's our view that most of that is speculation, not investing.

As we've said, the question is not whether we're at the bottom of the market. The question really is, "Do we have our appraisals approximately right?" At the end of the day, that's what drives returns — and that's where you either assume or eliminate risk.

So again, we spend almost our entire day looking at companies and trying to get the appraisals correct and trying to assess our partners reasonably well. So like any endeavour that you might undertake in a private business venture, the same holds true for public share investment. You want a good business, a good management partner — and thirdly, you want to steal it. And if you do all three of those things well, then you can virtually eliminate risk.

Do we care if things get worse? Not really.

Hawkins: There are not many businesses where we can comprehensively understand the drivers of the units sold, the pricing power and how they incur their costs.

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

However, when we do have a good understanding of the operations of an entity, and we feel as though we can appraise it, then we may have something to do.

Since March of this year, quite a few things have shown up. We're often asked the question, "Well, can't things get worse?" And we always respond: "Yes they can." But as a long-term shareholder, do you really care if things get worse if you own Disney? And our response is that we clearly don't. We think Disney's worth in the mid-$30s. And we think that in time, the market will go from voting in a *fearful* way to properly weighing the economics....

OUR PORTFOLIOS HAVE RARELY BEEN CHEAPER — AND IT'S NOT BECAUSE THEY'RE FULL OF JUNK.

Our recent discounts were at or near their highest ever.

Shareholder: During the height of the bearish sentiment [earlier this month], what was the price-to-value of the fund at that time compared to now?

Staley Cates: In Partners and Small-Cap, it hit almost 50% — and it's still in the low 50s. And Andrew, what was International — the mid-40s?

Andrew McDermott: International got down to 45% — and it's around 50% today....

Shareholder: How do your recent price-to-value levels compare with the numbers in 1990, 1994, and perhaps the spring of 2000?

Cates: Pretty consistent.

Hawkins: Yeah. In the spring of 2000, all three of our funds got pretty attractive.

Cates: Yeah, they were all at about 50%. And 50% is pretty much the lowest levels you've seen in the periods that you've named....

The best combination — a nice discount and nice growth....

Shareholder: What does "perma holdings" mean again? Staley used that term to describe...

Hawkins: When we use the term "perma holdings", we're referring to companies with dominant, low cost, competitively entrenched businesses where you're almost guaranteed a large and growing free cash flow coupon. So the company is currently producing a lot of distributable free cash flow that, when retained in the business, guarantees the accretion of the company's intrinsic value.

We cited a number of examples earlier. And in each case, they're #1 or #2 in their market share positions. And there's a lot of gross cash flow compared to working capital and capital expenditure needs. It's like a bond with a growing coupon — so your value builds as you reinvest.

Cates: Let me describe it another way: We talk about our price-to-values. We're usually focused on day one on the decision of, "How big is the discount to value?" But in those companies, you have the best outlook possible for the value itself. So you get the long-term luxury (you hope, at least) of not just closing that price-to-value discount from 50¢ to $1, but you have a dollar that can grow at really above-average rates.

Hawkins: And we hope at least 12 [of the names in the portfolio are in that category].

DISNEY HAS A WONDERFUL GROUP OF BUSINESSES, A GREAT MANAGEMENT AND A GREAT PRICE.

Overpaid? We're concerned Eisner isn't making *enough*.

Shareholder: Given your emphasis on management quality and having the incentives right, I was surprised by your investment in Disney where it seems management has an oversized ego and has overcompensated itself historically for rather mediocre results.

Hawkins: Our concern at Disney is that Mr. Eisner is not paid *enough*. All of his options are underwater. We think he's one of the most brilliant managers we've encountered in our 30 years. We want a manager who's engaged and hands-on. And we think Bob Iger and Michael Eisner are the two right parties to fix ABC.

We come away with an appraisal north of $30 for Disney.

Hawkins: Obviously, there's a lot of media grabbing going on by a few people to include maybe a couple of directors. But you don't find Disney at half of value *once* in my 30 years of experience. And when you look at the wonderful kind of movie titles in the library, the theme parks that are terrific businesses, ESPN, which we think is the best business in America today — and when you look at depressed earnings at the stations and at the network — we come away with an appraisal that's north of $30 and a stock at half that.

I don't think Eisner has just suddenly grown stupid....

Hawkins: There's an almost universal view today that Eisner isn't who he *used* to be. Well, let me tell you: Until the last few years, very few people had compounded corporate capital as fast and as well as Michael Eisner. We don't think he's just suddenly grown stupid. Anyway, we've got a billion dollar bet that this will work from $15....

No manager gets straight A+s....

Shareholder: As far as being good asset allocators, I don't really see it in terms of the performance in, let's say, the last half dozen years. Eisner and Iger have made big investments in retail, cruise ships and sports franchises. And even before difficult economic conditions hit us, earnings were either not growing or declining. I just don't see what you're seeing.

Hawkins: If you were to study Eisner's record up 'til two years ago, you'd draw a completely different conclusion than is being bandied about today. For example, take the Anaheim Angels investment. Can he sell it for more than he paid for it? Yes, he can. Was it the best use of capital? Probably not. But you can take *any* corporate manager in the world and he won't get all A+s — either operationally or on the capital allocation front.

But you have to make an assessment: Is he properly vested? Is he passionate about it? Is he hands-on? Is he

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

dedicated to turning around the problems that exist at ABC? We go through a whole checklist of evaluations of our human capital there — of our partners and our management team.

He's as frustrated as you are that it's not all coming up A+s. I think there's significant opportunity to further rationalize some of those pieces. He did a terrific job buying in shares a day or two after 9/11 at a very distressed level. That was, I'd say, a *very* good use of Disney's marginal capital.

In a different environment, Eisner wouldn't be an issue.

Hawkins: You don't get the opportunity to purchase a great business with a great management at 50¢ very often.... Disney is a wonderful group of businesses. Are they all five star? No. Are they on average very good? Yes. Are they competitively entrenched? Yes. (Maybe the network's not in that category.) Have they increased return on assets over a long period of time? Yes. Have they expanded the franchise? They've done that well, too.

But it's amazing how everybody's focused on the last three or four or five quarters. It's *tough* out there in the business world. And 9/11 was about as tough on Disney as it was on any company in the world.

Is that permanent? No, we don't think so. In a little different environment, you'd hear a lot less about Eisner. So if you disagree, then we'll just have to agree to disagree.

From this point, it should be easy to make improvements.

Shareholder: One follow up: If Eisner is replaced, what happens in your opinion?

Hawkins: Well, if Michael Eisner is replaced, that's going to be a point where we'll have to evaluate who our new leader is. But I think from this position, economically, it's going to be fairly easy to make improvements. It wouldn't change our case....

DISNEY HAS VERY, VERY VALUABLE ASSETS — INCLUDING ONE OF THE BEST BUSINESSES IN AMERICA.

At today's price, the consumer's not an issue for Disney.

Shareholder: The top holdings in Longleaf Partners look like they're fairly consumer-oriented — like Hilton and Disney. Where do you see consumer spending in relation to the valuation side of some of these holdings as it affects our portfolio of businesses? In other words, don't you need the consumer to spend to make Walt Disney's stock go up?

Hawkins: I don't think the consumer situation has to change a lot for Disney to do very well as an investment. Disney is losing $600-700 million at ABC. And Disney is very depressed in terms of theme park attendance. To that extent I guess the consumer is an item. But that's the reason you've got a $15 stock price. Nobody seemed to be worried about the consumer back when the stock was $40. Now that it's $15, it's a non-issue for us.

Disney's assets are *very* valuable. For example, ESPN....

Hawkins: We think we've done our appraisal with very conservative metrics. And all the aspects of that company are very, very valuable — the TV stations, the network, the theme parks, the library.... And again, they own what we consider to be one of the best businesses in America, ESPN — which has 15% contractual price increases for the next few years.

And if you go around and talk to any cable operator, whether it's here in Boston or elsewhere, they'll tell you that the only must-carry cable network is ESPN.

We believe Eisner and Iger will get the programming right.

Hawkins: So when we look at the whole, we come up with a very significant value. Are there problems at Disney? Yeah. They need to get the programming right. But we believe Eisner and Bob Iger will do that. And we have been a big supporter of those two along with anything the board does in its efforts to support them.

PORTFOLIO REPORTS estimates the following were Longleaf Partners Fund's largest equity purchases during the 3 months ended 9/30/02:

1. AON CORP
2. VIVENDI UNIVERSAL SA
3. DISNEY WALT CO
4. COMCAST CORP CL A SPL
5. VIVENDI UNIVERSAL SA ADR
6. GENERAL MOTORS CORP CL H
7. MARRIOTT INTL INC CL A
8. HILTON HOTELS CORP
9. TELEPHONE & DATA SYS INC

So we'll just "stay tuned", as they say, to see how the programming comes out and whether ABC can stanch the losses that exist currently. But the networks have a way of swapping positions — in effect, of taking turns with what is most popular. And we certainly hope it's ABC's turn.

We have opinions. We just don't let 'em get in the way.

Hawkins: However, as regards the consumer, certainly we all have opinions. You can argue either side — that it's too leveraged or that it's OK. But interestingly, real incomes are rising very nicely. And debt at a certain level is a real problem with 13-14% interest rates. However, at 4-5% interest rates, it's a lot more tolerable.

But everybody has a macro view on the consumer. And we have our own thoughts. But it doesn't prevent us from buying Disney and some other things — like Comcast. If we'd had a top-down view and we'd allowed it to throw us out of those kinds of things, we would not have performed the way we have for the last two decades.

It's interesting. Everybody takes it home and thinks about it. But it doesn't affect our decisions at Longleaf.

WE DON'T EVEN *LIKE* THE HOTEL BUSINESS. BUT WE *LOVE* HILTON AND MARRIOTT.

The hotel business? Ehhh. Hilton and Marriott. Yeah!

Shareholder: You [seem to be keeping] your bet on

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

the hotel business. Might you give us your thoughts about that business in this kind of environment with the partners you've chosen?

Cates: Well, I think it's important [to note that] we don't have a bet on "the hotel business" — because we don't particularly even like the industry as a whole.... And we haven't necessarily particularly liked it before even though we've owned a lot of these companies....

We specifically like the Hilton system and the Marriott system. We love Marriott International and the fees that they generate that are non-capital intensive. And Hilton has a *great* combination of some properties that are owned that are truly trophies — like the Waldorf Astoria and the Hilton Hawaiian Village. Plus, they receive fees from Hampton Inns and Homewood Suites — where they don't own the real estate. So we've made really specific bets on those two systems.

Our overall hotel exposure actually was declining before this whole market became unglued. You see we have a smaller position in Host Marriott — which is owned real estate. We still think the world of the company and its value, but we had reduced that somewhat.

Low new supply means great earnings going forward.

Cates: Going forward, business remains pretty slow.... But getting back to our long-term private business mindset, the numbers for the next 3 to 5 years are going to be *fantastic* — because this business is driven, as we've said before, much more by changes in supply than changes in demand. Demand is going to track GDP. And your guess is as good as ours as to when that turns back positive.

What's *way* more important is supply. And there is less supply coming on now than for the last six years. So you're going to see really good hotel pricing if you look out about three years. And you're going to see great earnings beginning in, say, '03 — even if it doesn't happen late in '02.

At Marriott International and Hilton, there's a lot to like.

Hawkins: So the values at Marriott and Hilton — while we took a big onetime hit that we talked about at length after 9/11 — from this lower point after we took those hits, they're going to grow nicely.... So especially with Marriott International and Hilton, we're more than happy with those despite the industry environment being so challenging right now.

I might just amplify a little bit on the business model that we see at Marriott International and the fee business at Hilton. You know, when you get a gross profit royalty off the revenue stream of others without any capital invested, it's a great business. And there's very little cap-ex or working capital required.

So as there are more hotels put up around the globe to service six billion people on earth and they put up a Ritz-Carlton or a Residence Inn for Marriott, for example, someone else is just sending a 6-7% gross royalty back. And that's a cash flow stream that's unencumbered. Well, there are not many of those in the world that we pursue where you have a very dynamic, growing, long-term stream of earnings that are free to the shareholder.

LEVEL 3'S WORTH TWICE THE PRICE TODAY.
AND ITS FUTURE LOOKS PRETTY EXCITING.

When money good bonds yield 35% to maturity, sign us up.

Shareholder: Do you plan to get heavily invested in the distressed debt of companies?... And if you are, at what fraction of your portfolio would you feel comfortable if the opportunity arose?

Hawkins: We have, as you know, loaned some money to Level 3. And we've looked at some other very interesting fixed-income equivalents with equity-like return potential.

But we're an equity investment shop. We don't like lending in the traditional sense because, as we've said, the return on ownership has historically been a lot higher than the return on lending. However, that's not to say that there aren't exceptions to every rule. And when bonds offer 35% yields to maturity and we think that the maturity brings us a full payment, we will look at debt.

It probably, Lee, would be restricted to about 30% of our portfolios given the new mandates from the SEC about being an equity fund.

Lee Harper: Actually, 20%.

Hawkins: But we're not there. So that's not something we've asked our lawyers to look at.

Level 3 has a tremendous opportunity to buy customers.

Shareholder: You also joined Warren Buffett and Legg Mason funds' [Bill Miller] on the $500 million preferred issue of Level 3. Could you talk about that?

Hawkins: We made a loan and got equity as well — that's how we looked at it — 9% convertible debentures that are convertible at $3.41 a share in partnership with Walter Scott, Jim Crowe and Sureel Choksi.

Level 3 has the best backbone in the world for transmitting electrons around the country. They have a tremendous opportunity to buy customers from *numerous* bankruptcies — whether it's about-to-be Genuity, WorldCom, 360 and XO — the list is long....

Level 3's system *ought* to be better — and it *is*.

Hawkins: Basically, the issue is revenues against a fixed-cost system. Level 3 has a 72% gross profit margin. And clearly, marginal revenues help a fixed-cost structure immensely. And we believe they will be very successful as a consolidator in this area.

Obviously, they are pursuing each of those opportunities aggressively. None have been announced. But there are other companies that *aren't* in Chapter 11, like Cable & Wireless, that are losing a lot of money — as was Global Crossing. And big users of these backbones are very worried. So it's not just a matter of price, but service and reliability, as well.

It's also a matter of a point many don't know much about — which is the backup. Is the system redundant? Level 3 has the only 100% redundant system. So if your backhoe digs up this street and cuts your fiber optic line, your data goes out and comes in from another direction so you're not down. And if you're the Department of Defense

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

or some other very important client, that's an issue for you.

So all in, we like our partnership with management. And we like the competitive position of their system. As Jim Crowe says, if you dig up every street in America and invest $13 billion, it *ought* to work. And you ought to be better than someone with a legacy system like AT&T's that's held together with baling wire.

Once they cover fixed costs, it should get pretty exciting.

Hawkins: But clearly, the demand curve hasn't been what all the folks who are much smarter than we are thought it would be. Instead of growth being 100% per month, it's been more like 100% per year.

But it's still early days in this broadband world. And video eats a lot more of it than a phone call. So as you swap pictures and download video, and video on demand becomes a bigger thing and you do more video conferencing, we think significant demand will be there.

Is there huge excess capacity right now? Yes. But we think that bubble is a six to eight-month bubble that will get absorbed. On certain routes in America today, there's *no* capacity — whereas on certain other routes, there's way too *much*.

It's not unlike a pipeline. Once you lay it, you've mainly got fixed-costs — depreciation and interest expense. And once you cover that fixed-cost, it gets pretty exciting — because the gross profit margin starts falling directly to the bottom line. We've seen that set of economics on numerous occasions in our 30 years. For example, we saw it in the cable business. You string cable past homes. You have to hook up a few. But once you get to breakeven, the ones you hook up thereafter become pretty attractive.

Level 3's at breakeven today — worth $8-12 as it sits....

Hawkins: So anyway, that's the nature of the beast. We kind of like the 9% returns. And if Jim Crowe and his team at Level 3 do what we hope they can do, they'll also produce equity returns for us.

We have an appraisal somewhere between $8 and $12 as the company sits today. They are at cash flow breakeven. However, we could use some more revenues. Therefore, we're as anxious as other shareholders and lenders to see those revenues develop....

(continued in next column)

LEVEL 3 HAS QUALITATIVE ADVANTAGES — AND IT SHOWS IN THEIR RESULTS.

Price is important. However, so are other things....

Shareholder: ...I just wanted to ask you what your feeling is in terms of Level 3 and their competitors — because obviously it's a difficult environment. And there are competitive advantages that Level 3 has — including Walter Scott, having cash on hand and also having multiple conduits for upgrading in the future. However, my concern is that Level 3 has competitors such as Williams who has been taken over by Leucadia National — and also Global Crossing with Hutchison Whampoa...

Given competitors who've come out of bankruptcy and, therefore, now have little or no debt, how do you think Level 3's going to compete against them?

Hawkins: As you said, the chairman of the board is Walter Scott.... And we've said that we think it's the superior transmission company for long distance, voice, video and data in the world led by one of the most capable management teams. And their service abilities are *unrivaled* in terms of hooking up customers.

They are in a very strong position vis-a-vis all of the underfinanced competitors at this juncture. And the question alludes to a world where those weak competitors wash away their debt and come out of reorganization without fixed charges.

That's a speculative world. If you're a customer, you always want the best service and the best technology — and you want a good price. And price is important, but it's not the *only* thing [that's important]. Again, if a backhoe digs up your fiber optic line, you want your system to be redundant. Well, there's no other redundant system in the world.

So if Global Crossing gets reconstituted, are they going to be a viable competitor? I don't think so. Williams Communications' largest customer, SBC with a $10 billion contract, is trying to leave them. I can assure you that they would like to talk to Level 3.

How will Level 3 compete with debt-free players? Very well.

Hawkins: It always gets down to how good a business you have, how good a management team and what kind of service you can provide. And we believe there will be a day when demand will greatly outrun supply and pricing will be very reasonable. Hopefully, it's the dark before the dawn in terms of a *whole* lot of customers coming on board for this particular firm. They're many in number and many *types* that we are hopeful will improve the cash flow.

So I don't think coming out of bankruptcy will give those companies an advantage [over Level 3].

Wiping out debt doesn't help if you have no operating profit.

Shareholder: What [other] relative advantages [does] Level 3 have compared to WilTel?

Cates: We think Level 3 has qualitative *and* quantitative advantages. But the simplest quantitative one to look at, probably, is the EBITDA performance. And forget about free EBITDA, which is even *more* important. Just look at the EBITDA or operating cash flow of WilTel compared to Level 3. Based on the last 10-Q that was filed by Williams before they went under, it was hemorrhaging

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

money on an operating cash basis. So it wasn't because it was overleveraged, but because it simply couldn't even manage to break even.

And that's what we think some people missed about the competitive assets out there: Some of these things may go into bankruptcy and wipe away a bunch of liabilities. However, that'll do them limited good if they can't even make money on the operating line — even *before* interest.

Level 3 has incredibly huge margins on managed modem.

Cates: The other advantage that we would point to is that Level 3's managed modem business — which is a little bit different than just kind of pure wholesale traffic — has a competitive advantage. It gets back to some interconnect agreements that they did with the Bells back in the mid '90s.

Probably the best way to look at that — if you want to look at the numbers — is to look at McLeod who had a managed modem business that they sold to Level 3 earlier this year. If you look at McLeod's numbers, you'll see that they lost a pretty huge amount of money on the $60± million of revenues that they were doing there. However, Level 3 already is making an incredibly healthy cash flow margin on those same revenues.

We just think WilTel's assets are pretty inferior.

Cates: Finally, Level 3 discloses very clearly on their calls, their website and everywhere else the makeup of their customers. It's got incredibly high-quality people and high-quality credits like AOL. And it's very manageable from the standpoint that you don't have just one or two gigantic customers.

But in the case of WilTel, you've got almost half of that coming from SBC. And you may have seen that there's been a lot of legal stuff going on with those guys. As I alluded to earlier, SBC's filed in the courts that they're not exactly happy having all this business on the Williams network.

So, we have great respect for Leucadia — in a lot of ways. And I'm sure that they'll be fine with whatever their investment rationale is. But frankly, we just think those assets are pretty inferior.

Level 3 has the best network — logically *and* anecdotally.

Shareholder: You say they have the best technology. How do you reach that conclusion? Do you retain an independent technology expert? What's your method?

Hawkins: Well, we are not Ph.D.s in electron chasing — that's for certain. But the [maximum distance between the equipment that] boosts their signals, the redundancy of their system, the fact that they've done some things in terms of software that are proprietary — and in interviewing and talking to customers...

We have a story about American Telephone hooking up Cox, for example. Cox gave half the business to Telephone and half the business to Level 3. Level 3 got it hooked up in a few days. American Telephone is *still* trying to figure out how to do it.

However, that's really just an anecdote. We do believe you *ought* to be able to have an advantage if you put $13 billion of plant and equipment in the ground and dig up every street in America. No one else really did it to the extent that Level 3 did. There are a lot of legacy systems out there that can transmit data. However, very *few* were recently done throughout the world in a compatible, consistent way.

That's not to give you a highly technical conclusion. It's just, in our way of looking at things, the best system out there. However, it needs more revenues. And therefore, we're very focused on that....

WHEN THE BAD TIMES END, LOOK FOR HUGE GROWTH. MEANWHILE, THEY'LL BENEFIT FROM THE DISTRESS.

We're not basing our optimism on some miracle comeback.

Shareholder: It looks like Level 3's managed modem and software sales businesses are pretty much driving the results right now. And I was wondering when you look into your crystal ball if you see their broadband business picking up anytime in the reasonably near future.

Cates: We wish very *much* that we had a crystal ball. Unfortunately, we don't. However, our hope for growth isn't so much our hope for a miracle comeback as it is a natural slowing of the process of disconnects.

As you may know, they report pretty clearly what their new business wins and disconnects are. And the disconnects aren't based on changes in their existing customers' technology investments. It's more dotcoms and people like that that've gone under.

When disconnects dry up, they should show huge growth.

Cates: So when we run the math, we don't assume that their new business wins change much from these levels that they've been doing this whole calendar year. But what goes away just because the bad credits are drying up is the disconnects.

The disconnects right now are basically equivalent to the new business wins. Therefore, if disconnects are cut in half over 12-18 months — which we think is reasonable because they're at unbelievable levels right now — then Level 3's revenue line would show pretty good growth.

But again, we're not basing that on some change in the environment, some miracle turnaround or some huge market share win — some of which are frankly possible.

We expect Level 3 to be a *beneficiary* of today's distress.

Shareholder: ...In a time of liquidity crisis — [when we're having] a parade of bankruptcies — is it possible that the creation of economic value *accelerates* for those companies that generate cash and have access to capital?...

Cates: Well, I think that's a very good point. Everything is so case-by-case. As you know, we just try to stay away from the macro. Mason has mentioned that GM is one where the value comes down if the stock market does. We think something like Yum — the old Tricon — is a total neutral depending on what the market is doing.

And as to your point, we couldn't agree more about something like Level 3. The whole math at Level 3 is just what you say. They are going to go out there and hopefully take advantage of all kinds of opportunities in the wreckage. And other good partners with good balance sheets are poised to do the same thing. We think that we have more than our fair share of 'em. So you're exactly right.

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

And of course, that's part of our micro [approach] — to find companies that take advantage of the macro [environment] rather than be terrified by it.

?
0

WE ARE WELL DIVERSIFIED TODAY.
BUT WE HOPE WE WON'T ALWAYS BE.

We view our Level 3 position as *two* positions....

Shareholder: If I'm reading this right, Level 3 is now about 15% of the Small-Cap Fund. Is that correct?

Harper: Yep.

Shareholder: Now, a full position is around 5-6%?

Cates: Correct.

Shareholder: I know Waste Management temporarily went up to something like 15-20%. Can you talk a little bit about what the intent is with Level 3 at 15%? Do you anticipate that if it approaches 20%+ pretty rapidly that you'll shear it back down? It's somewhat rare that one position takes up so much.

Cates: ...Internally, the way we view it, we divide that Level 3 into two different positions. One is the bonds — which yield 9-1/8%.

Hawkins: That's the coupon. The yield to maturity is much, much higher.

Cates: That's right. We bought those about a year-and-a-half ago. Those are not convertible. They're primarily a bond with what we feel like is an equity return potential and very, very, very little risk.... We're expecting an enormous return — most of which is current. And in those, we initially took the normal position you'd expect. And they have since appreciated. So those now represent a high single-digit percentage of the Small-Cap Fund.

However, as we got deeper and deeper into Level 3 — and felt like we got to understand it a little bit better and know the people better — we then, this year, did the placement with Berkshire and Legg Mason. And as we said earlier, we view it as more of a straightforward, quasi-equity investment. Technically, it's bonds. However, it's already in the money as far as the convert price goes. So we do view it as more of an equity.

Both positions have appreciated, but they're still dirt cheap.

Cates: Therefore, we don't view the non-convertible bonds as the same animal. Even though we've made good money in 'em already so that they now represent 9% of our portfolio, they remain insanely priced in our opinion. And there's just no investment reason we can think of to lighten up on them for risk/reward reasons.

And then, wearing our separate goggles on what's more of a quasi-common stock investment through these recent converts, those are more of a "normal position" in the fund. And we don't think those have even begun to realize what *we* feel like is their long-term potential.

So we don't see it as an apples-to-apples comparison to Waste Management when it got to be such a big percentage of the Partners Fund.

Shareholder: Right. So you really see it as about 9% in bonds, and about 6% in quasi-equity.

Cates: That's right.

We're well diversified now, but we hope we won't always be.

Shareholder: Does the IRS require the two positions to be added together for their diversification rules? Or are equities and bonds separate for that rule?

Hawkins: If we were to convert our convertible bond into equity, it would be an equity, whereas the other would remain a bond.... And I'm not sure about the diversification position there. We'd have to check.

Harper: The highest you can have, even if they counted it as one, is 25%. So we still would have — and we still at this point have — a long way to go, even if we had to count that position all together. But we don't have our lawyers in the room with us....

Cates: There are two diversification baskets. One is the 25% for the one name. And the other basket is the 50% for the 10 names. So even with both positions being in the non-diversified basket, we're well under the 50%. And as Lee just said, we're also well under the single 25%. So even if they're one issuer, we're OK on both thresholds.

Hawkins: Said differently, we're well diversified by the rules today, but we hope we're not in the future.

Cates: Yeah. [Laughs]....

YES, THE PENSION ISSUE IS A NEGATIVE FOR GM.
BUT THE MARKET HAS WAY OVERREACTED.

We've factored GM's pension shortfall into our valuation.

Shareholder: [A recent article] suggested that $3 billion of General Motors' free cash flow of about $3.5 billion would have to be put back into their pension — and that over the next couple of years, from $6 to $9-1/2 billion would also have to be added to their pension.

Is this accurate? And if it is, does it concern you? Have you lowered your appraisal of GM based on this — or is it already factored into your valuation?

Cates: Those are directionally correct numbers. It's hard to say because ... we won't know exactly what their pension plan performance is until they disclose it. But it's interesting that their plan through September was doing better than *we* would have thought just based on different market indices.

Shareholder: I read somewhere that General Motors has something like twice the number of people on its pension plan than are currently employed by GM.

Cates: That's right. It's a *huge* legacy burden. And it is something that we've always monitored and penalized them for in their value.

The numbers are iffy, but we've given it a heavy haircut.

Cates: Its pension plan definitely has a shortfall in it. It was $9 billion going into this year.

Shareholder: Wow — that's a big number.

Cates: And this year, it'll take probably the kind of

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

numbers you're talking about over time to fill that hole.

Shareholder: Two years is what I read in the story...

Cates: Well, that's where it gets iffy.

Shareholder: Based on expected market performance — based on a 5% or 6% return over the next two years — they estimate that they'll have to put in $9-1/2 billion from their free cash flow.

Cates: That's why it gets iffy because of the timing. But the main answer is yes, we are taking what we think is a heavy haircut for all those reasons. It *is* in our appraisal.

We think the decline in GM has been an overreaction.

Cates: To put it into perspective, if they contributed $3 billion — in line with that article — initially, they'd get a deduction on the $3 billion. [So the after-tax cost] would be about $1.8 billion — or $3 a share. And then, if they do the other, then you can run the same math on [what the impact would be] if they have to put another $8, $9 or $10 billion in there.

But those are numbers we have already taken out of the appraisal. We do update it as the stock market drops. And we just assume that they're seeing the same kind of drop in their pension plan. But as we quantify all the damage, we're closer to a $10 per share kind of number over the course of this year, because we had already reflected the $9 billion shortfall in last year's 10-K.

And against that, the stock's down about 25 points in three months. So we think it's an understatement to say that the market has overreacted to this issue.

So it is a true negative. It's a true economic problem. But it's one that's just kind of part of our case — and it's part of our valuation.

Shareholder: What is General Motors assuming their earnings rate is on their pension fund? And what did you assume as the earnings rate to calculate the shortfall?

Cates: They have 10% — and we have 7.5%.

Shareholder: And what would happen if it were actually 5%? Do you look at "what ifs" ever?

Cates: Yeah, we do. Another 2.5% off of that would be equivalent to maybe $1.25 billion pre-tax.

Shareholder: Per share, that's how much, roughly?

Cates: It would be a little over $1 per share.

Shareholder: So it wouldn't be that material....

Cates: [No, it wouldn't.]

Nobody cares today, but earnings are better than expected.

Cates: And what doesn't get equally highlighted in a time like now when fear kind of rules the day is that the truck and car earnings are just doing a whole lot better than we thought they would.

Shareholder: ...I agree with you. I think it's an overreaction. I looked at General Motors' dividend. It's yielding, what — about 5% right now?

Cates: Yeah, it's a big yield.

PENSION ISSUES ARE MANAGEABLE FOR GM — AND A *NON*-ISSUE FOR OUR OTHER COMPANIES.

Major decline in GM pension assets would be manageable.

Shareholder: I know you guys have used extremely conservative actuarial assumptions in your models on GM. But if the markets move down, let's say, another 25% or so — and stay down for a number of years — would that not imperil their finances?

Cates: If the market were to go down 25% from here, then, first of all, let's assume that they don't outperform the market — even though they've done a good job of outperforming the market with good equity managers. But let's assume that they perform in line with the market. And let's assume that the equities are half the plan. So if their pension assets were to decline by 12.5%, that would be down maybe $7 or $8 billion. That's a pretax number. To fill that pension hole you get the tax deduction. So 60% of that, call it $5 billion, would be the net, after-tax hit. That's less than $10 a share. So that'd be very painful, but easily manageable.

And I have not net present valued that even though that wouldn't be due right away. The payments that would be due to fill the pension hole are spread out over time....

And GM could fill that hole with this year's earnings.

John Buford: And isn't GM earning $5 billion a year?

Cates: Yeah.

Buford: So that's one year's earnings. So they could fill it with earnings. It wouldn't impair the balance sheet because they would just fund it with this year's earnings.

Aside from GM, pension assumptions aren't a big deal.

Shareholder: When you're looking at doing business appraisals and you've got one company that's assuming a 9.5% return on pension assets and somebody else is at 8%, how do you adjust for that?

Cates: We've marked 'em all down to 7.5%, basically.

Shareholder: And so, you equalize everybody's income and free cash flow assumptions?

Cates: Yes.... Frankly, in our range of companies at Longleaf right now, marking everybody down to 7-1/2% is an incredibly minor event except for GM — which deservedly gets a lot of attention because it's so out of whack because it used to have a giant share and a giant number of employees and very good benefits. And so, it's a big number compared to market values and earnings.

But making that adjustment on the other things that we own and that we'd like to own is just not a big deal.

WHILE FLEMING'S BEEN A DISAPPOINTMENT SO FAR, OUR APPRAISAL REMAINS *MULTIPLES* OF THE PRICE.

We're still sanguine about Fleming.

Shareholder: Given the confidence you've expressed in Fleming's management in the past, it seems as though

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

we got somewhat surprised by that whole situation. I just wondered if you might comment on it where you can — because you have a big position and there's litigation.

Hawkins: We own it in the Small-Cap Fund. We said that we believe management is capable. We still maintain that position. In the last couple of days, there have been a number of very important releases and disclosures.

Their whole business plan is now on the web — available for all to see. Their cash flow has developed nicely in the third quarter with receivables and inventories down and payables out. And they've clearly outlined their game plan — which is to exit retail and hopefully receive north of $450 million with which to strengthen their remaining balance sheet and business.

So we think Mark Hansen and his team have positioned the company well. It's a more diversified base of clients — especially with the Core-Mark acquisition and the building up of their supply ability to service the convenience store world, which also happens to have higher growth rates. So we're still sanguine about Fleming.

The short case is almost comical — albeit short on logic.

Cates: It's almost comical how much the shorts rule the press and all the discussion there is about Fleming. For a while, the big short case was how stupid it was to take the Kmart account and how they'd underpriced it. And Supervalu was saying that it was dumb that they took it — that it was going to sink the company to take the Kmart business. Now they're saying it's going sink the company if they *lose* the Kmart business. The big concern is, "What happens if Kmart goes away?" — which is no more meaningful to us than the previous short case.

So to answer your question, we don't agree with all the stuff that the shorts are spreading in the assessment of management.

Not that we're not disappointed with their retail venture.

Cates: If we do have a fundamental disappointment — forgetting all of the short stories out there in the press — it would relate to retail and how we end up concluding the whole venture into retail.

We think they'll get the proceeds they're advertising. But that's disappointing compared to what we thought that could be at one point.

We've learned how to deal with huge declines....

Shareholder: You've had a couple of large stakes in companies where the perception of value [fell dramatically]. Fleming was a $30 stock that went all the way down to close to $3. And you had a similar kind of experience with Waste Management. How do you manage personally situations like that where you have hundreds of millions of dollars at stake in situations where values are so volatile?

Hawkins: *Values* weren't. *Prices* were.

Cates: We manage with Malox....

By the way, Fleming's volatility has been a *positive* for us.

Cates: As Mason said, the values didn't change a whole lot. It's the prices that were [so volatile]. If you were to go back through the quarterlies, you'd see that we originally took a pretty low-cost position in Fleming. Then, as the stock got up into the $30s, we sold almost half of our position. And then as it dropped, we've added. So believe it or not, it's been a net positive experience for the Small-Cap Fund.

If you believe in the values, over a *long* period of time, volatility is the best thing that can happen to you — for it to get up to $36 so we can trim some back and then decline into single digits so we can add to it.

And our appraisal remains *multiples* of today's price.

Cates: Of course, that assumes that you're correct on your appraisal — and that your appraisal doesn't decline a whole lot. However, that is where Mason started — and that's the bottom line.

Hawkins: Well, to be fair, the appraisal at Fleming has not built. We're disappointed, as Staley said, on the retail part of that company. Yet it may be the best thing for the company long term to become more focused and more competitive in the wholesale arena.

So we're not happy that they didn't execute any better than they did in retail. But we're confident, as I said earlier, that they have a competitive position in wholesale.

PORTFOLIO REPORTS estimates the following were Longleaf Partners Small-Cap Fund's largest purchases during the 3 months ended 9/30/02:

1. RUDDICK CORP
2. ROGERS COMMUNICATIONS INC
3. FLEMING COS INC
4. NEIMAN-MARCUS GRP CL A
5. TEXAS INDS INC
6. PEPSIAMERICAS INC

And they have done a very good job of broadening their sales base. Our appraisal is *multiples* of the price.

Fleming can be a very attractive business w/low margins.

Shareholder: Fleming's such a low margin business. What exactly is the attraction there?

Cates: Low margins are a part of the business, there's no doubt about it. However, you boil all that down to the free cash flow that you'll generate every year, year-in and year-out over time — at least that's the plan. Even with low margins, if they can earn... The current range of estimates is a little over $2 — which is consistent with the company guidance. And that's what *we* believe they'll do — and that should grow.

So it just gets down to the fact that today's $6 to $7 price is pretty much out of whack with $2+ of earnings — even if it's low margin and even if it doesn't grow.

Hawkins: The answer lies in turnover as well as margin. When you get paid every 15-16 days, that's a whole lot of turnover on a fixed asset base. So it can be a very attractive business with reasonably low margins.

It's pretty clear that Fleming's in a unique position.

Cates: There's a serious competitive advantage here

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

as well.... If Fleming and Supervalu are, say, a fourth of the wholesale food industry and the rest are high cost co-ops, they should be able to take share forever.

Then if you look at the other very big piece of Fleming's business which is convenience store business, that's dominated by McLane who's a part of Wal-Mart. They've had a *giant* market share that Fleming should be able to take healthy pieces of — especially when they can go to their customers and say, "Why are you buying from essentially Wal-Mart?"

So we just think there's a lot of room to take share, and that it's pretty clear they're in a unique position — even though the nature of the business is low margins.

DEVELOPMENTS HAVE BENEFITED THEM HUGELY — AND YET FAIRFAX'S STOCK PRICE IS DOWN.

We remain fundamentally excited about Fairfax.

Shareholder: I'll ask you about one other that's been jumping around a bit. Anything new on Fairfax?

Cates: ...The stock price weakness is not related to anything going on in our appraisals because, frankly, we think they're better positioned than almost any insurance company we know of to take advantage of these markets.... We think Prem Watsa is now [able to] take advantage, on a micro basis, of a bad macro environment.

Within his investment portfolio, he's always retained a lot of flexibility. He had puts on the S&P and the Nasdaq. And fundamentally, as far as his insurance underwriting, you know the tailwinds he has. The premium increases are huge from just about every angle we cover.

So we remain really fundamentally excited about it.

We can't wait to see how Prem takes advantage of things.

Cates: Fairfax does have a lot of leverage. And as such, just about all the ratings news over the last couple of years has been negative — whether it's an actual downgrade or on negative watch or whatever. But we look through to the math we see and the capital that he has by piece. And we've talked about the different pieces that he has before and how they don't necessarily cross-collateralize each other or have recourse across the whole shop.

So we remain comfortable with it. And we feel comfortable that Prem has taken advantage of this in ways that we can't wait to find out about later when we see what he's investing in.

Market developments are playing into Prem's hand.

Hawkins: Fairfax had $2.1 billion of Treasury bills on the investment side — and they have been looking at some *very* attractive bonds. They had virtually *no* common stocks and, as Staley indicated, $600 million worth of S&P puts....

They took off half of that position and booked a huge gain. So as we look at P&C or non-life insurance companies around the world, we would say that Fairfax has the best investment flexibility of any insurance company anywhere. And when we look to Europe, a company might have 30 billion euros of equities against 13 billion euros, say, of stockholders' surplus. So it doesn't take a whole lot of markdown on those huge equity portfolios amongst the very largest insurance companies in Europe to put them into a *very* precarious position in terms of their underwriting abilities and strengths.

Therefore, both the equity market declines and the under-reserving in the insurance industry are all playing every minute of every day toward Prem's hand.

Earnings power will be reflected in earnings — and ratings.

Hawkins: We just think he's a fabulous partner. He's been *very* patient. One of the reasons why the earnings at Fairfax have been somewhat lacking is because he has been just so determined and disciplined on the investment side of his insurance company.

And that couple billion dollars in cash should be going into some *very* attractive yields today. Clearly, we've had certain assumptions about what that couple billion dollars of float would be invested in and what it would earn. But it has not run through his GAAP income statement.

Well, it's going to start running through his GAAP income statement. That's going to be very helpful to those people that want to see GAAP earnings as opposed to "earnings power". And with a couple quarters of big GAAP earnings and the price increases we're seeing in policies, we think the ratings could swing dramatically the other way next year.

[Editor's note: So far, half of the prediction has come through. Earnings were $19.31 in the third quarter, their highest quarterly profit ever. But the ratings have not yet been upgraded. In fact, on December 16th, S&P took them down to a negative credit watch from stable.]

Falling tide hurts Fairfax's stock, but it helps its business.

McDermott: There is one other thing — and this is something we see in a lot of the international names that we buy. When a particular sector hits some kind of trouble, as the European insurance sector has [recently] with some big earnings announcements, everything tends to get thrown out at the same time. We've seen this in telcos and in other areas as well. Even going back a couple of years, we saw it in food and beverages.

In the very short term, that's certainly contributed to Fairfax's decline. But all of the specific things that have happened, whether it's the decline in the equity markets or these foreign exchange problems — anything that is weakening capital bases at their competitors — is actually a huge benefit for Fairfax. And yet the share price is down.

A lot of that is driven by short-term bets against the whole sector — which we just tend to see a lot more internationally than we do in the U.S....

COMCAST'S VALUATION IS LUDICROUS. ITS FREE CASH FLOW WILL BE COMPELLING.

If we're even in the ballpark, Comcast is very attractive.

Shareholder: In the *Value Line* page on Comcast, their earnings per share figures from '86 through 2001

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

show a whole bunch of deficits — with things improving somewhat recently. And then, when you take a look at the, admittedly naive, cash flow calculations *Value Line* presents, I see a few deficits and not much of a positive trend in so-called "cash flow" until the last few years or so.

Have you made an estimate of what kind of internal rate of return they're earning on their capital expenditures? Is it greater than the 9% or so they're paying on their debt?

Buford: I don't know if we would characterize it as an internal rate of return. We've looked at what maintenance capital spending is for that business and at what they're spending over and above maintenance capital spending. Then we've made estimates as to what we think they'll get for those dollars — in other words, what new businesses could reasonably be added, what kind of penetration rates they can achieve and what the monthly revenue would be from, say, adding a cable modem customer, a digital customer, a video-on-demand customer or a telephony customer. These are all businesses which can be added once you get to a certain level with your plant — which is what they're spending that additional capital for. And so you have to make assumptions about penetration rates, monthly revenues and what kinds of margins you can reasonably expect.

And if you run those numbers, it's very attractive. So you would want them to spend the money if your assumptions are anywhere in the ballpark of reasonable. So you do have to look out into the future and make some assumptions. But that's the way we've looked at it. It's not so much an internal rate of return as it is a cash on cash [analysis] — what would be the cash return versus what you would have to spend to get that customer and those new services?

Heavy cap-ex of the past few years wasn't for maintenance.

Cates: Maybe another way to look at that would be the heavy cap-ex over the last few years... Obviously, if you go back to the '80s, the heavy cap-ex was to lay this cable. And that last mile of cable to somebody's home has a multi-year life without maintenance recurring cap-ex that has to be associated with it. So the earnings are dramatically understated compared to the free cash flow after you've done that front-end hook up.

(continued in next column)

Well, we all know, whether as analysts or users, how many subscribers they have — and we know what they generate per month. You then go through and look at the incremental margins. So, as John says, on the margin going forward, we're comparing the cash flows that are going to come from these new services to the capital that was laid out over these last few years.

So, if you looked at that *Value Line* page and just said, "Well, all that cap-ex was required just to keep the lights on and keep the place running," then obviously the returns were terrible. But if you look at the last few years of heavy cap-ex, they've done that for two main purposes. One was to go from analog to digital cable. And the other was to position themselves to sell cable modems. So if you believe all those dollars they spent in capital will lead to digital cable, which of course they have, and that they'll lead to increased cable modem sales, which they are as we speak, then your take on the cash flow's a lot different.

Properly adjusted, free cash flow becomes very compelling.

Hawkins: The bottom line is they spent a decade laying this system and putting the technology in place to do these things that John alluded to. And the depreciation is huge compared to the maintenance capital spending that will be needed. So if you subtract maintenance cap-ex from depreciation, you get a huge, huge addition to free cash flow that would be net income. When you do the math, the free cash flow coupon becomes very compelling....

So we not only have a system with fixed costs in place, we have all of these growing revenue streams which should *dramatically* drive the production of free cash flow as they hook up these additional revenue sources — whether they be telephony or cable modem or digital — to go along with the normal video that people have watched historically.

Comcast's current valuation is *ludicrous*.

Cates: And we want to own *more* than the 3% of Comcast [that we'll receive when] the AT&T/Comcast deal is approved.... Comcast has gone from selling for 15 times cash flow to 5. So things may get worse. Maybe the 5 goes to 4 or 3, but the 5 is *ludicrous*. So we'd like to own at *least* a full position when we can pay 5 times cash flow and be in business with the Roberts family.

WE BELIEVE CABLE'S BIG CAP-EX IS IN THE PAST AND ITS BIG CASH FLOWS ARE IN THE FUTURE.

With Shaw, we like management and our past experience.

Shareholder: I noticed that we've taken a position in a couple of Canadian cable stocks. Might you say a few words about what you see in them? They've been a tough group. But obviously, there's something you like in there.

Hawkins: Well, first of all, one of the two is Shaw. We made a tremendous amount of money the last time that we owned Shaw. And we like the management team. So we've revisited it.

[Editor's note: And some other savvy investors appear to agree. As of September 30th, Berkshire Hathaway and Chieftain Capital owned 9.7% and 12.8% respectively. GEICO, which held 21 of Berkshire's 22 million shares at December 31, 2001, has an average cost of $17.71/share.]

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

Big fixed costs are behind them and big revenues ahead.

Buford: Basically, we look at Shaw and Rogers very similarly to U.S. cable companies. The business model is very similar. The margins are similar. The barriers to entry are similar. So we don't see a lot of differences between the Canadian cable companies and those in the U.S. If you can find one that has the dominant share of its market and a decent balance sheet, we think there's opportunity.

We think they've been painted with the same brush as the U.S. cable companies. A lot of it has to do with the cap-ex question. And a lot of it has to do with Adelphia and some of the others who, quite frankly, are just over-levered.

We think there are some good, solid, not overly-levered companies out there — both in the U.S. and Canada — that are selling at 40-50¢ on the dollar. And therefore, we're *thrilled* to be able to partner with 'em.

Hawkins: I think you also should know that we believe that the big cap-ex investments that they've spent in the last decade are behind them. And they have a *number* of growing revenue streams over fixed costs that should pay very handsome dividends as those revenues move north....

TRIZEC'S WORTH A MULTIPLE OF THE PRICE.
AND THE WINDOW'S STILL OPEN FOR AON.

Our appraisal on Trizec is in the $20s.

Shareholder: Could you give us a little more insight into Trizec Properties. I guess it's sort of controversial — given Munk and the new management. And could you please talk about its current price versus your appraisal?

Hawkins: Our appraisal on Trizec Properties is in the $20s. It's pretty straightforward: office buildings capped at an interest rate with many comparable sales to support it. And that'll be paid out now in dividends because it's a REIT as opposed to a c-corp.

On Peter Munk and Trizec, now that it's a REIT, it's just a question of producing the cash flow and paying out the dividend. And the dividend alone should get you a *much* higher share price. Clearly, it's one of those companies that will have to justify its value through its cash production.

And we believe very strongly that they're making the right moves not only to improve their occupancy, but to get their average lease rates up. That should be forthcoming in the next few quarters....

The investment window remains open to buy Aon.

Shareholder: ...Aon hit $14 because its earnings were bad. At that time, there was a lot of press about potential SEC investigations.... If you bought it anywhere under $20, how in the world did you satisfy yourself that there would be no meaningful SEC enforcement when everybody was so concerned with that possibility?

Buford: Your time frame versus the price range is off. You're right that the stock went from $25 to $14. And part of the reason was this SEC issue. But they announced that they got clearance from that in mid-August. And the stock sat there below $20 for months after they got that issue completely resolved. So, as a potential investor, you had a window — a fairly long period of time — that we think continues to this day when you can buy Aon for less than $20 without taking on this SEC risk.

We're not in the business of taking on unknowable risks.

Shareholder: So you bought it after that SEC announcement was made....

Buford: Well, I'm not going to comment on when we bought it. But yeah, we're not in the business of taking on unknowable risks like that....

We were right about USG, but wrong about the litigation.

Shareholder: May I ask your thoughts on USG and the bankruptcy process there?

Cates: Asbestos is just an unbelievable, out-of-control creature. And when everything is settled, we will have incurred a permanent capital loss at USG — which will have been a mistake on our part. Our mistake was in the asbestos arena strictly because the rest of the business has done even better than we ever thought it would. The people, we still believe, are better than ever. It's just a whole different issue with nothing to do with sheetrock.

Shareholder: Of course.

Cates: We have a pretty pessimistic view of all that.

Shareholder: So you don't think they'll come out with any value for equity holders?

Cates: Well, we'd never go that far and say anything publicly — because even if we thought that, we're not going to go there publicly to help anybody else's trading or anybody else's lawyer. So we really can't comment on how we think it's going to come out much more than what we've already said.

Relative to their peers, Waste Management's doing great.

Shareholder: Is Waste Management performing in line with your expectations? I've noticed the price has come down considerably.... Are you happy with the way that they've been ... executing?

Buford: Yes, we are. It's a difficult environment for everybody. As opposed to most of the companies that we follow, their earnings have been more or less flat. Their volumes are down, their prices are up a little bit and margins are flat to slightly up. So compared to the rest of the world, it's pretty doggone good.

You ain't seen nuthin' yet.

Buford: In terms of the plan and fixing the business — the computer systems and the cost savings — all of that stuff is ongoing and they're making strides. They've started a head-reduction program which the new IT systems are allowing them to do. They're more efficient than they were. So we're encouraged by what that management's doing.

And we think if they get a little economic tailwind — which probably isn't going to happen this year, but will sooner or later — there's a lot of operating leverage there,

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

as well. And that's really kind of what we're waiting for.

Hawkins: We've got a mid-$30s+ plus appraisal on Waste Management. The stock's at $24. Maury Myers is doing a terrific job. It's producing a lot of free cash flow. And they're dedicating it all to share repurchases at this discounted price-to-value relationship.

WE'RE VERY, VERY COMFORTABLE IN JAPAN — THE BEST BARGAINS WE'VE SEEN SINCE 1974.

We expect even *better* returns in Longleaf International....

Shareholder: Have you been having more difficulty on the international side than on the domestic side?

Hawkins: No, just the reverse.... We're having less difficulty finding qualifiers offshore than we are domestically.

Shareholder: But in current investment performance, isn't the International Fund down substantially?

Hawkins: It's true that we are down more in the International Fund than we are in our domestic portfolios. However, therein lies a better price-to-value relationship and, we think, better returns in the near future.

Our Japanese ideas are as compelling as any since 1974.

Shareholder: As of the most recent quarter, Longleaf International Fund had about 35% of its money in Japan. However, there's now even more turmoil in Japan about their $500 billion in bad debts and whether or not the finance guy is going to make any meaningful changes.

Are you comfortable sitting though any future macro debacles in Japan if the Nikkei goes from 8,000 to 3,500? And do you have any point of view on the macro issues in Japan and how they might affect a third of this portfolio?

Hawkins: Our investments are in companies that sell candy, insurance and video programming. And we believe that they'll continue eating sweets. They'll continue insuring their automobiles. They'll continue subscribing and signing up to watch the equivalent of cable TV from satellite broadcasters. As you know, we're focused on the appraisals and the managements that run those business.

We feel that those investments in Japan are as compelling as any we've seen since '74.

Bad news in Japan is good news for investors....

Shareholder: And those investments, if they're crossheld by the various banks or insurance companies that have to sell them wholesale because their capital goes down, aren't at risk of going bankrupt if their equities collapse to near nothing? You're comfortable sitting through further problems that might be totally unrelated to the operations of those companies?

Hawkins: We are *very*, very comfortable. And if some crossholding gets unwound, it's a huge opportunity for the managements to buy in these shares cheaply — to build our value per share.

Cates: They're getting unwound *now* — which is the only reason we have this opportunity to pay these prices.

McDermott: And if you don't need access to capital — which none of these companies do, because they have good balance sheets... In fact, they're selling at less than cash in a lot of instances. In that case, if your stock goes to a dollar, it doesn't affect your ability to sell candy and underwrite insurance. So as long as you don't need access to capital during that period, you should be OK.

Hawkins: Let me just add that we like being involved in 13-year bear markets.

Things are so bad that it's hard for 'em to get a lot worse.

Harper: We should also say that we aren't relying on the Japanese market overall to run up 100% in order for us to get *paid* on these businesses. The values are building nicely in spite of what the market's doing.

McDermott: In spite of all this negativism, Japan's been the best-performing market in the world this year —

PORTFOLIO REPORTS estimates the following were Longleaf Partners Int'l Fund's largest equity purchases during the 3 months ended 9/30/02:

1. VIVENDI UNIVERSAL SA
2. KONINKLIJKE PHILIPS ELECTRON NV
3. SHAW COMMUNICATIONS INC
4. FAIRFAX FINL HLDGS LTD
5. FIAT SPA
6. NEWS CORP LTD ADS
7. NIPPON BROADCASTING SYS INC
8. SKY PERFECT COMMUNICATIONS
9. NIPPONKOA INSURANCE CO LTD
10. CABLE & WIRELESS PLC

which is amazing since it's down 13%. But more importantly, our Japanese positions have held up *very* well this year. And we think that's a reflection both of managements' willingness to buy in shares as they come unwound, and also the fact that these are good businesses at very low valuations that have not seen their results drop as much, in fact, as many of our companies in the U.S. and Europe.

And that's partly because their operating results are *already* so low because they've been in a bear market for so long that it's hard for 'em to get a lot worse. And there are a lot of things that could happen where they could get a lot *better*.

Debate and dislocation is a good sign — unlike before.

McDermott: And as regards the bad loans, all of those bad loan decisions were made 10 years ago. And from our perspective, anything that deals with them now is good. But more importantly, you're not seeing the building of $200 million golf courses and that kind of stuff. On the margin, the returns on capital in Japan are improving.

And the fact that there's debate and dislocation and concern now is a *good* sign — unlike 13 years ago when all these bad decisions were being made and all you could read about in the press was how great Japan was and the

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

Nikkei was at 40,000. We're much happier here — although, of course, we don't know what's going to happen in the medium term with all this macro stuff.

A FEW THOUGHTS ABOUT INCENTIVE COMPENSATION.
OPTIONS? WE THINK THERE'S A BETTER WAY.

What do we think about stock options? We can't *stand* 'em.

Shareholder: Could you comment on Longleaf's perspective on stock options? Have there been plans that you thought were particularly good? Have there been plans you voted against? Warren Buffett has said that most existing stock option plans tend to be lottery tickets — that they're unrelated to the individual employee's actual contribution to the business' success or lack thereof.

Hawkins: I wrote some notes coming up on the plane on stock options. But generally, we can't *stand* them. Stock options are a flawed form of compensation in our view. And they violate the spirit of partnership investing.... It's, in many ways, a one way street. And as some have said, it is kind of a lottery ticket. I wouldn't disagree with that.

We've never once issued a stock option at Southeastern Asset Management.

But if you must, here's how we think they should work....

Hawkins: But if they're going to be used, I'll tell you how we believe they should work:

(1) All options should be indexed to inflation plus a real return or to something like the S&P 500 — whichever of those two is greater.

(2) There should be a long-term vesting period for options before you can benefit from them.

(3) Managers should be required to keep their shares. They shouldn't be able to cash out of them — unless there is a true emergency. And there can be conditions for that.

(4) Companies should buy back sufficient shares such that there's no dilution.

(5) And finally, if you do have a stock option program, we don't believe that annual awards should exceed 1.5% of the shares outstanding.

[Editor's note: It appears Southeastern Asset Mgm't has made an exception in the case of Level 3 — because we understand it stands to suffer all-but-guaranteed dilution of at least 4% per year. However, because those shares are not traditional options, but grants (Level 3 calls them outperformance stock options [talk about an oxymoron!]) we guesstimate that they'd be equivalent to 6-7% per year dilution in a company with a traditional stock option plan.

On the other hand, perhaps with Berkshire Hathaway and Longleaf as large shareholders, Level 3 will moderate its incentive compensation program to be something less than what appears to us to be *beyond* egregious at present.

In any case, due to the structure of its stake (some straight debt and the balance convertible debt), Longleaf isn't as exposed to that dilution as common shareholders.]

We prefer that employees be treated like everyone else.

Hawkins: Instead of stock options, we prefer plans that incent ownership. We often cite American Stores [now a subsidiary of Albertson's] as a great example. It implemented a program like we have at Southeastern. Basically, you have to borrow the money to buy the shares. And the money you borrow is with full recourse [— you're personally liable for the money you borrow]. That seems to really focus the employee on ownership.

If the employee doesn't have any financial resources, those loans can be accommodated by the company. And if certain goals are met — certain objectives for the employee — then the company could waive the loan or accommodate the interest burden. And then you would measure the total cost of the compensation.

So again, we generally don't like stock options as a form of compensation. We much prefer the employees ... borrow the money, buy the shares and participate fully in the downside as well as the upside.

It's more about excess compensation than accounting.

Hawkins: On the expensing of stock options, I think there are really two issues: One is accounting — and the other is excess compensation. And I think it's important not to combine the two when you talk about options.

On the accounting: the accounting treatment today *does* account for [the expense] in certain regards — because the denominator goes up as the options come in the money. So the options are in a sense being expensed. But whether it's entirely expensed is debatable.

However, for people like ourselves who are opposed to the granting of options without tying them to an employee's performance, the issue is more one of excess compensation than whether you account for them properly.

We believe very strongly that there is a better way.

Hawkins: I think it's fair to say that people who've spoken up about this — people like Bogle and Buffett and Bill Miller and ourselves — believe very strongly that there is a better way. We love for people to make a lot of money if they perform. And in many cases, it's appropriate to accommodate the ownership of a company's shares. But we don't think stock options are the way to go about it.

The pendulum swung *way* too far. But that was then....

Hawkins: We've voted against stock option packages. However, our vote was in the context of *total* compensation and the competency of the managements that were receiving those shares.

I do believe everyone is going to be a lot more vigilant. I believe that this is a win/win issue for corporate America. The pendulum had swung *way* too far to the excesses. And some good always results when there are excesses in our system.

IF YOU'RE NOT CONSERVATIVE ENOUGH,
YOU'RE ONLY FOOLING YOURSELF.

First and foremost, you must not fool yourself.

Shareholder: ...I'm curious how your price-to-value

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

equation eliminates the process of making a mistake about the general valuation and the general risks you take in owning a business. I know you've done this through many cycles, so you must have honed it down. But I don't have an appreciation for how you do it.

Hawkins: Staley will amplify on this. However, basically, a business is worth the future cash that it will produce after required capital spending and working capital needs discounted back to the present. Think about it as a coupon-producing bond where the coupon grows. It's very, very simple. You try to determine what the coupon is, you are conservative in what you think the coupon will grow at, you take it out a period, you put a terminal multiple on it and you discount it back at a conservative interest rate.

We've done that for three decades. And clearly, you have to not fool yourself. There are certain companies where you *can't* do it. You must be able to understand the business. Second, you must be able to value it. And third, you try to buy it at half of appraisal.

We want to be roughly right, not exactly wrong.

Hawkins: Today, we're using very, *very* conservative discount rates ... in view of a 4.4% 10-year Treasury. Even though the 10-year Treasury has declined significantly in the last few years, our discount rates have *not* changed that much. So we believe that our growth rates on our projections for future earnings [are conservative]. We believe that the terminal multiples that we apply to those earnings out six or eight years from now [are conservative] — and we believe that the discount rate on discounting back the terminal value plus the six or eight years is also conservative. So there are *three* bits of conservatism there.

Again, you want to be "approximately right instead of precisely wrong". And that's why Ben Graham talked about the need for a large margin of safety. If you do a conservative appraisal and arrive at a valuation of $100, and you pay $50 for it, even if your appraisal is off by 10% or 20%, you still have $80 or $90 versus the $50 you paid — so that you become "approximately right" even though your appraisal might have been off by a tad. Again, you are only fooling *yourself* if you are not conservative with your appraisal.

At the core of what we do is a private business mindset.

Hawkins: And it's back to our acid test at our shop: Would you put your entire net worth in the company? And you can get to that position if you've done your appraisal conservatively, if they're honorable people and if there is not too much debt. It's not much more complicated. Staley, you want to add anything?

Cates: Well, that's a good summary. The only thing I'd add is that it is just with a private business mindset. Those calculations of value that Mason's talking about all are without regard to if the company is even *public* or not, much less whose name is on the stock certificate and how many households own stocks and whatnot.

Time is the friend of the great business....

Cates: As Buffett has said, don't buy a stock unless you'd still want to own it if the exchanges were going to shut down for the next 10 years. With that mindset, which goes with owning a really good company, as long as that company is building its value — which is the number one most important thing fundamentally to us — then it doesn't matter when the stock market realizes it. You can just sit back and say, "The stock market is something we take advantage of."

If it throws out a stupid price — like when it gives us Disney at $15 or Comcast at $20 — that's just something to take advantage of. And then somewhere out there — in year three or six or nine — the price will reach our appraisal. As long as that value is growing, we can be kind of blasé about when those lines cross.

WE COULD JUSTIFY A LOWER DISCOUNT RATE,
BUT WE *LIKE* BEING CONSERVATIVE WITH OUR MATH.

If we can't value it, we can't buy it at half of value.

Shareholder: Clearly, your estimate of intrinsic value using a discounted free cash flow model is driven very much by the discount rate you use to discount back your projected future free cash flow streams and terminal value. Do you use varying discount rates from business to business? And if so, what are the variables that determine the rate that you use?

Hawkins: We try to use conservative assumptions. And we don't normally go below 10% for a discount rate — usually it's 10-12% — and never below 9%, even for the most stable and sound business. In today's interest rate market, I think that's *hyper*-conservative. So we do vary it some. But if it has to vary much, it means that we really can't understand the future streams. So we're very careful about that. If we can't understand a business, we can't value it — and if we can't value it, we can't buy it at half of value.

You can make the case that our discount rate is way high.

Cates: Generally, we use a discount rate of 10%. For blue chip quality companies that have competitive advantages — or, as Buffett would call them, "moats" — that are of the highest tier possible, we might use a 9% discount rate. How do we get to those numbers? The very first step is where the government bond is. Then you take a step over that and look at where corporate spreads are. Then you would say, "For us to invest in the equity instead of just buying those corporate bonds, we need another few points of return." And that's how we come to the discount rate. And the thing of interest now, as Mason said, is that you could make the case that our 9-10% discount rate is incredibly high compared to a 4% 10-year bond.

But you can make a case for a higher long-term rate.

Cates: The reason it's a little sticky for us as far as bringing 'em down is that some of the pay raises and the wage changes we see — company by company — are higher than reported CPI. And productivity's been fantastic — and that's kept CPI under control. But if the long bond ever responded to the CPI that didn't have that productivity

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

factor in it, then you'd make a case for an intrinsically higher rate on the long bond. And then that would kind of cascade upwards.

Industry participant expectations support a higher rate.

Cates: Finally, when you're using a 9% to 10% discount rate, that is on totally un-levered cash flows. So to convert that to an IRR [internal rate of return] a private business person might look at, that would be something like a 14-15% IRR at a kind of basic 50% leverage. And that rate doesn't change a lot either — in terms of different companies or different business people we talk to as far as their requirements for IRR. So for all those reasons, we're not bringing our discount rate down from 9-10%.

Toughest of all is to be intellectually honest with yourself.

Hawkins: There are a lot of businesses where we can't understand what the drivers of their free cash flow will be in six or eight years. And if we can't, then [what discount rate to use is] not applicable.

So I think the biggest thing that you fight is whether you're being intellectually honest with yourself — because these computers just receive data without regard to whether the input is valid. To that extent, it was better when we used to do it on a spreadsheet by hand, and look up the factors in the discount rate tables as opposed to just punching a button and having it give you something that, as Mr. Buffett says, is maybe precise, but absolutely wrong.

If inflation is 1% and long-term Treasuries are 4%, we're still going to use 10% discount rates to reflect the return hurdle that we need as an equity owner. Again, we're trying to be conservative with our math. We want to come up with an appraisal we can live with and defend in almost any regard when we start comparing that appraisal to the price that we're asked to pay.

And a sticky high rate means a conservative appraisal.

Shareholder: During the life of Longleaf Partners Fund, is 10-12% the range you've used as a discount rate — or have you ever been as high as 15%?

Cates: It's been a long time.

Hawkins: The Partners Fund was started in '87. But if you went back to '81 when you had 15% Treasuries, obviously the discount rates would have been north of that.

Shareholder: So you are reacting to some degree to the current interest rate environment...?

Hawkins: Not at this point....

Cates: But over time, yes.

Shareholder: Is it not true, too, that if you were to use a higher discount rate, you'd wind up with a lower appraisal number?

Hawkins: That's the way the math works.

Cates: Exactly. So that we're being conservative on our appraisals....

EVERY BULL MARKET SEES EXPLOSION OF FRAUD.
AND THE MORE IT'S SPOTLIGHTED, THE BETTER.

There have *always* been accounting issues....

Shareholder: Would you comment on the rash of accounting scandals and what effect you think they've had on valuations in the marketplace and our intrinsic values?

Cates: They've really not affected our day-to-day at all. And that's because it's always been our job to go through the accounting shenanigans that are making the headlines to begin with. It's new news to the guy on the street that this stuff is going on. But ... we've seen this in 10-Ks and 10-Qs forever.

Before all this stuff ever started, before we bought a Level 3 bond, we were going through comparing it to its peers in terms of who books their swaps, how everybody treats their options, what the special purpose entities are off balance sheet, what the accounts receivable financing is that doesn't show up in long-term debt and on and on. So I don't mean to be blasé. It's just that these have always been accounting issues. It's getting a lot of publicity now, but it's *always* been there — and it's been our job to sort that stuff out.

We could show you all kinds of horror stories of companies that we passed on because we saw a bunch of Mickey Mouse stuff that they do.

Every bull market has exponential increase in greed/fraud.

Cates: To the extent that it is spotlighted, that's only a *good* thing. I mean, the more scrutiny and the better the disclosure rules, the better for all of us as investors. And it makes it probably somewhat easier for us to sort through all that stuff. Mason, do you want to add to that?

Hawkins: Well, I think every bull market's got an exponential increase in greed and fraud. And this time around, it seems that the mantra of Wall Street was meeting quarterly expectations — regardless of whether the company was making money or not [chuckles]. And in order to meet those expectations, it appears that more companies than normal played games with some of their accounting —whether it's taking more or less into reserves or booking revenues more rapidly than they might have.

There are a lot of things, discretionarily, I guess, that managers can do — which gets back to your assessment of whether they're honorable and reasonable partners.

Developments have been healthy from where we sit.

Cates: But clearly, the focus now will push the pendulum back the other way. CEOs having to sign the financial statements and swear in blood that they're accurate is probably a worthwhile thing. Certainly, the [upcoming] numbers are going to be more conservative. That I can assure you.

There's been a lot of discussion in the media about how much that will impact what the consensus earnings estimates are. And that's healthy from where we sit.

With excess capacity almost everywhere, pricing is tough.

Shareholder: In this environment, it's become increasingly difficult for companies to raise prices. How do you incorporate that reality in valuing a company?

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

Hawkins: Pricing is always difficult in a competitive environment. It's especially true with excess capacity. We're not economists, but we're operating at very low levels of capacity in almost every industry. So pricing's tough. Only those that are uniquely positioned can get away with inflation pricing today.

Your point's one worthy of great study. We spend a lot of time on pricing power in the hopes that you can raise prices more than your costs escalate so that your margins increase. But I think that you have to get to greater rates of utilization before you're going to see any real pricing.

It's kind of hard to *see* inflation at this point. However, again, we're agnostics on that....

Environments such as today's play into our hands.

Shareholder: There's been a lot of talk this afternoon about taking advantage of the environment here. And the environment has shifted. On a macro basis, there are changes now — not only in the way people are reporting and/or paying taxes, but in how they're doing business. So to some degree, you don't have a historic continuum. Does this create some new opportunities for you?

Hawkins: Yes, we do believe that business will be conducted on a more conservative basis going forward and that it will probably bring additional liberal accounting policies to the surface. All of that, I think, plays into our hands as conservative business appraisers — because the market usually reacts pretty dramatically to surprises every 90 days. We're hopeful *more* opportunity will surface....

SWINGING HARD IS ONE THING,
LEVERAGING UP QUITE ANOTHER.

There's only one way we know to ameliorate risk....

Shareholder: How do you integrate emerging U.S. foreign policy into any of your investment decisions?

Hawkins: We don't. Obviously, everyone in this room is concerned about war. We're also concerned about the counter of that — which is why we're considering it. And those are very tough decisions. But if you're a thoughtful person, there's *always* a lot to be concerned about.

Therein lies the reason Ben Graham talked about buying businesses with a huge margin of safety — because it gives you big shock absorbers for either mis-evaluation or for 9/11s. There's no way to ameliorate risk — at least from where we stand — other than buying businesses that are above average at below-average prices.

Because of our discriminating process, we don't find a lot of qualifiers. Therefore, it's imperative that we swing pretty significantly when we find a few that we like a lot.

We would not counsel anybody to use debt to invest.

Shareholder: ...For the first time in my career, I am seriously considering, *perhaps*, taking on [some leverage]. I haven't done it yet. I want your point of view on the math. With lending rates at 30-40-year lows, where you can get a home equity line at 4.75% or 5% and margin debt at 5% — and I know both of those are variable — with price-to-values near 50% and the broad markets off 76% and 46%, it would not seem unreasonable to take out a modest loan to buy more of your Longleaf funds at 50¢ on the dollar if one can withstand a couple of years of net negative spread waiting for the value to be obtained. Beyond the simplistic answer of, "That's a risky strategy because you're going into debt", is there something wrong with my math?

Cates: We would be of the John Templeton school that would not counsel anybody — kind of on principle — to have debt in order to invest. The math on paper that you went through is truly sound. It's definitely a logical argument. But as you know, what sounds good on paper may not always work if you do have a rough ride for, say, one or two years. We just would never feel comfortable counseling anybody, even when the numbers line up correctly, to borrow money to invest in equities.

And maybe we're over-conservative. But leverage kind of takes away the very thing that may be our biggest asset — which is our patience and our ability to look long term and not get panicked over two bad quarters in the name of doing something good for three years.

We wouldn't even encourage our *own* people to use debt.

Cates: As far as Longleaf goes, we certainly also don't encourage our *own* people to borrow money to invest. Whether they do that with their home mortgages or not is something we don't frankly pry into. I think people at Longleaf might feel more comfortable doing that because they're here day-to-day. They may feel the level of control that you feel when that is your full time job, and so all your assets are there. But that wouldn't translate into a generic investment recommendation....

Absence of leverage provides much-needed shock absorber.

Hawkins: I think Mr. Buffett had a great comment — and I can't remember it exactly — but he said, "You know, if you're smart, you don't need debt — and if you're dumb, it'll kill you." The compounding process, in our view, works very, very well with a conservative balance sheet. And when you can compound at very high rates without leverage, it gives you that additional shock absorber, or additional cushion, in the event you misjudge the bottom.

If you misjudge the bottom with leverage, it's not just a *psychological* disaster, it can become a *financial* one.

[Editor's note: Sequoia Fund's Bill Ruane mentioned something similar in our May 31, 1990 edition. Quoting Albert Hettinger (the late advisor/associate of Lazard's Andrew Meyer) who made and lost two fortunes compliments of leverage: "You should never borrow money to buy stocks. If you're smart enough, you don't have to; and if you're not, you better not."

Incidentally, Ruane said Hettinger went on to build another fortune that he kept — *without* leverage.]

The margin clerk doesn't know the P/E — and doesn't care.

Hawkins: None of us are smart enough to know how much of an extreme the psychology can tilt to as it shifts from greed to fear. A lot of that shift is not based on rational economics in the short run. It can be based on

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

basically the margin clerk blowing the stock out because someone *else* is too leveraged. As they say, the margin clerk doesn't know the P/E — and doesn't care as well.

So we'd counsel *very* strongly against using leverage. And we just can't say it any better than Mr. Buffett said it.

HOWEVER, ALL DEBT ISN'T CREATED EQUAL. THERE IS SUCH A THING AS *GOOD* LEVERAGE.

If we think creditors could usurp our position, we don't play.

Shareholder: It seems that the fallout that we see in the markets comes from companies with substantial debt. And in your portfolio, there are companies that do seem to have fairly high debt levels. How does that impact your margin of safety when you do your analysis?

Hawkins: Well, we start in making a decision on the front end if we want to play or not. That's a function of debt to total capital, as well as coverage. Furthermore, we do utilize stress tests in terms of worst case cash flow projections vis-a-vis interest and principal payments. And if we think that the creditors could usurp our position as an equity owner, we don't play to begin with. So we clearly do our appraisal after net debt.

We're mindful of operating leverage and financial leverage.

Hawkins: And we are very mindful here to what we call appraisal risk. If you have a company with 50% debt to capital and you have a minor change in your operating cash flow, then that gets magnified on the equity holdings — on the equity base. Clearly, there's more appraisal risk the higher the leverage. So when we go through time, we are mindful of the operating leverage *and* the financial leverage that we have.

It's a question of whether we want to play, and secondly, how much it affects our appraisal under adverse circumstances.

All debt's not the same. There are also *qualitative* factors....

Cates: The other part of it is that the structure of the debt is usually important. For example, take the case of two companies that have more debt than we typically like to see — Fleming and Forest City. Fleming doesn't have any meaningful maturities coming due until 2007. That's a very, very important point and affects a lot of their bargaining position and all of that stuff.

Then, Forest City is *so* intelligently financed. They're a real estate company. They finance each real estate deal on its own — nonrecourse back to the company. So what looks like a lot of debt on the surface is an incredibly well-managed way to advantage the equityholder. So as you can see, we put the qualitative factors in there, too.

HAVE WE REACHED THE BOTTOM? WE DON'T KNOW. IN FACT, WE DON'T *CARE*. LOWER MAY BE *BETTER*.

Have we hit the bottom? We don't know and we don't care.

Shareholder: You've mentioned that you've put a lot of cash to work this year.... Have you given any thought at all to whether or not there is some potential for things to get a lot *cheaper* — and that they might stay cheap for awhile?

Hawkins: In other words, have we seen the bottom?

Shareholder: Exactly.

Hawkins: We don't know — and *you* don't know. But what we *do* know is in Disney and Comcast, very conservative addition, subtraction and division produced twice the price — just as it did in '74, just as it did in '70, just as it did in '66 and just as it did in pre-Gulf War '90.

And we've managed to produce a return of over 20% a year for 20 years — that's 600 basis points [of outperformance] — by buying one company at a time, building a foundation of 15 to 20 businesses, with the knowledge that we feel really good about the next five years for those companies.

There's no more aggressive buyer today than Berkshire.

Hawkins: We can't fine-tune it as to whether or not the Democrats may take over the Senate or the House. And we can't fine-tune it as to whether or not we're going to have another attack. I wish we *could*.

I'd dare say there's been no more aggressive buying going on in the world than out in Omaha right now at Berkshire. If you're waiting for some kind of green light to flash "go"... You're never going to get that. There have been four or five hundred years of capitalism where people have wanted the green light — a shortcut. And yet ... I don't know the way to get there....

We're not *interested* in the averages.

Hawkins: So, it's very possible that the S&P 500 could go down further. You know, when Nasdaq was 5,000 in February of 2000, had you been worried about Nasdaq, you wouldn't have owned all these great companies that we have compounded your capital with over the last 2+ years. If you had been worried about the S&P 500 in February of 2000, you would be a lot poorer today for two reasons: because [chuckling] (1) you wouldn't have been in Longleaf and, (2) you probably would have been indexed.

So these macro views speak to average stock price and average earnings and to the average corporation. But we're not *interested* in the averages. We're interested in one company at a time — whether it's a very competitive

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

entity, whether it's financed conservatively, whether it's run by honorable and capable people and whether it's selling at a very big discount to intrinsic value and, secondly, whether that intrinsic value's going to grow....

We don't have a crystal ball. But we do know the assets.

Shareholder: In other words, whatever the level was that you felt was the right level...

Hawkins: There wasn't a level. There was a price versus an appraisal [on a company-by-company basis]. So it's not going to bother us if Vivendi goes back to $9 on the way to $34 because the probability of it going to $30 in the next five or six years we think is very high....

We do know that those assets that we owned at MCA and then at Seagram are very, very understandable, that we've owned them twice prior and that when we add up the value of those assets and take out the debt, we get a big number versus the current price of the shares.

We can live with declines. Maybe it's our time horizon....

Hawkins: Yeah, I'm not going to like it a *bit* more than you are if Vivendi goes back to $9. I didn't like it a bit in '90 or a bit in October of '77-'78. I didn't like it a tad when we sold for less than a couple times earnings in some individual cases in 1974. But we're in it for the 10 years — not the next 10 days. So maybe it's a matter of time horizon and perspective that drives us....

We're not watching the quotes. And lower may be *better*.

Hawkins: If we have to wait patiently for a couple of years sometimes, we may have an opportunity cost because our capital is not performing in "the marketplace". But we're not paying attention to what the quotes are. We're paying attention to the intrinsic value accrual as the free cash flow streams are retained and reinvested — hopefully intelligently.... And our time horizon is three to five years.

In fact, the lower that our partners' share prices are — and the *longer* that they're lower... Over the long run, that may be the very *best* thing if our corporate partners are ... buying in their shares at half of value....

"FEEL" DOESN'T GO VERY FAR AROUND HERE. IT'S JUST BUSINESS, PEOPLE AND PRICE.

Why so few LBO's? Because there are so few lenders.

Shareholder: With valuations getting more attractive and low interest rates, why haven't there been more acquisitions or going private transactions?

Hawkins: Well, first of all, as we've said, equities are attractive vis-a-vis bonds. They're not *wildly* attractive. Why haven't there been more cash acquisitions? I think there have been some. In fact, there have been quite a few.

You've not seen a lot of LBOs because there are few lenders. Those markets are very thin — not very extended....

We leave "feel" to the newsletter editors and talking heads.

Shareholder: Mason, would you take a second and just comment about how this market feels, or some of the similarities between what we have going on now and what happened in '73-'74?

Hawkins: Wow, you know how old I am, I guess.

Shareholder: Yeah, sorry....

Cates: Could you also talk a bit about the '31 market after that, Mason? [Everyone laughs].

Hawkins: Boy, I get a lot of compliments on these calls. Well, "feel" doesn't go anywhere in our shop. It doesn't mean much. We try to quantify it and qualify it. And we try to divorce emotion from our decision making. One of the things that we have been very, very conscious of throughout our careers and throughout our studies has been to say, "Look, let's get away from this in terms of the way we feel." And I think that's stood us in great stead.

We've always been rightest when we've been nauseous.

Hawkins: Feel has never been part of our equation for investing capital. It's business, people and price — and getting our appraisals correct, getting our assessments of management right, and doing it conservatively so that when something is [trading at] half of value, we can act with great conviction....

To make successful equity investments, you must have sufficient information to properly evaluate a business and its management. You must use the information intelligently and constructively to properly appraise the company. And you must act on the facts of the analysis with conviction when the requisite discount from appraisal exists. Nowhere in that is there anything about feel.

In fact, we've always been the rightest when we've been about to throw up. And I'm sure if you were to sample our shop, there have been some nauseous people around here this year....

One thing we *do* know: 50¢ dollars don't stay around long.

Hawkins: Are we at the point of maximum pessimism as John Templeton often talks about? I just don't know. And we *never* know. But we *do* know when we get to half of our appraisal and those appraisals are conservative — and that's all we ask for.

It's unlikely that the companies are going to stay at half of appraisal. We live in a free, capitalistic society. And so 50¢ dollars don't lie around for long. Mergers and acquisitions occur, going-private transactions take place and shareholder repurchase programs get initiated with significant effect — not only on growing the intrinsic value per share, but on closing the gap as well....

—OID

For additional information you may contact:

LONGLEAF PARTNERS FUNDS
6410 POPLAR AVE., STE. 900
MEMPHIS, TN 38119
(800) 445-9469

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from page 1)

Berkshire clearly is a much more valuable and admirable company because of what he has taught us." (Your editor can't help but add a hearty amen on all counts.)

Also from Buffett's foreword, "Charlie truly is one of a kind. I recognized that in 1959, when I first met him, and I've been discovering unique qualities in him ever since. Anyone who's had even the briefest contact with Charlie would tell you the same.... To me, what makes [him] special is his character. It's true that his mind is breathtaking: He's as bright as any person that I've ever met" [Ed. note: This from someone who is close friends with Bill Gates!] "and, at 76, still has a memory I would kill for."

(Lowe relates that Buffett's eldest son, Howard, says that his father is the *second* smartest man he knows — that Munger is the first.)[1]

Continuing from Buffett's foreword: "He was born, though, with these abilities. It's how he's elected to use them that makes me regard him so highly. In 41 years, I've never seen Charlie try to take advantage of anyone, nor have I seen him claim the least bit of credit for anything he didn't do. In fact, I've witnessed exactly the opposite: He's knowingly let me and others have the better end of a deal, and always shouldered more than his share of the blame when things go wrong and accepted less than his share of credit when the reverse has been true."

"He is generous in the deepest sense and never lets ego interfere with rationality. Unlike most individuals, who hunger for the world's approval, Charlie judges himself entirely by an inner scorecard — and he is a tough grader."

Seeing Charlie in action, longtime friend and partner Ira Marshall "became convinced Charlie had the ability to think through a future event and come to a conclusion different from what others assumed it would be, 'and I've hardly ever seen him wrong'."

Elsewhere, Buffett adds: "Charlie shoved me in the direction of not just buying bargains as Ben Graham had taught me. This was the real impact he had on me. It took a powerful force to move me on from Graham's limiting view. It was the power of Charlie's mind. He expanded my horizons."[2]

Buffett says he slowly came around to Munger's point of view on many points. "I evolved...."[3]

To that, Buffett's added a simple observation: "Boy, if I had listened only to Ben, would I ever be a lot poorer."[4]

Putting Graham and Munger together, Buffett says, "I became very interested in buying a wonderful business at a moderate price."[5]

We consider ourselves equally fortunate to have had Munger as a teacher and an *OID* contributor. As long-time subscribers know, he's been right about the major issues of the day — including the savings and loan scandals, debacles in derivatives, misleading accounting and outrageous, self-serving incentive compensation, to name but a few — *before* they became front-page news. And he's been an equally astute observer about other issues such as errors in human cognition and human nature generally.

The excerpts which follow were selected from his answers to questions from shareholders who attended Wesco Financial's latest annual meeting which took place on May 8th in Pasadena. As always, we second Buffett's comments about the enormous value of learning from Munger and highly recommend a very careful reading (and re-reading, etc.) of anything he has to say. Ignore Munger at your own peril. We hope that you find his insights and observations as entertaining and valuable as we do.

DERIVATIVES ACCOUNTING HAS BECOME A SEWER.
AND IF I'M RIGHT, THERE'S GOING TO BE HELL TO PAY.

Originally, derivatives traders tried to match their books.

Shareholder: At Berkshire's meeting, you commented on derivative accounting. Can you give us a better description of what's involved in accounting for derivatives? Your comment was that it's worse than a sewer — or something to that effect — and that our Berkshire companies are getting out of derivative trading as a regular business.

Charlie Munger: The main derivate that was originally traded was the interest rate swap. In this, you agreed for a considerable period ahead to pay some fixed-for-life-of-contract interest rate in return for receiving a fluctuating interest rate that a very-creditworthy borrower would pay for short-term credit during the contract period, or *vice versa*. Such a contract would often move enormously in value based on the way the interest rate curve changed. And the same contract had different values for signers of different creditworthiness because of inherent clearance delays.

Even without effects from credit risks, you could make or lose a lot of money in such a contract if you wrote it "naked". Therefore, most traders tried to end up with a "matched book" whereunder, if there were no defaults in performance from opposing contracting parties, they would pay X% on their book each month while receiving X%+Y% for the same month. And in the original accounting for such trades, Y% of their book attributable to each month would come into income (before other events) for that month. The accounting, therefore, resembled that of a savings bank.

You aren't satisfied with reported profits? No problem....

Munger: However, the traders couldn't claim to be making all the profits they wanted to claim under such savings-bank-like accounting. Moreover, "naked" trades had to be valued. So the traders somehow convinced accountants, who should have known better, that reliable "market" prices for these non-fungible contracts could always be fairly determined by the traders with light checking by auditors.

(continued on next page)

[1] Roger Lowenstein, *Buffett: Making of an American Capitalist* (New York: Random House, 1995), p. 162.
[2] *Forbes*, January 22, 1996.
[3] L. J. Davis, "Buffett Takes Stock," *New York Times Magazine*, April 1, 1990, p. 61.
[4] Carol J. Loomis, "The Inside Story of Warren Buffett," *Fortune*, April 11, 1988, p. 26.
[5] L. J. Davis, "Buffett Takes Stock," *New York Times Magazine*, April 1, 1990, p. 61.

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

Thereafter, reported profits multiplied like rabbits and derivative trading similarly expanded. And finally even the Morgan Bank, which was the last big holdout against the accounting of the crowd, caved to pressure to hold its trading personnel and join in the enhanced earnings claiming, facilitated by "market value" accounting for non-fungible contracts involving large and fluctuating clearance risks. And so came looser and more optimistic standards for accounting that was none too good before.

The traders also invented various very exotic and peculiar derivate contracts of all kinds covering energy and other things in addition to interest rates. And practice morphed into valuing trades based on theoretical models invented by the traders and people hired to help traders. Meanwhile, outside auditors and FASB accounting standards makers combined their work to bless massive earnings that showed up as desired through use of the theoretical models.

All kinds of assets that don't exist come into the books.

Munger: The end result is that all through America, all kinds of assets that don't exist are on the books of major institutions. And all kinds of earnings that are being reported and certified by all of our major accounting firms aren't really being earned from these derivative books under sound accounting.

The accountants have written 800+ pages of complex rules — FASB rules — to govern all this stuff. And if you're extremely venal, you can do what Enron did or something approaching it. And if you're not very venal, why, the forces of your own personnel system will nonetheless drive you into a lot of inappropriate trading and lousy reporting. So I said that derivative accounting was a sewer — and that to say so was an undeserved insult to sewage....

It's become a *hell* of a mess. And there's no easy way out.

Munger: You can begin to see how it was bound to work out. Enron had this big derivative book which was blessed by its auditors. And, of course, when they reach for the money, it just melts away....

It never was there. And the accountants and FASB never should have allowed it to be certified as there. And the directors never should have set up systems which compensated people for creating reported earnings which weren't there in substance. But how good are a bunch of directors at correcting accounting blessed by financial managers and auditors?

So it's a *hell* of a mess.... If I'm right, there is going to be hell to pay in due course. There's no easy way out. All of you are going to have to order your lives so that you take into account the possibility of there being big trouble ahead from American derivative books....

It's a crazy activity for people who are already rich to be in.

Munger: To me, it's obvious — it's *always* been obvious — that the system was ridiculous. The whole *system* is crazy. In the ordinary trading of say, government bonds, you've got to pay quickly. And my bid is no better than Joe Schmo's bid — because both bids are going to clear so fast.

But with these derivative books, the clearance is delayed and delayed and delayed. As markets and creditworthiness change, people owe these vast sums.... And a lot of the trading is without collateral. Some of the collateral clauses, where they exist, leave a lot to be desired. There's no sign a person wears saying: "I'm going naked". So if some guy on the opposite side is swinging for the fences and he gets in terrible trouble, you can have a big receivable on your books which is no good. I think it's a crazy activity for people who are already rich to be in.

Now, if you're a derivatives trader and it's not your money at risk, it's been a wonderful business. But for rich people like Berkshire Hathaway, it's a crazy business to be in. And I think it's a crazy business for the big banks to be in the way they're doing it. Moreover, bank regulators want to sleep instead of doing their duty, if I'm right.

We're not depressed about American Express.

Shareholder: I know you don't like to comment on individual holdings of Berkshire. But do you feel that American Express' disclosures have been adequate over the last year or so when they have experienced quite a few embarrassing losses in derivatives and junk bonds? Have they disclosed all the material issues in the company?

Munger: American Express has made some investments that didn't work out well. And they've had various little blips downward which have been irritating to them and to other shareholders of American Express.

However, am I satisfied with what we know about American Express? I think the answer is "yes". We never thought that their investments were going to be handled exactly the way we handle ours. And we're big boys. Besides, we make mistakes, too, and get blips down. So we're not depressed about American Express.

TWISTED INCENTIVE STRUCTURE ON WALL STREET MEANS BEHAVIOR WILL ALWAYS BE MEDIOCRE AT BEST.

Ethics on Wall Street have been imperfect for a long time.

Shareholder: Given how long you've been around, could you give us your perspective on Wall Street's ethics?... I just wondered if the '60s or previous go-go periods were this bad — or if we've reached a new low for honesty on Wall Street.

Munger: Well, generally speaking, I think ethics on Wall Street have been far from perfect throughout my lifetime. When I was young, the traditional way of merchandizing securities in a town like Pasadena was to buy stocks over the counter and sell them to sweet little old ladies with a 5% markup — which was totally undisclosed. You'd meet the old lady in the church and cotton up to her and tell her that you were helping her and then tack on five points when you were doing some risk-free trade.

I always considered that unethical.

But today, anything that *can* be sold *is* sold.

Munger: But underwriting standards, I think, were better in the old days than they are now. I think the general standard now is that things that *can* be sold *are* sold. And people just rationalize whatever they have to

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

rationalize to get it done. That's a terrible development.

If you go back to the days of First Boston when it was controlled by the Mellons, they had all kinds of things they just wouldn't do — even though the merchandise was saleable at a good profit. That is a much more ideal way in which to run an investment bank.

Wall Street ethics generally will always be mediocre at best.

Munger: All that said, there are still a lot of high-grade, intelligent people in the securities business — probably many of them in this room. But many of those people, my guess is, have to fight their own firms to some extent on behalf of their customers.

It's always been a hard business to keep wonderful ethics in. You get some guy who is trying to pay his kids' tuition by making a certain amount of gross commission each month, and it gets late in the month and there's Aunt Suzie's account — and lo and behold, a little action occurs. There are huge temptations to misbehave....

Any time you create large differences in commissions where the guy gets X% for selling A, which is some mundane security, and 10 times X for selling B, which is something toxic... I think in the nature of things, the ethics of Wall Street are always going to average out mediocre or worse.

Business of turning an analyst into a shill is nothing new.

Munger: Even so, there are some marvelous people in it. The service Berkshire and Wesco have had from Wall Street has been fabulous. But I don't think you should judge Wall Street by that. I don't think you get a lot of credit in life for not committing adultery with the Virgin Mary. [Chuckling] It would be hard to sell the kind of service to us that's sold to a lot of others. We'd be a hard sell.

This business of turning the analyst into a shill for the underwriting department was *always* present to some degree. But it simply went crazy in this last period because there was so much money in doing it — given the dot-com boom and so forth. But it looks like we'll recede now from the worst of the recent behavior.

Incentive structure will keep Wall Street behavior mediocre.

Munger: But will we get wonderful ethics? I don't think so. The incentives are twisted against many customers. The firm can't make much money selling some institution shares when the price for the execution is 2¢ a share or something like that — and yet the firm can make a lot of money from underwriting some company which its analysts praise.... It's very hard to expect the analyst to behave perfectly, given these facts.

To set up incentives which reward A and then tell people that you want B ... is always going to cause a lot of A.

(continued in next column)

That doesn't mean there aren't some intelligent, honorable people on Wall Street — there are....

SHAREHOLDER DEMOCRACY? THAT'S A FICTION.
THE CEO PRETTY MUCH DOES WHAT HE WANTS.

Directors generally have one job — and that's to vote "yes".

Shareholder: Regarding corporate governance, I'm curious as to how much influence a director actually has on the board of a large public company.... I think you mentioned that when you, Mr. Buffett and Mr. Simpson were all on Salomon's board, things nonetheless happened that were contrary to what you thought were best. I think in Coke's annual report, it shows that their expected return on their pension assets is 8-1/2% — and I seem to remember you and Mr. Buffett saying that you're more comfortable with a lower percentage. So is there a disconnect there? What do directors actually do? [Munger and attendees laugh.]

Munger: I can answer that question by telling a story. Joe Rosenfeld, who was a fine and brilliant human being and a great friend of ours, once said, "I was asked to be on the board of Northwestern Bell — and it was the last thing they ever asked me." [Attendees and Munger laugh.]

The agendas would come and he could vote "yes". And I'm afraid that's what is normally expected in American corporate culture....

Even as large shareholders, we have little influence.

Munger: There are times when a CEO will know he's got some expertise on the board — and he'll voluntarily go to that expertise when he's in doubt, ask for an opinion and so on. But in the end, the CEO tends to make the decisions. He doesn't too much like, ordinarily, reversing his own staff — which is understandable.... So even when we're on the board as substantial shareholders, I'd say we have very little influence.

The CEO rules. That's just the way the culture works.

Munger: Now, there are occasional exceptions where somebody has a high regard for one of us and will ask us a question or two privately. But averaged out, the CEO does what he wants to do — and the board says "yes". Anything else is rare. The culture just works that way....

Given this culture, Warren and I have been lucky to serve with so many wise CEOs.

A PILOT DOESN'T TAKE OFF WITHOUT A CHECKLIST.
AN INVESTOR CAN CRASH WITHOUT ONE, TOO.

In financial institutions, there are *lots* of ways to blow it....

Shareholder: This is a follow-up to some of your comments earlier about risk in financial institutions. And I'd like to tie it to a comment that you and Mr. Buffett made last year at the annual meeting in Omaha, and how you said you sold your Fannie Mae and Freddie Mac because something made you nervous. You likened it to an iceberg — where you can see the ice on the water, but you don't know where the ice is beneath the surface. Outside of a derivatives book, are there any other red flags

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

to look for in annual reports?

Munger: Well, the reality in most financial institutions is that there are a lot of ways to go to hell. You can foolishly push credit. You can charge into new businesses you know nothing about. You can make dumb mergers at very high prices. You can leverage yourself so greatly that a slight puff causes you huge distress.

So, certainly, looking for trouble in financial institutions involves a lot more than looking at derivative books. After all, financial institutions were getting in plenty of trouble before we ever *had* derivatives. So I haven't got any simple prescription for predicting trouble.

Without an adequate checklist, you may crash.

Munger: Generally speaking, I think you need mental models — and what I call checklist procedures — where you take a worthwhile list of models and run right down them: "Is this here? Is that here?" and so on and so on. And by the time you complete your many-part checklist procedure, you've made an intelligent attempt to analyze the situation.

Now if there are two or three items that are very important that aren't on your checklist — well, if you're an airplane pilot, you can crash. Likewise, if you're trying to analyze a company without using an adequate checklist, you may make a very bad investment.

Proof of Munger's point about learning correct thinking....

Munger: So, generally speaking, I think you've got to have a bunch of models in your head and you've got to use them in a checklist fashion. That is obvious. Yet, how many of you were taught in your college educations that that should be your routine way of tackling problems? Will you raise your hands? There's *one*. Well, one. Where did you go to school?

Shareholder: MIT.

Munger: MIT. See.... Here again, we see the value of the ethos of science. And that's why I think it's so important for people who can handle a little science education to be forced to have it. All of you who are influencing children and grandchildren should take this to heart. If they can do some science, make them do it.

By the way, this MIT business wasn't rehearsed. It just happened. One man raises his hand in this whole room who's got the correct way of thinking. And where did he go? MIT. Can you imagine what kind of nonsense we'd have gotten from somebody from the poetry department of Amherst?

If I *gave* you the items on the checklist, they wouldn't *stick*.

Shareholder: You mentioned mental models and a checklist. Would you share the investment checklist that you go through before making any decisions?

Munger: I don't have time to talk endlessly about mental processes. They're different for different companies — for different areas. But the general *procedure* of considering it my duty in life to get a bunch of checklists related to deep patterns and to *use* those checklists in thinking — that is something I'm recommending to you. I could never make it easy by saying, "Here are three things, if you'll just learn them, that will do."

Besides, you won't hold a checklist in your mind if somebody just tells it to you *ex cathedra*. It's when you learn to derive or induct it yourself ... that the checklist gets slotted into your head so you can use it for the rest of your life. Science education is so good because it forces convincing derivation after convincing derivation plus good induction after good induction.

In investing, there's no substitute for experience.

Shareholder: When do we make the decision a stock is a good buy? For example, I'm looking at Smithfield Foods. It's the largest pork producer in the world. It earns a 20% return on equity and sells at 10 times earnings. Its management doesn't overpay. It got outbid by Tyson for some meat company. And they're buying back shares. At what point do I come to realize that I can be confident in making a purchase decision?

Munger: Well, that's a perfectly good question. But I can't tell you when to buy some pork company. And it's not because I know and I'm holding back from you.

If you're going to be an investor, you're going to make some investments before you've learned the game as well as you may eventually learn it. And if you just keep trying to get a little better all the time, it's been my experience that in due course, you start making some investments where you're practically sure that the odds are overwhelmingly in your favor. You get justified confidence through work, discipline and practice — ending with powerful habits.

There's no shorthand way to get it by going to the master and whispering in his ear for the solution. [Chuckling] It's like learning to play good golf. You've got to have some aptitude — and then *work* at it.

LOOK FOR YOUR AREA OF COMPETENCY — AND RECOGNIZE WHEN SOMETHING'S OUTSIDE IT.

An awful lot of stuff just goes in the too tough basket.

Shareholder: ...Is there some direction and clarity you can give us when you think about trying to increase your circle of competence regarding a particular industry or company? And I know you've answered the question partially [by saying] go out and do it yourself and just keep fighting until you get everything you need.... But are there things that you look to first?

Munger: Well, there are things that we stay *away* from. We're like the man who said he had three baskets on his desk: in, out and too tough. We have such baskets — mental baskets — in our offices. An awful lot of stuff goes in the "too tough" basket. And then we work on the rest.

Now, we can't put a thing in the too tough basket if it's some subsidiary of our own. We've got to deal with it. But if it's some security we don't own now and it looks too tough to decide whether or not to own it, we just put it in the too tough basket and think about something else....

I don't know any other way of coping with reality.

Munger: I don't know any other way of coping with reality when it's as overwhelming as *all* securities and *all* businesses. We want something to come in where we can

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

have a very valuable insight that other people don't have. And there are certain fields where we feel we have a greater likelihood of getting such an insight.

So we ordinarily put all the others in the "too tough" basket. I think all of you are going to have to do the same thing. You have to look for some area of competency and then specialize in that, while not forsaking some generalized wisdom from many disciplines.

WARREN WOULD'VE BEEN A GREAT INVESTOR EVEN IF HE HAD NEVER MET BEN GRAHAM.

Buying assets at a deep discount worked fine for Graham.

Shareholder: Mr. Buffett has said that he's learned quite a bit from you. Could you tell us what you feel the main things that you've taught him have been?

Munger: You've got to remember that Mr. Buffett sometimes overpraises his friends. Warren came to investing at the knee of the master, Ben Graham. And Ben Graham by then had been able to run his Geiger counter over the detritus from the '30s when everyone despised stocks. So he was able to buy some stocks at ridiculous prices in relation to their asset values per share.

And by buying things at ridiculously cheap prices and letting them bounce up in due course, he made 20% or so on small amounts of capital over a long stretch of years. He usually invested in a bunch of mediocre companies which had reached such low prices that he could easily diagnose undervaluation. He wanted easy diagnosis because, great teacher that he was, he wanted to help a multitude.

And that was Buffett's background, too.

Munger: Because Mr. Buffett was trained by the inventor of this system — which had worked well for the inventor — and because that system long worked very well for Mr. Buffett when he was young, he may have been a little slower than I was to come to the standard idea that the real money was to be made in the great businesses which earned very high returns on capital over a long, long period of time.

That was not part of Ben Graham's system — although in fact he made most of his fortune in one great business: GEICO. He was sheepish about it. He said it was peculiar that he taught one practice all his life and made most of his money in another way. If I ever helped Buffett, it was by not so revering Graham.

Evolving beyond Ben Graham was perfectly natural for us.

Shareholder: When you study Mr. Buffett's track record, particularly before he ran into Mr. Graham's ideas, you see he tried a number of things. And over the course of his career, he has evolved as an investor — obviously, influenced by Ben Graham and then later by Phil Fisher. How would you say that *you* as an investor have evolved?

Munger: Even though we're in a different time now, we're applying Ben Graham's *basic* idea of discipline in seeking more value than you pay for. But primarily, we're trying to find undervalued companies in a category which might be called "good to great companies". That specialization was foreign to Ben Graham. He usually looked in different, more obscure places.

I think you can still make money Ben Graham-style — from buying lousy businesses when easy diagnosis shows they've become *ridiculously* cheap. But it was a way to employ only a very modest amount of capital — and pay a lot of taxes. And it wouldn't work at all for us now. And so our evolution was natural. We were discarding chains.

In a field like investing, Warren was bound to rise.

Shareholder: Would you speculate on what you think Mr. Buffett would have done if he had *not* met, or run across, the ideas of Mr. Graham? Might he have come up with them himself, or come up with something else? And what if you had not run across Fisher's ideas?

Munger: Do I think Warren would have morphed into a great investor if he'd never met Ben Graham? The answer is yes. And I think Warren became a much greater investor than Ben Graham was. He doesn't get the *credit* Ben Graham so thoroughly deserves for being the founder of a whole discipline. But Warren is also a great teacher — and this is not a small virtue.

I think Warren would've been a great investor just by the nature of the man and his interests and his aptitudes. I think he'd have been a very great investor if he'd never met any of his cronies — including me.

He's always giving credit to a lot of people in his life, but he'd have done very well in a different environment not including any of these people. I don't think he would have done well if you'd thrown him into the world of ballet and said, "Well, Warren, [chuckling] do what you can." He needed a field that required a high I.Q. and quantification and a certain risk-taking nature. But in that kind of a field, I think Warren was *bound* to rise if he lived long.

The biggest difference between us? Assets under mgm't.

Shareholder: No two investors are the same — even if their philosophies are the same. I would be interested in hearing your thoughts regarding how you feel the investing of Mr. Buffett, Mr. Simpson and you differ.

Munger: What are the differences between Mr. Buffett, Mr. Simpson and me? Not much. By now, we're all very similar. In fact, Lou Simpson is here. And he can probably answer your question better than I can....

Lou Simpson: Charlie, I was actually asked that question in an interview for PBS which will be shown on Memorial Day by Linda O'Bryon from PBS. Bob Miles, who wrote the book about Buffett's CEOs [*The Warren Buffett CEO — Secrets of the Berkshire Hathaway Managers*], sort of hooked me into it. But I figured Warren would want me to do it anyway.

And actually I said the big difference between you and Warren and my situation is a difference in *size* — that we're managing about $2-1/2 billion, a little bit less, at GEICO. You're managing considerably more — many times more. We should have an advantage in being able to look at smaller situations versus what is happening at Berkshire. And if we could find something of $200 or $250 million to invest in, it can make a reasonable impact, whereas at

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

Berkshire, you'd need a much bigger position. To me, that's the big difference.

Munger: It *is* a big difference. And whether it's size of assets managed or whether it's because Mr. Simpson has more talent, his record in recent years has been better than ours.

THERE'S NO WAY TO ELIMINATE MARKET RISK.
BUT MARKET VARIABILITY SHOULD BE YOUR FRIEND.

Risk reduction is rarely maximized through hyperactivity.

Shareholder: At your annual meeting, there were some contentions that one can eliminate risk on investments by constantly trading and looking at certain data by mathematicians or economists. Is it possible, as they claim, to eliminate market risk?

Munger: Well, I don't think hyperactivity will normally improve results — even for the able.

I had a relative by marriage who died in his late 80s. And I don't think he ever had a loss. He only did about eight things in his lifetime. He started with a small poke, and if something wasn't a near cinch, he didn't do it. He lived well and died rich. I think it's possible for a great many people to live a life like that where there isn't much risk of disaster and where they're virtually sure to get ahead a reasonable amount. It takes a lot of judgement, a lot of discipline and an absence of hyperactivity. By this method, I think most intelligent people can take a lot of the risk out of life.

The hyperactive way of dealing in securities by formula has never been attractive to me — and I don't believe it will work reliably for many others....

Who'da thunk that borrowing money at 3% could be fatal?

Shareholder: You and Warren value stocks relative to interest rates. If we were in an environment where there was zero inflation and interest rates were 2%, would you give businesses any more credit or value than you do now? How low would you go on interest rates?

Munger: Regarding interest rates, that's a complicated subject where a lot of factors interact. Are interest rates important in our valuation of stock prices? Yes. But I can't give you an automatic formula.

(continued in next column)

One of the really interesting things that all of you should think about is Japan. And what's interesting is that almost every life insurance company in Japan is in substance insolvent. And the reason they're insolvent is they agreed to pay about 3% interest on money left with them by policyholders.

Now, who would have guessed that life insurance companies could become insolvent because they'd agreed to pay 3% interest? But interest rates in Japan went down near *zero*. And they *stayed* there year after year after year while equity returns were negative.

Could it happen here? You bet.

Munger: Something like that would, of course, have *dramatic* effects on everybody in this room. And the circumstances that caused it — which are *very*, very interesting — have not been at all good for Japan, net.

Warren keeps saying over and over that over 40 or 50-year periods, a lot of strange things are going to happen that nobody is going to predict. Did anybody predict that Japan's life insurance companies would become in substance insolvent because nobody could earn 3% — and that if they tried to solve their problem by investing in equities, they would earn a *negative* return?

Think how *you'd* like a 13-year stretch where the return from owning stocks was negative and interest rates were about 1%. It's *inconceivable* to most of the people in this room. They've never *seen* a period like that.

However, is it inconceivable that it could ever happen? I don't think so. Strange things happen.

Variability of stock prices should be your friend....

Shareholder: ...You said in Omaha that it's important to be able to turn around your decision on something if you think that you've gone wrong. If you bought a share and it just continues to tick down and down — and you can't see that there's any reason for it to have done so and there's no change in the news at all — how do you know when you've just made a mistake and when you should just sell?

Munger: Over many decades, our usual practice when we buy something and it keeps going down is to buy more and more and more and more. And we don't like the idea of buying something at X if we wouldn't be *much* more eager to buy it at *half* X. But once in a while, something will happen that changes the prospects of X, or you realize you've made a mistake. So you just turn around and sell out and go to something else. But by and large, you want to develop a correct confidence in your judgement that will cause you to buy *more* as things go down.

You want the variability of stock prices to be your friend and not your enemy. If the direction of market movements is telling you what you should be buying or selling, you're using investment methods different from ours.

THE WEALTH EFFECT IS AN *IMPORTANT* DRIVER.
HOWEVER, IT'S NOT THE *ONLY* ONE.

I think the wealth effect is more important than most do.

Chris Davis [Davis Advisors]: When I look at the

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

notional value of the market cap that was wiped out in the last several years — trillions of dollars — I've been surprised that the reversal of the wealth effect seems to be smaller than I would have expected in American Express' volumes or NetJets' sales or other consumer spending. I'd be interested in your view of whether you think that there is still a pent up impact from this loss of stock market wealth or whether the accumulation in loss happened in such a short period of time that the effect will be muted.

Munger: The wealth effect that Chris Davis is talking about is the extent to which consumption is goosed upward or downward by changing prices for common stocks. Now, obviously, there *is* a wealth effect — meaning, when stocks are going up and everybody feels richer, there's some increase in spending, and *vice versa*. I made a talk before a bunch of foundation officers in which I said I thought the wealth effect, redescribed by me in an unconventional way, was bigger than most economists think it is and had been very important in some of the excess we saw before we had this collapse of the last two years.

[Editor's note: Amen.]

The wealth effect is one factor, but it's not the *only* one.

Munger: I would not change my opinion on that. And Chris is now basically asking, "After we've had all this reduction in stock market wealth, why are people still spending at a good rate?"

My answer to that is this: The wealth effect from the stock market is *one* driver of economic consumption — and an *important* one with important effects. But it's not super monstrous or the *only* driver. The United States government in each of the last two years, back-to-back, has increased government expenditures by 10%! This last happened decades ago. So you've had *huge* effects of another kind on consumption.

And of course, the reduction in interest rates helped keep housing demand going up. And that's a big part of the overall wealth effect. People feel richer when the houses in their neighborhoods keep selling at higher and higher prices. So I think there have been some countervailing effects to cushion the blow from declining stock prices.

You've got to think of *all* the factors in coping with life.

Munger: But if you were to look at the sales in Omaha at Borsheim's Jewelry when Level 3 stock cratered 90%+, you would find a quite significant effect. And there are a lot of million-dollar-and-more homes in Omaha for sale. There is a negative wealth effect when a lot of paper wealth disappears. But it's only one of many major economic forces that are operating at the present time.

So many people try and predict macroeconomics by looking at one factor: the price of gold, the interest rate, the trend of employment. I've always regarded that as total nonsense. If you've got a multifactor, complex system, you've got to do your best to cope with all the factors instead of just picking one factor to consider....

SO MUCH CONSUMER CREDIT IS NOT *MY* SYSTEM.
BUT WHEN WILL THE TROUBLE COME? I DON'T KNOW.

I'm the wrong person to ask about consumer credit....

Shareholder: ...Have consumer credit standards been relaxed to such a degree that they're at dangerous levels? Is the consumer over-leveraged? What sort of model or framework might I use to understand this seemingly ubiquitous issue?

Munger: You're probably talking to the wrong person. My natural liking is for a nation getting ahead the way Germany did in the years following World War II when there was practically no consumer credit. The Germans just saved until they had enough money to buy something. And yet their GDP per capita went up wonderfully. That's a Munger-favored type of system, as you might guess.

Consumer credit being pushed so hard makes me nervous.

Munger: America's gone off on a different kick where we've pushed consumer credit, year after year, harder than it was pushed in the year before. And occasionally, we run into terrible company reverses as with Providian.

Do I think you could eventually push consumer credit so hard that you have some kind of general economic convulsion? The answer is yes. Excess often departs in a painful manner.

I don't like consumer credit getting pushed as hard as we push it in America. It's not my sort of system. And once you get *used* to pushing your economic performance as a nation by increasing consumer credit each year by another 5%, what do you do when you finally reach the limit? It makes me nervous.

Having serfs today just doesn't fit my temperament.

Munger: People have made *fortunes* out of easy consumer credit. I think some people always did. If you could figure out a way to own slaves, you'd make money. And if you could figure out a way to get a lot of nice people to work very hard and pay you 36% interest — where they're just fiscalholic enough to pay the 36%, but not fiscalholic enough to go broke so you don't get your money back — making money out of those people is like having serfs.

I don't like it. Yet it's the way of our present world. However, I would not like to spend my time dreaming up advertisements to get people to use their high-interest-bearing credit cards more. It doesn't fit my temperament. But it's not illegal. Maybe the world's better for it. However, temperamentally at least, I don't like it any better than Ben Franklin would have.

In any case, I've got no model for telling you when and if big trouble will come.

WHY DID WE SELL OUR FREDDIE MAC?
WE JUST GOT A LITTLE NERVOUS.

With Freddie Mac, we obviously got a little nervous.

Shareholder: ...My question is about your letter to the shareholders, and specifically about the "other operating earnings".... If you go back to the spring and

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

summer of 2000, Federal Reserve Chairman Greenspan and I think Senator Breaux from Louisiana were making a lot of noise about the implicit government guarantee that stood behind the perceived credit ratings of Fannie Mae and Freddie Mac. That was about when you sold about $1-1/2 billion worth of Freddie Mac shares....

Considering that good investments don't come along all the time and considering that we have more cash than we can find a place for it — and considering that by selling, we lost a large loan from the government in the form of unpaid taxes — and considering your statement that you just reiterated that basically you don't sell a stock unless something fundamental has changed with that company, could you just give me a little more background about what went into the decision to make that sale if it's not too embarrassing? And the reason I'm asking is that it led to a large amount of speculation, but never (so far as I know) any definitive answer.

Munger: We held that stock for a great many years — and we did fabulously well with it. All that said, both Warren and I tend to get nervous about financial institutions with vast amounts of leverage unless we're nearly *100%* confident that something unfortunate is never going to creep into the culture. And obviously, we got a little nervous. And that's just the way we are. We don't claim to have all the insights in the world....

What the hell, I'm rich already. Why should I be nervous?

Munger: A friend of mine who has run a big business very successfully for a great many years with no trouble fired one of his big producers years ago. And the guy said, "Why are you firing me when I'm your big producer?" And the boss said, "You make me nervous." [Attendees laugh.]

In other words, the boss worried that the guy would get him into trouble. And he didn't know for sure that he was right. But he thought, "What the hell, I'm a rich old man — why should I be nervous?" [Attendees laugh and applaud and Munger chuckles.]

I'm afraid *that*'s what happened.

We're not criticizing Freddie Mac. It just made us nervous.

Steve Wallman [Wallman Investment Counsel]: When Freddie Mac's policies changed and you sold your stock, I couldn't help but wonder if Berkshire might ever reach the point where it would have to be more aggressive in protecting its interests given the steadily dwindling pool of opportunities for Berkshire's capital. Do you think that will happen? And do you think you can reasonably expect to have any influence?

Munger: Well, we don't know that we're right about something with respect to Freddie Mac's business and that Freddie Mac management is wrong. So I'm not suggesting that was the fact. It's just that it made us nervous. And are we likely to be running around engaging in proxy fights? The answer is no.

WHY DID WE DECIDE TO TAKE A POSITION IN USG?
WELL, IT SEEMED LIKE A GOOD IDEA AT THE TIME.

Might we buy something like Level 3? Sure, it's conceivable.

Shareholder: I've been reading with interest Rick Lawson's analysis of Level 3 in *Outstanding Investor Digest*. And I wonder if there's *any* price at which you or Mr. Buffett would consider that kind of purchase?

Munger: We have the same trouble everybody else has with Level 3.... It's *very* hard to guess the future when the technology is changing like crazy and you've had this enormous flood of capital into the telephone infrastructure business.

But could we conceivably move into something like that? Sure, it's conceivable. After all, we're in the business of distributing electricity in England. We're in the business of generating and distributing electricity in Iowa. Of *course*, it's conceivable that we might get into the telephone infrastructure business.

We do have a history, when things get really horrible, of occasionally wading in when nobody else will. So it's conceivable.

[Editor's note: Of course, subsequent to making the above remarks, Berkshire Hathaway participated in a convertible bond offering — investing $100 million — alongside two other *OID* contributors, Longleaf Partners and Legg Mason.]

Buffett doesn't need Moody's service, but most people do.

Shareholder: At your press conference, I paid particular attention to a remark that was made in passing when a reporter asked about our purchase of Moody's. I believe we have a 15%± [stake] in it. And I understood Mr. Buffett to say that he didn't rely on Moody's credit ratings in evaluating bonds. He felt, I understood him to say, that if he was buying bonds, it was his business to know the credit rating — and he depended on his own past experience.

But I don't know how to interpret that statement. Does that mean that you don't rely — that our company doesn't rely — on credit analysts that are employed by the insurance companies to invest in bonds?... Is he saying that Moody's doesn't provide a valuable service? Or is he saying that it's something that I should be able to do as a bond investor?... I'd like some background on that.

Munger: Well let me give it to you. It's very simple. Most of the bonds that Berkshire buys, Warren Buffett is picking himself. Warren does not need Moody's to buy bonds. He does not rely on the Moody's rating when he

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

buys the bond. But he *also* said he thought that Moody's ratings were *very* useful to the world.

And I would agree. And that's because not everybody is a Warren Buffett.

We regard the ratings as very useful to the civilization.

Munger: I sat down once with Louie Vincenti. And we wrote the regulations for the state of California that governed the investment in preferred stocks by savings & loans. We wanted to write regulations that were foolproof, under which no savings & loan could get in trouble if it stayed within the regulations. That we did. And we specifically referred to Moody's ratings in defining what was permissible. This example shows that we regard the ratings services as very useful places. We're glad they exist. And we're glad we own part of Moody's.

But that doesn't mean that Warren Buffett looks at the Moody's rating in deciding which bond to buy.

USG seemed like a good idea at the time.

Shareholder: You've spoken about the longevity of resolving tort reform — and, specifically, asbestos liabilities. I just wanted you to comment maybe on why Berkshire decided [to take a position] — even though it was a relatively small one — in USG?

Munger: Well, obviously, so far, that one hasn't worked very well. And it wasn't only the rising concern about asbestos that caused trouble. The market for wallboard also went to hell. Prices went to unprecedented lows. I think we mis-guessed on that one. So what can I say?

I once knew a man who had a nice wife and children. And in five minutes between trains, he managed to conceive an illegitimate child by some woman he met in the club car. When asked why he did it, he said, "It seemed like a good idea at the time."

WE'RE MILDLY OPTIMISTIC IN INSURANCE, BUT YOU HAVE TO JUDGE IF WE'LL BE RIGHT.

We *try* to be conservative. And I think we'll usually succeed.

Shareholder: I'd like to thank you for your comments last year about accounting and the story you so graciously handed out. You helped my family to avoid the siren songs when last fall my broker recommended that I take a margin on my Berkshire and buy Enron. [Munger and attendees crack up.]

Here is my question this year: You've said that because loss costs must be estimated, insurers have enormous latitude in figuring their underwriting results — and that makes it very difficult for investors to calculate a company's true cost of float.

At Berkshire, we strive to be both consistent and conservative in our accounting. First, how would you quantify the extent that Berkshire's results are affected by this conservative accounting? And how does our accounting for losses compare to other large insurers in our peer group?

Munger: What is the state of our insurance accounting? This applies to both Wesco and Berkshire. *Generally* speaking, we think we're more conservative than most insurers. That said, there have been periods in our history where we've mis-guessed reserves on the low side and other times where we've mis-guessed them on the high side. In the last four or five years, we've taken a lot of money back into earnings because we overestimated losses in certain periods in the past.

General Re mis-guessed by reserving on the low side in the last year or two. Almost everybody in America did. Losses really went up in traditional lines. And that's why General Re took that big extra reserve last year.

Despite such episodes, I predict that averaged out over time, ... we're not only going to *try* to be more conservative than other people, we will also *succeed* at it....

But you people have to judge whether I'm going to be right.

Munger: Insurance will continue to be a very tough business. I said at the Berkshire meeting that the ordinary result from selling reinsurance at professional companies will normally be pretty punk. So when I say I think we'll do pretty well, I am predicting that we're going to be in the top 10% or something like that. And you people have to judge whether or not you think that's a pretty decent guess or unjustified hubris.

One advantage — we are willing to do unpleasant things....

Munger: At least we have a somewhat different attitude. We're willing to do things that other people won't do. You remember when GEICO was in trouble years ago when we first bought into it? Jack Byrne asked New Jersey for an appropriate rate increase. And the regulators, playing to the political masses there, gave totally inadequate rates. The next day, he announced GEICO was leaving the state. GEICO never renewed another policy in New Jersey. Almost nobody else did that. Later, some imitated us. And New Jersey hasn't improved that much.

As I said in Omaha, we're one of the few places in America that's running off a derivative book. We inherited one — a trading book — at General Re Securities when we bought General Re. We never liked the business, but we thought maybe we could sell the whole thing or something or other. Nothing worked out — and we are now letting that book run off.

So we are willing to do some unpleasant things. And that tends to be a good cast of mind if you're trying to have your insurance underwriting work reasonably well.

We're mildly optimistic about our insurance operations.

Shareholder: Has there been a change in how Gen Re reserved prior to its acquisition by Berkshire and subsequently? And how has that affected us?

Munger: Well, they've always *tried* to do it right at General Re. And practically everybody in America mis-guessed reserves in this exact period. Some general forces crept up on almost everybody.

You would think that, after becoming part of Berkshire, their reserving practice, which was *always* pretty good, would get better. But that's not because we're causing it — [General Re CEO] Joe Brandon is doing it. He very much wants to operate a culture which is consistent

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

with General Re's tradition — and also consistent with Berkshire Hathaway tradition — in insurance. Generally speaking, as we sit here, we're mildly optimistic about our insurance operations.

WE HAVE SPECIAL ABILITIES IN REINSURANCE. BUT WE'LL HAVE TO BE SMART, TOO.

I think we'll make a lot of money in reinsurance.

Shareholder: About three years ago at Berkshire's annual meeting, I asked you and Warren a question. And it basically went like this: Since Berkshire's always sought businesses with unique, dominant, non-commodity positions that earn high returns on capital, why were we then pursuing the reinsurance business so aggressively in a world of great capital mobility and liquidity and not much of a moat against competition? I think your answer was that reinsurance was not as much of a commodity as it appears, that balance sheet strength differentiates Berkshire and, maybe, the Gen Re distribution franchise does, too.

But at this year's meeting, you mentioned that you've been surprised that the flight to quality in reinsurance has not been happening at the pace that you expected — despite 9/11. So my question is, why not? And is your answer three years ago still your current thinking or would you qualify it in some way? And finally, have other factors come to the fore?

Munger: First, I *do* think we get some advantage in reinsurance because people trust our willingness and ability to pay more than they trust that of others. So I do think that reinsurance isn't a total commodity. Second, I think we have some special talents in this field that not everybody else has.

But it's dangerous to rely on special talents. It'd be much safer to own a bunch of lawfully dominant, foolproof businesses. However, where are there a lot of such businesses available at reasonable prices?

I think we have some special abilities in reinsurance. And I think that we've made reasonable money, net, exercising those special abilities and will continue to do so.

But it's a *very* tough business. We'll have to be smart.

Munger: I'm *glad* we have the reinsurance business. But I think it's a *very* tough business for most people — and I'm warning you that this is *not* a no-brainer. This is a field wherein we're going to continue to serve you well only if we're able to handle "brainers".

So there may be some danger for you. In the past, we've been especially good at finding no-brainers — not dealing with "brainers".

BECAUSE WE'VE DELEGATED POWER INTELLIGENTLY, BERKSHIRE'S CULTURE COULD GO ON A LONG TIME

We're not changing Gen Re's culture. That's up to its CEO.

Shareholder: At the last meeting, [Buffett said] that there had been some drift in the culture of General Re, but that underwriting discipline had been restored.

This is an organization with over 3,000 employees. How can it be that easy to restore underwriting discipline? And what kind of process does it take? Is this new CEO enough to change the underwriting discipline — or is it a long-term process? How do you go about doing that?

Munger: Obviously, at Warren's level, he's operating through the CEO only. And the CEO of Gen Re is the one who has to tinker with culture. General Re's culture always was — and is — a good culture. It's just that the world is so tough that having it a little better is mandatory.

And what can I say? We think it's getting better. And we have a world of respect for Joe Brandon. But *he*'s the one who's got to do it.

Our culture is about much more than Warren....

Munger: As Warren says, Berkshire's so decentralized, we've practically *abdicated*. And certainly where we've got able people in place — which is practically everywhere — he is describing a system of near abdication.

Having a system that works like that is probably a particularly good idea if the head guy is Warren's age. This culture could go on a long, long time quite well because it has decentralized power into the hands of so many people who deserve to have the power.

[Editor's note: It's well known, of course, that Buffett is scary smart about business and investing. But he also has the extremely rare trifecta of also being able to recognize and retain outstanding managers.

And while your editor tries (and usually fails) to emulate Buffett on the investing front, we've learned the hard way that like most people, we couldn't recognize outstanding managers if they were to sit on our laps.]

Buffett didn't consult me on Gen Re. Get used to that.

Shareholder: A couple of years ago, the business press reported that when General Re was purchased, Buffett did it without consulting you. And I wanted to hear your comments on that — whether or not that was true.

Munger: The General Re deal was *very* far along before I ever heard of it. Warren's right on that. And there'll be more of that as the years unfold.

Lloyd's culture got quite bad....

Shareholder: Not that many years ago, Lloyd's of London scandals were in the news. And various plans were being advanced to try to save Lloyd's and so on. For those of us who aren't in the insurance industry, we've never really heard the end of the story. How does the present Lloyd's compare to Lloyd's before the scandals? And did any of this accrue to the benefit of Berkshire?

Munger: The present Lloyd's is greatly improved.... But some of the ethics at Lloyd's became terrible. It was the result of perverse incentives, balkanized responsibility, easy money and three hour lunches with plenty of alcoholic beverages. Some of the culture got quite bad.

So Lloyd's degenerated into *huge* underwriting losses, scandals and litigation, etc., etc.

It's way, way better today, but the jury is still out.

Munger: What about today? It is way, way better. Has it totally reformed so it's a perfect insurance

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

operation? The answer is no. What is its future? I think the answer is that the jury's still out.

Berkshire, as you know, has *some* hopeful involvement at Lloyd's. But it's not a materially large part of our operation.

THERE ARE NO GUARANTEES IN LIFE, BUT WE'RE IN BETTER SHAPE THAN MOST.

A lot of things happen to us that we can't predict.

Shareholder: As I understand it, there are some types of float ... that are very benign and highly predictable. On the other hand, in terms of a lot of the P&C float, I think you and Mr. Buffett have said many times that surprises in the insurance business are almost always unpleasant.

When you apply a knowledge of history and a very wide and deep latticework of mental models and actuarial studies and such to try to price policies, there are still (in my opinion) many things in certain policies that the past cannot tell you and will always be unpredictable.

I'm always concerned there is this 1,000-year flood or 10,000-year flood that may show up in the next 10 years. And September 11th was a data point, but I don't think it encapsulates all the different [possible outcomes]. So even when you have NCB [Nuclear, Chemical, Biological] exclusions, etc., I think that there seem to be many things that can happen where the past is not an indicator. And even if you as intelligent men think about things, you cannot possibly cover all the scenarios.

So when you have $38-$40 billion of float and you have certain assumptions, I'm concerned about what happens if those assumptions are way off.

Munger: Well, of course it's in the nature of life that you can't predict a lot of major things that are going to happen to you between birth and death. And businesses have their share of that problem. Would anybody have predicted two years ago that the government would go suddenly from huge surplus to deficit and that we'd raise the Federal budget by 10% back-to-back in two years? Who would have predicted the war on terrorism — including the loss of those two big towers? And of course, many people didn't fear that the dot-com craziness would end in a debacle.

But a lot of things are going to happen that won't be predicted. We've got no exemption from that. A lot of things happen to us that we can't predict.

On the other hand, I think we're more careful.

Munger: But we try and arrange [our affairs] so that no matter what happens, we'll never have to "go back to go". I have a friend that likes that phrase from Monopoly. He says, "I've been to go. And I don't want to go back to go." We try and run our company so that the chance of going back to go is very low no matter *what* happens.

I think we're more aware than most people that strange things can happen.... I think that protects us some. But I don't think anybody's got some absolute guarantee that nothing could ever go wrong in a big way.

I think it's less likely to happen to *us* — spread around the way we are. I think we're more careful in the clauses we put in a lot of our policies. We're more aware of aggregation risks in insurance.

Some businesses are more predictable than others....

Munger: Moreover, I think a lot of the things we do are fairly predictable. Let's take our Texas brick company. Now, they've been making bricks since Babylon. Brick is no longer a structural material in America. It's a facing material — but a *good* facing material. It lasts and lasts and lasts. A lot of people like it. The consumption seems to be quite regular as a percentage of construction. And we've got all these brick yards that tend to do well in their areas even though volume fluctuates with construction.

Is it predictable that our brick business will do pretty well? I think it is. We tend to buy things — a lot of 'em — where we think it's quite predictable what the outcome will be. We don't know *exactly* what it'll be. But I think it's quite predictable that the outcome will be decent. Most other insurance companies don't have a lot of brick companies and the like.

No guarantees, but we're in better shape than most.

Munger: A lot of people own Berkshire in a very lopsided kind of a way — where it's half or more of everything they own in life. We're *acutely* aware of that. Of course, the same is true for Wesco — although I think it's less common there. We never forget these facts.

So the answer is there are no guarantees. But I think we're in better shape than most places and care a lot about not causing disaster. And I think that good business culture runs pretty deep in Berkshire.

TERRORISM SAFEGUARDS ARE WAY BETTER NOW, BUT THEY STILL HAVE A LONG, LONG WAY TO GO.

In the long run, a *lot* is going to happen that we don't like.

Shareholder: Mr. Buffett's said he believes that it's a virtual *certainty* that sometime ... we'll have a devastating event in this country — either a nuclear, chemical or biological attack by the fanatical forces that envy and hate us and who, I think want to destroy the United States....

Could you comment any about the current struggle — which I really think is a worldwide struggle between civilizations — between our civilization and our country, and those who I'm absolutely convinced hate us? It seems to me that they'll stop at nothing and really don't care if they lose their own lives.

How is that going to play out? And what do you see as being the impact on our civilization — and secondarily, on business — going forward?

Munger: I think Warren is correct. In the long run, a *lot* is going to happen that we don't like. Every person in this room is going to be dead in due course. And in due course, the U.S. will no longer lead the world — it won't be the most important nation. Every *other* nation that ever was the first in the world in due time passed the baton. So in a long-term sense, there are troubles that come.

And Warren was merely saying that in due course, we'll have significant convulsions of one kind or another in this country and we haven't seen our last big terrorist act

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

— and that we ought to have a mindset where we try to prevent it and limit the damage if it comes....

Bureaucracies functioned very poorly against terrorist risk.

Munger: I would argue that our handling of the terrorist risk has been insanely sloppy in recent years. Someone comes in with an Arabic name and takes flying lessons for a major airliner and says, "I don't care about learning to take off or learning to land. I just want to know how to *steer* it for a while." And some bureaucrat writes a little note to some other bureaucrat and nothing happens...

An event like this defines dysfunction. And, of course, dysfunction won't go away, because that's what bureaucracies *do*: They subdivide into little territories. Collectively, they often function very poorly. And that's exactly what happened with our risk reduction in this field.

I'd run the world in a much more risk-averse way....

Munger: We're way better now, but we're *still* terrible. I'd be in favor of foolproof identity cards. And I wouldn't be using too much due process in the finding and deporting of illegal immigrants. In fact, I would run the world in a much more risk-averse way than we're running it.

But we live in a democracy which likes to slop through in its own way. And Canada's even worse. Canada practically *welcomes* terrorists. Canada in effect says, "Terrorists come here and then cross our easy border with the United States". We should do better on that kind of stuff.

And it's sad that it takes something as dramatic as September 11th to have us wake up to the most elementary considerations. But it's the nature of things....

By the way, I don't think the sole risk is some terrorist from the Near East. I think you could get a local crazy who was a lot more effective than the Unabomber. There are *lots* of significant risks in this country. And I think we should be a lot more worried about them and handle 'em a lot more intelligently than we do.

WHEN WE CAN'T FIND STOCKS, WE BUY BONDS. BUT ALL GOOD THINGS EVENTUALLY END.

When we can't find stocks we like, we buy bonds....

Shareholder: At the end of the year, Berkshire was holding about $41 billion worth of bonds. I presume it was government bonds. And from what I can understand from the annual report, they're for trading purposes. Could you explain what Berkshire's doing in the bond business?

Munger: Well, Berkshire holds bonds in two ways. In one way, we hold bonds in the insurance company portfolios because we can't find stocks attractive enough — and therefore our default option is bonds. By and large, our default option has been mortgage-backed bonds in the last year or so. So most of the bonds are in that category.

We also buy U.S. government bonds. We even buy a few junk bonds from time to time. That's one way of investing money when we can't find stocks that we like.

Bond category #2: Miscellaneous Warren Buffett Activity.

Munger: The other way of investing in bonds is in our finance subsidiary at Berkshire as part of what I call "Miscellaneous Warren Buffett Financial Activity". I don't think there's a name for that in accounting, but that's what it is.

As long as Warren's doing it, I love to see it done. And we've made a few hundred million pre-tax dollars doing that over the years without much risk or fuss. So we have that extra category.

Finova took a hit from 9/11. But it should work out fine.

Shareholder: At your Berkshire annual meeting, there were some comments about Finova/Berkadia [the joint venture with Leucadia] from Warren. Is this basically a runoff situation or are there assets there that will be kept permanently?

Munger: Finova is a runoff situation. However, it's not going to run off as well as it would have run off if September 11th had not happened. A lot of those aviation assets and so on were reduced in value by what happened.

But I think it's going to work out fine. I think Berkshire will make some hundreds of millions of dollars start to finish, but not nearly as much as we *would* have made if September 11th hadn't happened. But it's a runoff. It's a blip in the history of Berkshire....

All great aggregations of capital forge their own anchors.

Shareholder: This is a very general question. How big can Berkshire eventually grow? And what are the factors that will limit the growth?

Munger: Well, the main limits to growth are that it's a finite world and it's a very competitive world. Therefore, all great aggregations of capital eventually find it hell on earth to get a lot bigger, even when they have had a long history of earning abnormal returns.

I can remember when IBM was the darling high-cap stock of the world. And over the last 20 years, IBM has had a hard time moving forward at its primordial rate. In a finite earth, a large aggregation of capital will eventually have a much lower rate of return.

It all depends on the meaning of the word "eventually"....

Munger: What makes life interesting is that "eventually" is a very ambiguous word — because it could mean 15 years from now or it could mean next week. And there's a lot of difference.

Personally, I think Berkshire will eventually be a lot bigger than it is — and a lot stronger. Whether it will produce perfectly wonderful returns to shareholders who buy at the current price is another question. The one thing we've always guaranteed is that the future will be way worse than the past.

Fear of a spike in Berkshire's price keeps it out of the S&P.

George Brumley III [Oak Value Fund]: My question is about Berkshire's inclusion in the S&P 500. A couple of years ago when Berkshire did the acquisition of Gen Re, Mr. Buffett was asked that question about when and if Berkshire would be included in the S&P 500. His response

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

at the time was that he thought that it would, but did not know when.

Could you give us an update on that thought process and any pluses or minuses you might see in its inclusion?

Munger: Yeah. It's people like you that make the people who run the S&P reluctant to put Berkshire in. If Berkshire were owned by a bunch of big, heavy-trading institutions, it'd *be* in the S&P by now. But when you've got a devoted following of shareholders — many of whom have been there for years and have no plan to leave quickly — Standard & Poor's is afraid to throw Berkshire in for fear of a big price spike. And that would be embarrassing to everybody and no good for anybody.

Sooner or later they'll figure out a way to do that. We'll get in. But I don't think it'll happen tomorrow.

We like our stocks high, but not undeservedly so.

Shareholder: Mr. Munger, you used to publish the intrinsic value of Wesco in your annual report. But in the last two years you haven't done it. Could you tell us why?

Munger: Well, we got tired of it. And we were no longer so distressed by Wesco selling miles above its intrinsic value. We went to that practice when some people got carried away with the notion that Wesco was a way better stock than Berkshire and so on and so on, because it was smaller — which was a very stupid idea.

We don't like our stocks to get too high. We like 'em to get *deservedly* high. But *un*deserved spikes in our stock price, as far as we're concerned, are undesirable. So we tend to throw reality-inducing bits of cold water when we're in those periods.

You remember the prospectus that Berkshire put out saying, "We wouldn't advise anybody to buy this stock. And if our children and family and friends asked whether we would buy it, we'd tell them, 'No.' "?

I think in spite of all that cold water, people bought hundreds of thousands of shares. But we were doing our best to dampen it down....

FRANKLIN CONTRIBUTED A GREAT MANY THINGS. BUT HIS GREATEST CONTRIBUTION? HIS EXAMPLE.

Franklin gave new meaning to the word "versatile"....

Shareholder: Like you, I'm a real big student and fan of Benjamin Franklin. I was curious — what would you consider his biggest contribution to the world?

Munger: Well, that's very hard, because what was interesting about Franklin is that he had such an enormous range. In fact, I'd argue that we've never seen his equal in terms of range. He was the best writer in his country. He was the best scientist in his country. He was the best inventor in his country. He was certainly one of the best statesmen in the country. He was one of the best legislators in the country. He was one of the best philanthropists in the country. It's a lot. And he played four different musical instruments. [Ed. note: And invented one — which he named the Armonica (aka the glass harmonica).]

It's *awesome* what Franklin did — just an *amazing* story.

Munger: And he invented all of these things like bifocal glasses — which I'm now wearing. And of course, he was present, by the accidents of life, at the creation of a great and prosperous country.

[Editor's note: It's been suggested that the U.S. wouldn't have declared independence from Britain without Franklin — and that even had it done so that it would almost certainly not have won its independence.]

Munger: And other things he helped create as a founder turned out like the University of Pennsylvania. It's *awesome* what Franklin did in his life starting as a poor, self-educated apprentice. It's an *amazing* story.

And the whole was greater than the sum of the parts.

Munger: But I would say that the *example* of his whole life was the contribution. And it's hard to say that one factor of the example was a lot more important than another. For instance, some people say that we couldn't have won the revolutionary war without the enormous treasure that he helped wrest from France. And that may be correct.

But does that mean it was the main contribution of Franklin? If that's all he did, would anybody remember him now? I don't think so. I think the example of his whole life has been very useful — and *will* be useful for a long, long time to come. I, for one, am better because I learned from Franklin's life.

SCIENTIFIC LITERACY IS TERRIBLY IMPORTANT — ESPECIALLY *OUTSIDE* OF SCIENCE.

Ice Age is one of the best books I've ever read.

Peter Bevelin: Good afternoon Mr. Munger, my name is Peter Bevelin. I'm from Sweden.

Munger: Well, I'm delighted to see you.... You've cost me several thousand dollars.... Mr. Bevelin is the shareholder who sent me the book, *Ice Age*. And I have since spent thousands of dollars buying copies of this book and given them to my friends. It's one of the best books I've ever read. I recommended it to Berkshire shareholders. It will be published in the U.S. this fall. So I've got mixed feelings when you get up — because I'm afraid you might send me another book. [He chuckles.]

What opened my eyes to science was Newtonian mechanics.

Bevelin: What caused your interest in scientists' methods? Were there some real eye-opening notions that heavily influenced your thinking in business and in life?

Munger: You've got to realize that I have a very limited science education compared to yours. What happened to me was that I early realized that math's a vital part of the language necessary in understanding life. I picked that up automatically due to my nature and being exposed to schoolwork and games.

But what really opened science up to me is when I took freshman physics. Just as Einstein was charmed when he found Euclid's geometry, when I saw Newtonian mechanics, how perfectly it predicted and how wonderfully

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

accurate it was, it just *charmed* me. So the drift of my mind was heavily influenced by that experience.

Not learning fundamental science if you can is a mistake.

Munger: I think everybody who's capable of handling physics without some crisis of self esteem ought to be forced to take physics. And that's the way our best private schools now work. I gave a talk last year at a great Catholic girls' school in New York. And that school, in effect, forces every girl who's not going to flunk physics to take physics — which is a very creditable way to run a school — because the habits of mind you get from understanding the power of science are *very*, very useful.

Part of what I find interesting about science is that even without being a scientist, you can pick up the big ideas — even from courses you never took. The fundamental thermodynamics of life is pretty simple. I don't mean you can describe it in a paragraph. But it's a pretty simple set of relations. And it's hard to understand how the whole biological system is working if you don't understand the essential ideas in thermodynamics. And a lot of people haven't bothered to learn the big ideas in thermodynamics. I think that's a mistake.

The mindset of science is very useful outside of science.

Munger: The gas company in my neighborhood years ago bought a real estate developer. And the developer had backed some inventor who said he was going to get cheap energy by extracting hydrogen from seawater. Well, they poured a lot of money into this project. Now if that had come to me, even when young, I would have told the client to get another lawyer.... I'd rather make less money than help maintain a sort of mad hatter's tea party.

That couldn't possibly work. You would be getting more energy out in a way that's forbidden by the laws of thermodynamics. Yet educated people wrote all those contracts and authorized the expenditure of all that money.... And similar things happen all the time in America. So I think scientific literacy is terribly important.

I think the mindset of science is very useful outside of science. And by the way, this is orthodoxy now — except among people who should be kept far away from practical decisions....

If you don't fool yourself, you have an enormous advantage.

Shareholder: I'd like to get back to physics and Richard Feynman — a great physicist from down the street. Did you know him? Any Feynman stories?

And a little more difficult, you quote him about "avoiding fooling yourself". That's very important to do. That was from a Feynman piece now entitled "Cargo Culture Science". It was a commencement address originally, I believe. But he argued in that piece that the key to science — what made science, science — was making sure you avoided fooling yourself.

Munger: That's why those of us like Bevelin *love* it so much — because it tries harder than any other discipline not to fool itself. That is a wonderful ethos. That's what makes science education so important.

I would argue that Feynman was a very peculiar man. His personal life was chaos in many ways. And yet he had this superb rationality in science and this love of truth in science and so forth. He was one of a kind.

The ethos of not fooling yourself is one of the best ethoses that you can possibly have. And the reason why it works so well outside science is that it's so *rare* outside science. You have a real advantage if you get good at it.

THE SCOTS HAVE HAD *EXTRAORDINARY* INFLUENCE. HERE'S A BOOK THAT EXPLAINS HOW THEY DID IT.

If you don't like *Ice Age*, you have some limitations.

Shareholder: [Are there any other] books that you've read recently that might be of general interest to us?

Munger: Yeah, I already mentioned this *Ice Age* book that Peter sent to me by this astronomer from the University of Sussex and his wife. That is a *fabulous* work of science exposition. And it will give you a feeling of the power of science. And if you buy it and find you don't like it, you should give it to somebody else in your family — because if you don't like it, you have some limitations. And other people in your family should be helped to avoid those limitations.

Book #2: How the Scots Invented the Modern World.

Munger: The other book that I hugely enjoyed — and a shareholder sent me that, too — was *How the Scots Invented the Modern World*.

[Editor's note: The full title of the book is, *How the Scots Invented the Modern World: The True Story of How Western Europe's Poorest Nation Created Our World and Everything in It* — which was written by Arthur Herman and published by Crown Publishers.]

Munger: It's another book written by a professor. Living in America, I'd always considered it interesting that the Scots have had such an enormous influence. To find about a million poor people in some miserable climate with lousy resources having the influence in the world the Scottish people did I could tell was a powerful and important phenomenon. And I tried to work out theories of my own as to why it happened. But I'd never seen a systemized attempt to analyze that problem. And this professor *did* that....

There must be a lot of Scottish blood in this room. And to the extent that there are a lot of Irish, I regard that as sort of the same genetic stock, but with a different religion. So the Irish to some extent are reading about themselves when they read a book about how the Scots influenced the modern world.

It's a *wonderful* book. It's a very interesting story how such a tiny handful of very poor people could have such a large and constructive influence.

If a Frenchman compliments it, it *must* be great.

Munger: There's one place in the book where the author talks about Adam Smith. He quotes two of the great thinkers who were contemporaries of Adam Smith. One of them was Kant, the great German philosopher, who said, "We have no one in Germany to equal Adam Smith."

Voltaire was more extreme. He said, "in France we have no one who can even be *compared* to Adam Smith."

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

The Scots came up with some very remarkable mental types, despite poverty and hardship.

THERE'S PLENTY WRONG WITH LEGAL PROFESSION — LAW FIRMS HAVE GOTTEN AWAY WITH MURDER.

Too many lawyers are helping rascals and fools.

Shareholder: In light of Enron and other companies that are currently following or will follow its fate, there's been a lot of discussion about the securities industry and the accounting industry, but very little that I've seen — at least in the press — about the legal profession and the role of complicity or duplicity of the legal profession. Would you please comment on the legal profession and their role in what changes should be made going forward?

Munger: Well, I think there's plenty wrong with the legal profession. There are plenty of law firms that take clients they shouldn't have. There's a lot of law business that successful law firms would be quite intelligent to do without — whether they seek honor or self-interest.... Rejecting certain classes of clients and certain individuals is part of practical wisdom in life. Leading law firms have been too hesitant to resign accounts and to decline accounts.

And I think too many lawyers get involved in helping rascals and fools. To the extent the culture now pulls back from that, it will be a good thing.

And the accounting profession is guilty of the same sin.

Munger: The same is true in spades in accounting. This sale of phony tax shelters by major accounting firms for contingent fees with pledges of secrecy from the clients — it's a total abomination. If you let that kind of ethics creep into your accounting partnership, why are you going to expect your audits to be trusted or your partners not to cheat you? I think ethics troubles are *catching*. They're contagious. They spread from place to place.

I believe most major professions contain practices that are very much to be regretted. What is so sad about accounting is its combination of two factors: (1) extreme importance and (2) a fast rate of deterioration.

Lawyers have been able to get away with murder....

Munger: Law firms have gotten by with murder. Accountants, when they made mistakes, have long faced terrible lawsuits and liabilities.... But it's been a rule of thumb in this country that a lawyer could defend anybody, using almost any method and do almost anything to help a business client without incurring much chance of disgrace or liability for the lawyer.

Well, that's changed. Now, people *are* starting to sue lawyers. So the risks have changed. And the lawyers are joining the accountants as targets when scandal comes.

This is not a welcome change in the legal profession, but it may do some good as well as harm.

[Editor's note: Amen. No other profession in our society is allowed to create the laws that govern it and be the court of last resort in the interpretation of those laws (which lawyers do by constituting the vast majority of nearly all of our legislative bodies and all of our courts). It's like the old saying: Power corrupts — absolute power corrupts absolutely.]

The traditional view is that saving the guilty is *wonderful*.

Shareholder: I hold the view that the legal profession should focus on justice first and go after the bad guys. And what I've found is that the very common view today is that the idea is to defend the client at any cost regardless of whether he or she is guilty or not — that the client comes first and justice is secondary. Could you give me your thoughts on that?

Munger: The traditional answer from all of the law schools is that our system guarantees justice on average by giving even the guy who's on the wrong side a good lawyer and letting him argue against another good lawyer and then having an impartial judge or jury decide what is right. The theory is that if you have a vast talent and you use that vast talent to help John Dillinger avoid conviction for his 42nd bank robbery, then you're helping justice. That is the ethos of the legal profession.

And there's something to be said for that attitude — for instance, when John Adams defended British soldiers, decent people who faced popular rage.... The idea that lawyers should be willing to work for the despised side has a long history.

If lawyers thought more like me, the world would be better.

Munger: Personally, I think this idea of benevolence in helping the despicable rich has been pushed too far. I never had the least interest in defending miscreants or helping them misbehave. And I believe that to the extent the major law firms would get to thinking more like me, the world would be a better place.

But that is a minority view. The traditional view taught to lawyers is that it's just *wonderful* what Johnny Cochran did [for O.J.]. There's an old joke, "What is the second happiest day in the life of a great criminal defense lawyer?" And the answer is, "When he gets an acquittal for an innocent man."

THERE'S A LOT WRONG WITH EDUCATION. IT'S *AMAZING* HOW WRONGHEADED IT IS.

Central city miseducation is a disaster for our republic.

Shareholder: I've always enjoyed the times that you've digressed or been asked questions *outside* the field of Wesco, Berkshire or economic matters — talking about the miseducation of American youth by universities or public school reform. And I'm curious if you were made emperor of the United States, what are the big things that you think are being done wrong that you would change?

Munger: Well, I'd certainly correct the miseducation being delivered by our central city school systems. I think that's a disaster for our republic. [Ed. note: Amen.] And I think one reason the disaster is so great is that it's hard to handle the problems the system's been dealt. But hard does not mean impossible. And other people succeed with students of a type that are failing within our great central

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

city public school systems. So, certainly, that's one thing I'd correct.

And there's a lot wrong in the rest of higher education.

Munger: In university education, I think I'd remove *many* of the people. Not so in hard science and engineering, biology and medicine. But I think there's a *lot* wrong in the rest of higher education.... [Ed. note: Amen again.]

In one talk, I quoted Alfred North Whitehead who wrote about the "fatal unconnectedness" of academic disciplines. People get into these little departments and live there and select other people to join them who are like themselves — all without trying to see how their ideas fit in the larger reality, including the output of other disciplines.

And yet academics don't feel guilty about their errors.

Munger: The universities have a vast complicity in troubles of the wider civilization. But none of them feel at all guilty about dysfunction in their former students. [He chuckles.] They feel if someone gets his Ph.D. and teaches what his department believes, he has done his duty for the next generation, no matter what happens.

This, by the way, is in the greatest universities in the world. The U.S. has the best universities in the world.... However, when you get over to the business schools, law schools and sociology departments, there's much wrong. And yet people are proud of their errors.

Same forces created the Arthur Andersen/Enron debacles.

Munger: Much the same thing happens outside academia in great bureaucracies. And the reason why so many companies are so dysfunctional in their thinking is that they get balkanized into bureaucracies. Each bureaucracy takes care of its own turf. So too few denizens see the whole picture.

I think something like that happened at Arthur Andersen and at Enron. It isn't like Arthur Andersen is full of evil people. The culture was dysfunctional in the way that it dragged many good people down.

I think that it's very easy to create a culture where good people end up delivering terrible results. All kinds of government departments — and even charitable foundations — are quite dysfunctional. They often don't see the world the way it is, and they rationalize doing what helps small groups of insiders.

PEOPLE CALCULATE TOO MUCH — AND THEY THINK TOO LITTLE.

Do I use a computer? Not so far....

Shareholder: I'm a Berkshire shareholder as well as an educator. I would like to comment on your statement. As an educator for 21 years, I truly agree the educational system is failing. However, I'm one educator who *does* care.

But here's my question: At 78 years of age, do you utilize a computer when you're looking at economic trends or companies that you want to buy? Or do you rely heavily just on the annual reports and newspapers, books, etc.?...

Munger: No doubt, the education system would have deteriorated faster if we had fewer people like the woman who just spoke.

Do I use a computer? Not so far. [Attendees crack up while Munger continues to deadpan.] I've just had one installed in my office, but the screen is still dark. I don't even type — one of my *many* serious mistakes. Will I ever get around to using the computer? We'll see.

It's amazing what you can do with organized common sense.

Munger: Generally speaking, I'm a follower of what I call the Thomas Hunt Morgan school. Morgan was one of the great biologists in the history of the world who figured out a lot of genetics with very slender resources in a so-called "fly room" — first at Columbia and then at Caltech.

And when Morgan reached Caltech, he did something that was very peculiar. He banned the Friden calculator — which was the computer of that age — from the biology department. Everybody else at Caltech used the Friden calculator endlessly for all kinds of statistical correlations and much else. Morgan *banned* it.

And they asked, "Why are you doing this?" He said, "I'm so located in life that I'm like a gold miner in 1848 who could just walk along the banks of the river and pick up enormous nuggets of gold with organized common sense. And as long as I can do this, I'm not going to use scarce resources in placer mining."

Well, that's the way *I* go at life. I think if you get the big points with organized common sense, it's amazing the placer mining you never have to do.

I hope to get all the way to the grave without placer mining.

Munger: I'm perfectly willing to go to placer mining eventually if I *have* to. But I'm hoping to get all the way to the grave without ever resorting to it. And it's worked pretty well so far. And it worked pretty well for Morgan.

I think organized common sense is rare — and is especially effective because of its rarity....

[Editor's note: Living legend John Templeton basically says the same thing.]

People calculate too much and think too little.

Munger: I know that if I were raised in the current age, I'd be like everybody else in computer usage. And I know that the correct path today is to be very computer-literate. All of us teach our children and grandchildren to do it.

But is there still enormous gain to be made with organized common sense that doesn't require a computer? I think the answer is "yes". Are there dangers in getting too caught up in the minutiae of using a computer so that you miss the organized common sense? There are *huge* dangers. There'll *always* be huge dangers. People calculate too much and think too little....

Well, I guess that's enough for one more year. [Shareholders applaud].

—OID

[Editor's note: For subscribers who think (like Buffett and yours truly) that too much of a good thing is wonderful — especially when that good thing happens to be Munger — you can find our previously unpublished coverage of Wesco Financial's 2001 annual meeting at www.oid.com.]

OAKMARK FUNDS'
BILL NYGREN & HENRY BERGHOEF
(cont'd from page 1)

Thankfully for himself and his shareholders, Nygren has proven thus far to be a far better money manager than prognosticator. From the fund's inception on November 1, 1996 through its first five calendar years, Select was up an amazing 29.0% per year versus 11.5% per year for the S&P 500 and 16.8% per year for the S&P MidCap 400.

Despite having been rather ordinary in 2002 — having suffered a decline of 12.5% through December 31st — Select has run circles around just about any index that you might want to choose since its inception. For example, for the five years ended December 31st, Select's performance puts it in the top 1% of all funds and makes it the top mid-cap value fund according to *Morningstar*.

Of course, we wouldn't ordinarily put much weight on a five-year track record — no matter *how* impressive it might be. However, having read his letters and listened to him explain his rationale first hand, we're convinced that he and Select co-manager Henry Berghoef are the real deal. As you may recall from our interview with them (in our Year End 2000 Edition), before joining Harris Associates, Berghoef worked with very highly regarded Lou Simpson — chief investment officer of Berkshire Hathaway's GEICO insurance unit — one of the very few people to whom Warren Buffett and Charlie Munger have ever been willing to delegate their investment decision-making authority. And coincidentally (or not), in that same interview, Berghoef presented an extremely compelling case for Office Depot right before Berkshire and GEICO began establishing their own position (in the first quarter of 2001).

And it appears that his talents have not gone unnoticed. Berghoef, currently Harris' Assistant Director of Research, will be promoted to Director of Research in 2003.

As we've said before, in our experience, Nygren's investment performance has been matched only by his keen insights. The following excerpts were selected from Nygren's latest conference calls — held August 1st and November 6th. And then, we're pleased to bring you excerpts from comments by Nygren and Berghoef at a special Oakmark Funds Breakfast which was held December 12th in Manhattan. We believe you'll find them to be unusually valuable reading.

GROWLING BEAR ON COVER OF *BUSINESS WEEK* AND VALUATIONS SUGGEST VERY GOOD RETURNS.

Equities now offer the probability of very good returns....

Bill Nygren: In May, investors began selling the equity asset class and putting their money into bonds and money market funds. During this phase, unfortunately, all stocks have been treated similarly. Small cap, large cap, value and growth have all experienced similar declines — and, recently, pretty similar bounces.

We think the equity asset class now offers the probability of very good returns relative to returns available in fixed income. Many stocks now meet our valuation criteria. And a growing percentage of our approved list — and therefore our portfolios — is composed of larger cap, higher quality businesses....

When I talk about stocks, you should always take my opinion with a grain of salt. When I talk about the market, you might need a whole shaker. With that caveat, my personal belief is that we've seen the bottom.

Valuations always drive our thinking. And my primary reason for thinking the bottom may be behind us is that the S&P 500 reached a low of 16 times next year's earnings estimates — and that's a level we consider a bargain compared to a 4% government bond yield.

But in addition to valuation, I was comforted that the edition of *Business Week* prior to the bottom had a growling bear on the cover and the following edition included a primer on short selling.

Fair value for the S&P? Something in the area of 1,250....

Nygren: The S&P right now is at, what — 924? And it's supposed to earn something like $50 a share next year. So you're looking at a multiple of about 18-1/2 times.

If you use something like the Fed model, which I think is as good as any estimator of what a fair intrinsic value is for the market, that would suggest that the P/E ought to be the inverse of the 10-year bond rate. And I believe that's right around 4% right now. That would suggest that a fair value P/E is about 25 times. So that would suggest the market is — in ballpark terms — 20% undervalued.

But you must be careful with that kind of analysis — because you can arrive at very precise numbers. However, in my judgement, fair value's a very broad band. I've found using a model like that as a guide is only helpful when stocks get undervalued or overvalued by more than about 20%.

So as the market got down to an 800-ish level, that seemed to me to be enough below what was implied by a valuation level on the market that it was quite safe to call the market *under*valued and expect that the returns would be above average. If the market got back up toward its old highs of 1,400-1,500 on the S&P, I think it would be safe to call it *over*valued.

Stocks remain undervalued relative to bonds.

Nygren: Despite the market rally, I continue to believe that stocks are undervalued relative to bonds — and that because of the combination of a strong bond market and weak equity market performance, most investors are currently underinvested in the stock market. Because of that, we have a positive outlook on the market. And we expect that through our stock selection criteria — buying growing companies managed in the shareholders' interest, but only when they are cheap — combined with our patience, that we'll be able to continue to add value via our stock selection approach....

The belief that business values and stock prices must eventually converge is what drives our investment approach

(continued on next page)

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

— and it's what allowed us to gain confidence about future returns as stock prices were falling.

WE'VE SEEN MORE QUALIFIERS LATELY THAN WE'VE SEEN IN THE LAST TWO YEARS.

Many high-quality, large-cap growth ideas are cheap.

Nygren: As bottom-up investors, what really excites us now is the opportunity to buy stocks like AOL, Abbott Labs, Boeing, Bristol-Myers, Duke Energy, Home Depot and Stilwell Financial — all companies we have long admired — but stocks whose valuations were generally much too expensive for us.

During the third quarter, we found many new stocks meeting our buy criteria. Unfortunately, most of 'em in our portfolio *continued* to meet our buy criteria. In the Oakmark Fund we found four names to add: Comcast, Disney, Echostar and Sun Microsystems. In Select, we added AOL Time Warner — which had been added in the prior quarter to the Oakmark Fund.

All five of these names continue the theme that we've talked about for several quarters — that the severe decline in high-quality, large-cap growth companies has allowed *many* of those names to be purchased on value terms....

Based on the opportunities, we're voting with *our* dollars.

Nygren: Our largest holding in both funds continues to be Washington Mutual. It sells at 9 times expected 2002 earnings, has double-digit EPS growth, a 3% yield, and a growing cost advantage versus its competitors. And it's values like Washington Mutual that give us in the Oakmark family the confidence to use price declines to increase our personal weighting in equities.

And if I'm wrong and the bottom is still ahead of us, you can be sure that all of us at the Oakmark family will be further adding to our holdings in the funds.

We've seen more qualifiers lately than we have in 2 years.

Shareholder: ...Do you have any sense of what the market value of your portfolio is on an overall basis as a percentage of your valuation today?

Nygren: We don't keep the statistics that way.... But I would say that the number of stocks that we were seeing over the last quarter that met our 60% of value criteria was higher than it's been in the last couple of years.

INVESTORS WORRY ABOUT A WRITEDOWN AT WAMU. I BELIEVE IT'S LIKELY THERE'LL BE A WRITE-*UP*.

Impact of deflation? You're probably asking the wrong guy.

Shareholder: My question has to do with the lead story in the November 6th edition of the *Wall Street Journal* about the Fed's concern about the potential for deflation rather than inflation going forward. You've said that you don't make macroeconomic predictions or base your decisions on those factors. But with the Fed running out of room to lower rates, what effect do you think that might have on some of your portfolio holdings — particularly Washington Mutual with its mortgage servicing business?

Nygren: As regards the Fed cutting rates and the possibility of a deflationary scenario: I think across the board, deflation would be bad for equity values. Implicit in equity values is some small level of pricing power — nothing like what it *used* to be, but the idea that prices will go up 1-2% a year and that that'll be a positive contributor to their growth rate.

However, I really don't think that we're the right place to look for macro insights and how you should structure a portfolio if your believe that deflation's a higher probability than the market believes.

Washington Mutual is a *beneficiary* of lower rates, too.

Nygren: However, specific to Washington Mutual, I don't worry much about deflation at all. I think that Washington Mutual has done an unusually good job of both structuring its business and the financial side of their balance sheet in a way that they've become quite immune to interest rate moves. As you correctly point out, a declining interest rate environment is a negative for their mortgage servicing rights.

However, that is offset by two things: (1) the fact that they're hedged on that portfolio, and (2) the high rates of refinancing that comes about when rates are declining is a *very* big positive for them — both in their spread business and their mortgage origination business.

Write-*downs* in mortgage servicing? I'm expecting write-*ups*.

Nygren: I actually think the *other* direction is more likely to be an issue for Washington Mutual. And that is that recent prepayment rates have been *very* high — they've experienced very rapid prepayments. And that has caused them to mark the servicing life down to record lows for their mortgage portfolio. And my judgement would be that the mortgages that they are writing now are mortgages that are unlikely to be refinanced until people move.

Although investors have been concerned the last couple of years about markdowns in Washington Mutual's mortgage servicing rights, I believe it's *highly* likely that we'll see a decrease in prepayment rates over the next couple of years to the point that they'll have to *increase* the valuation of the servicing rights on their portfolio.

BASED ON VALUATION, WAMU STICKS OUT — JUST AS IT DOES IN RETURN POTENTIAL VERSUS RISK.

Select was designed to be concentrated from the start.

Shareholder: I just wanted to delve a little bit deeper into Washington Mutual — specifically in the Select Fund. According to the September report, it looks like it's now just under 18% of the fund.... You suggested earlier that you had more ideas than money right now based on valuations.... Obviously, you think it's that much better than some of the other things that are out there?

Nygren: Right. First, as regards position sizes, from the time we started Select, we said the goal of this portfolio was to maximize the impact of our stock selection — that we weren't going to worry about volatility that would be

(continued on next page)

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

caused from any specific issue; and that we'd make no attempt to structure the portfolio in a way that it would match any sort of index. We designed the fund as a specialty fund either for high-risk/high-return investors or, more likely, to be a slice of somebody's portfolio. And the assumption is that the investors who own Select don't need Select to be a fully diversified portfolio.

We don't have many 10%+ positions — in fact, just one....

Nygren: With that in mind, we said there'd be times when our top five ideas would represent more than half the assets in the portfolio, and that when we thought an individual stock stuck out as head and shoulders above our other ideas in the portfolio, we'd be willing to invest 15% of the portfolio in that type of idea. And that's basically the parameters I continue to use.

When Washington Mutual's up to 15% of the portfolio, I no longer add to the position. So it's at 18% not because we *put* it there, but because we were buying it when it was at 15% of the portfolio, stopped buying it, and then it's performed better than the rest of the portfolio since. And that's why it's increased its weighting.

If you look, you'll see that there is not any other stock that we have a double-digit percentage in.

And that's not just based on valuation either.

Nygren: And that's because I don't find a second one that sticks out as being that much more attractive than the other names in the portfolio. Whether it's just based on valuation, where Washington Mutual sells at about 9 times earnings with the market at 18 times earnings — I don't think there's *anything* else in my portfolio selling at a lower multiple. Even EDS is at *about* that multiple. So based on valuation, Washington Mutual sticks out.

But then, WAMUs expected growth — the combination of its 3%+ dividend yield and double-digit earnings growth — *that* sticks out as substantially above average. We tend to think in a 3-5 year time frame. And I look at Washington Mutual selling at 9 times earnings that are growing at a double-digit rate and think about what could happen to this company over the next 5 years.

When I do that, I figure that their earnings should grow between 50% and 100% in total over that 5-year period. The dividend return that you receive from today's price would be something like 15% to 20% over a 5-year period. And I think it's very likely that if its growth rate continues as we expect, the multiple will end the 5-year period at something more than half the S&P multiple — which is where it's trading today.

One of our highest return potential ideas and lowest risk.

Nygren: Lastly, confidence in the management team — looking at their history of success at Washington Mutual, looking at the way they articulate their strategy, looking at the way they invest their capital, their willingness to shrink their equity base when buying their own shares provides a higher return than increasing their business does...

So when I combine the earnings growth, the potential for the multiple gap to contract, its dividend yield [and our confidence in management], I see it as one of our highest return potential ideas with one of the lowest risk levels. That's why it's our largest holding.

Shareholder: So the fact it's twice the percentage of the next holding just [means] you have twice the confidence in it — based on all those scenarios, obviously.

Nygren: Well, I haven't really thought about it in terms of *twice* the confidence. But it's a lot more. I have not only a lot more confidence that there is greater upside in WAMU than the other names in the portfolio, but also in looking at the different assumptions we use in thinking about what happens if we're wrong on those assumptions. What kind of downside is there? And I find it very hard to develop a credible case that Washington Mutual has significant downside based on a multi-year time horizon.

[Editor's note: An additional factor not mentioned by Nygren which further buoys his case is pointed out by Samuel Mitchell and Chris Niemczewski et al. in their latest letter to clients of Marshfield Associates. As they describe, "Defaults may increase, but Washington Mutual has an outstanding credit management operation, and as a matter of policy focuses on loans whose value is low relative to the market value of the underlying asset. We don't see the company getting into trouble because of sloppy credit analysis and management, and we like the fact that the company has put a priority on developing a best practice risk management program.

[But] we'll be wrong if we're dramatically underestimating the level/scope of mortgage loan defaults and have misjudged the company's culture of integrity and prudence."]

Trade tickets to trim WAMU are the hardest ones to write.

Shareholder: Would you ever let it go *above* 20%?...

Nygren: I think it's unlikely that I'd be comfortable letting it go above 20%.

Shareholder: So you're about top end right now?

Nygren: I think that's a fair statement. The stock has at various times this year touched 19% of the portfolio — and that's usually been a trigger for me to trim a little bit of the position. And those are the hardest trade tickets for me to write — because I really don't believe those trades will look very good in hindsight. But I think it's the prudent thing to do for the portfolio.

PHARMA GROUP TODAY IS GETTING NO RESPECT. BUT PEOPLE WILL VIEW IT AS EXCEPTIONAL AGAIN.

Most of the good pharmaceutical research is *not* behind us.

Shareholder: Many argue that the big pharmaceutical stocks' pipelines have kind of dried up ... — that they've basically pushed combinatorial chemistry as far as they can go. And biotechs still haven't hit that point of the hockey stick where they're kicking in — although there are a few profitable biotechs. Does that particular point of view factor into your thinking at all?

Nygren: I've always been suspicious of the thinking that all the great inventions are already behind us. Look at

(continued on next page)

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

the advances that have been made in healthcare research. Today, it is done on so much more of a targeted basis rather than on the trial and error basis in which it was done going back a couple of decades. So I think that somewhat offsets the idea that most of the good research has already been done — because today's research can be so much more targeted.

I've always looked at biotechs and pharmas the same way.

Nygren: And I guess I'm not a believer that there's that much difference between the biotech industry and the traditional pharma industry. They all approach research in a relatively similar way. They're all shooting for pills that can cure the same set of healthcare problems.

The biggest difference between them is that the traditional pharma companies have much greater current cash flow relative to their existing business values. The biotech companies tend to be valued much more based on what they may produce going forward.

So when you see something like a Bristol-Myers or a Merck falling to as low a P/E as they got to, I think their pipelines relative to current market values are every bit as good as the biotech pipelines — and you get the existing business kind of thrown in for not much of anything....

In five years, pharmaceuticals will again get a premium.

Shareholder: So basically, if I read between the lines, you're treating the pharmaceutical sector as a once every decade opportunity to get into an attractive industry?

Nygren: Yes. I think that's exactly right — because we haven't seen this kind of discount to the market multiple on the pharma sector for a decade. I just refuse to believe that in five years, people will look at the pharmaceutical industry as anything other than an exceptional industry.

So we continue to like the pharmaceutical industry.... And we think something like IMS International is a good way to participate in that.

We still believe IMS has a royalty on drug industry sales.

Shareholder: Can you talk a bit about the effect of the Pfizer merger on IMS Health's business long-term as you see it?

Nygren: Large pharmaceutical mergers are negatives for IMS International in the short term — because when the merging firms' sales forces get integrated, usually they don't need to subscribe to quite as many copies of the IMS database as they had previously. But once the sales forces are integrated, the growth rate resumes at the growth rate of the combined companies.

So I don't tend to worry too much about what that does to IMS' results. We think it's the gold standard of information for the marketing of pharmaceuticals. There really isn't a good substitute product available. And I continue to expect that IMS will be somewhat like a royalty on drug industry sales.

Best of all, almost no reinvestment of capital is required.

Nygren: So you have one positive and one negative — the negative, again, being that when there are mergers, you do get declines or lack of growth short-term in their revenues. But the positive is that their business requires almost no reinvestment of capital. And therefore, they're able to support a growing sales base with fewer shares outstanding year in and year out....

Opportunities in the drug sector are extremely attractive.

Shareholder: None of the big pharmaceutical stocks showed up in Oakmark Select. They went to Oakmark instead. Why was that?

Nygren: In Oakmark Select, I view both Chiron and IMS as kind of surrogates for what's going on in the pharmaceutical sector. I have not yet gotten comfortable with the idea of adding a third name to that sector. But between those two, we've got about 8% of Oakmark Select invested in the same area, broadly....

One of the other reasons quite candidly is that trying to sort through the large pharma names we own to pick a favorite, I have a hard time picking one over the others. And that's held me back from kind of randomly choosing one of the others [in the Oakmark Fund] to put in Select.

So even though I think the opportunities today in the drug sector are extremely attractive, I don't really differentiate between Schering, Merck, Bristol, Abbott Labs or Guidant. I think *all* of them are attractive. It's one of the first times — if not *the* first time — since the Oakmark Fund's inception that we've had more than a market weighting in drugs and medical devices. It's unusual to see the market turn so negative on the healthcare sector that it can become an overweighted position for us.

THERE ARE TWO WAYS TO BUY MULTICHANNEL TV — CABLE AND SATELLITE. AND WE LIKE BOTH....

We think both satellite and cable will prosper.

Shareholder: I know you own Echostar. What's your opinion on satellite? Is it specific to that stock — or do you feel there's long-term potential in the satellite TV business? Do you foresee a winner between cable and satellite, or are they going to both do well going forward?

Nygren: It's definitely not a company-specific thing since we own GM Hughes in Oakmark, as well. We also own Comcast and AOL. And one of the big pieces of value at AOL is its cable system ownership. So it's not a satellite versus cable thought process.

What we're looking at is that multichannel TV is a very successful product — one that's very highly demanded by consumers. There are two different ways to get it: cable and satellite. Both ways make sense — depending on what the consumer's needs are and where they're located. And we think that both cable and satellite will prosper.

[Editor's note: Interestingly, Longleaf Funds also own both cable and satellite companies.]

For cable assets, EBITDA is a perfectly fine metric.

Nygren: And we believe that the market plus the fear of an EBITDA-type valuation approach that's been caused by some of the high-profile disasters over the last year...

(continued on next page)

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

In our judgement, there have been companies where an EBITDA approach was *inappropriately* used. However, the cable industry has kind of gotten thrown into that group as, "Gee, these guys don't make money — and they don't report net income. Maybe there really isn't value here."

Well, we think there's a long history of acquisitions that suggests that cable subscribers are worth something around 11-12 times cash flow.

And satellite assets are very similar to cable....

Nygren: And satellite subscribers generate *almost* the same amount of cash flow that cable subscribers do. The satellite companies don't *report* quite as much in EBITDA because they're spending to grow their subscriber base more rapidly than the cable subscriber bases are growing. But on a per subscriber basis, we find it hard to believe that a satellite subscriber is only worth a third of what a cable subscriber is worth. However, that's how the market's pricing them today.

So it's kind of across the board that we like the area right now.

WE LIKE EVERYTHING ABOUT COMCAST TODAY — AND WE THINK THE FUTURE LOOKS EVEN BETTER.

At Comcast, it's the people, the assets, the price and more.

Shareholder: A lot of managers seem to be getting into Comcast. I realize that's a new position. Could you talk a little about it?

Nygren: Sure. We think Comcast management is among the best — if not *the* best — in the cable industry. We think the company has done a great job of growing business value for its shareholders over its entire history. We believe the AT&T broadband properties they're purchasing were mismanaged under AT&T's stewardship. And we believe that Comcast is very likely to achieve their cost-cutting — and revenue-enhancement — goals under their own management.

[Editor's note: The list of other recent Comcast buyers is impressive. According to *Portfolio Reports*, it was one of the top four purchases during the third quarter of Chieftain, Gardner, Russo, Gardner, Longleaf Partners Fund,

(continued in next column)

Oakmark Fund, Tweedy, Browne and Weitz Funds.]

Nygren: I believe the company's five-year target is to have $4 a share in cash flow. This is an industry that has normally sold at double-digit multiples of cash flow. Even better, more of its cash flow today is excess cash flow — not needed to be reinvested in the business — than it had been historically.

So basically, we like the people and believe the value is going to grow. And relative to private transactions that we've seen in cable companies, we believe that it's selling at less than 60% of value.

Why we sold AT&T and bought Comcast.

Nygren: Also, we had owned AT&T. And the biggest piece of our AT&T investment was the implied investment in Comcast. I believe we were to receive something like one third of a share of Comcast [for each of our AT&T shares].

PORTFOLIO REPORTS estimates the following were Oakmark Fund's largest equity purchases during the 3 months ended 9/30/02:

1. ECHOSTAR COMMUNICATIONS CL A
2. COMCAST CORP CL A SPL
3. SUN MICROSYSTEMS INC
4. DISNEY WALT CO
5. MCDONALD'S CORP
6. HOME DEPOT INC
7. INTERPUBLIC GROUP COS INC
8. SUNGARD DATA SYS INC
9. MGIC INVESTMENT CORP
10. AOL TIME WARNER INC

The two other pieces to the AT&T bet were owning the AT&T Communications stub which was priced, I believe, at $2.80 at the end of June. And it's currently at $5.90. It was at something like $5.60 at the end of September. So in a market that went down dramatically in the quarter, the AT&T stub almost doubled in price.

[Editor's note: Subsequent to the Comcast transaction, the surviving AT&T had a reverse (1-to-5) split.]

Nygren: And the last piece of the AT&T bet was that the arbitrage discount would decline. At the end of June, it was something like $1.20. At the end of September, it was down to something like 15¢. So we felt of the three bets that were implicit in our AT&T holding, two of them had worked in our favor – and we were no longer anxious to have those bets continue.

The one that *hadn't* worked yet was Comcast. And we felt that on its own merits Comcast deserved to be in the portfolio, and AT&T was no longer a cheaper way to own it.

There's no evidence of consumers balking at new offerings.

Shareholder: Are you comfortable with your understanding of [Comcast's] cash flow projections? Over time, my take on it has been that the cable operators were the pipeline into the house for an ever-expanding array of services and revenues.... As we've evolved here, is there resistance on the consumer side to just keep buying more and more and more so that their monthly outlay goes from $100 to $200 to $300 to $400? In light of the way things

(continued on next page)

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

have changed, are you comfortable with how they're projecting out growth and cash flow regarding those issues?

Nygren: I am. I don't think there's been any indication yet of consumers not being willing to expend more for more services. The cable broadband offering is a *very* good value relative to a dial up internet service provider plus a second line. It effectively has the same functionality as a second line devoted just to your computer. In markets where they've offered telephony, they've been able to offer more services than the local phone company has at either a competitive price or a modest discount. And within the cable side, a large percentage of their customers continue to be willing to pay more to have more product offerings.

To make the argument that there will be resistance, you need to say the consumer really doesn't understand how much they're paying for all these separate services — and when it's highlighted to them by getting it in one bill that it's going to be a shocking number and something that they object to.

I've found it's worth giving the consumer more credit than that. I think people *do* know pretty much what they spend on things. And if they can have it done in one bill at a cheaper price than all the others combined — and with more functionality — they'll view that as a good thing.

We believe cable assets today are in the $4,000/sub area.

Shareholder: ...Would you mind going through your [estimate of] intrinsic value for Comcast?

Nygren: The way we look at the cable TV industry is to look at what prices transactions have occurred at when groups of cable systems have been purchased. Those numbers several years ago — before cable modems and digital cable — were running around 11 times EBITDA, somewhere in the $2,500-$3,000 level per subscriber. As cable continued to offer more services — cable modems, extended viewing options, more pay-per-view — average bills went up, the amount of EBITDA per sub went up and, because growth expectations were higher, multiples also went up getting to levels approaching 20 times EBITDA.

We believe that the private market values today for cable systems continue to be in the $4,000-per-sub area at a mid-teens multiple of EBITDA. Comcast today sells at a very significant discount to that — whether you look at the existing Comcast or the expectations for the combined Comcast/AT&T operation.

Comcast has the two other things we look for, too....

Nygren: In addition to looking for the undervaluation, the two other things we look for are growing business value and managements on the same side of the table. Taking the latter point first, the Roberts family has been one of the best operating families in the industry. And they continue to have most of their family net worth invested in Comcast.

And looking at the potential for growth, not only have revenues per subscriber been up almost every year, but the opportunity ahead of them for efficiencies from the merger with AT&T gives us a *great* deal of comfort that 3-5 years from now, the cash flows in this business will be significantly higher than they are today. And therefore the per-share business value will also be significantly higher.

And so do AOL and Liberty Media.

Nygren: So we look at those three criteria. We think, whether we're looking at Comcast or AOL or Liberty Media, a similar approach is applied of valuing the assets based on private transactions and demanding at least a 40% discount to that value. And we believe we've got that at today's prices. I think our media names are extremely attractive....

JANUS SELLS AT A LARGE DISCOUNT TO ITS PEERS. AND WE THINK IT'S A BETTER BUSINESS TO BOOT.

At Stilwell/Janus, we think there's a lot to like....

Shareholder: On Stilwell, I guess from a big picture [perspective], Janus drives a significant part of that, as well as DST. With the problems that Janus has suffered, do you get concerned about — I don't want to say it's a run on a bank... But do you get concerned about the significant outflow of monies out of the mutual fund area from Janus? I don't know if you've factored that into your equation or not.

Obviously, it's been getting hit over the last year or so. But every time they come out with the funds' money flows, Janus has taken yet another hit from people moving away from some of its more aggressive funds.

Nygren: Right. Certainly Janus has suffered some outflows this year. But most of the decline in assets at Janus has been because of *market* performance as opposed to outflows. If you compare Janus to other growth managers, its numbers are still quite good. We think the brand name of Janus is very powerful. And the mix of its assets lends itself to more stability than a purely retail mutual fund would offer.

And the large discount that Janus sells at versus many peers in the investment management industry that we believe are inferior businesses to Janus suggests to us that a more significant outflow at Janus than at the other fund families is *already* priced into the stock.

You have to remember, this stock was at $54 just a couple of years ago — and it's selling at $13-and-change today. So it's already lost something like 70% of the value of what it was selling at in the market two years ago. And at current levels, we think it's quite attractive.

Growth investors *haven't* suffered like value investors did.

Shareholder: Bill, I have a broad question for you on growth versus value. I think it comes to the nub of the Stilwell position in your Select Fund. Have growth funds suffered as much pain as value funds did back in 2000 when several prominent value investors exited the business and there were all those redemptions of the Oakmark Fund from $9 billion all the way to $3 billion or $2 billion or whatever? Do you feel that the growth style has been taken out behind the woodshed and given the spanking to within an inch of its life the way value was?

Nygren: [Laughs]. No, I don't think so. And it doesn't sit well with my opinion of fairness — especially being a value investor. But I think it's typical of what's happened historically. Value gets hurt when it's not

(continued on next page)

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

keeping up with an up market. And growth gets hurt when it's going down faster than a down market. People are more anxious to sell out of a fund that has kept them from *making* money than it is to sell something that's down. That's just a function of human nature.

And I think the pain that the growth investors have gone through has come out of investment performance.

I think Janus has gotten more back to its roots....

Nygren: The assets in the Janus funds are down by over 50% from what they were at the peak. I don't know that any of us can predict when the pain will end. However, they've been through a lot already.

And I guess the other thing is I have never been a big believer in the growth versus value comparison. The bigger difference is how value's performed versus *momentum*. And I think Janus did get caught up in a momentum market and has gotten more back to their roots now of being fundamentally-based growth investors.

Shareholder: Interesting — because I think many advisors, myself included, think of Janus as the people who brought us Enron, Tyco and AOL at $70 a share, etc. Those are the holdings that used to show up on their portfolio fact sheets two years ago. Enron was a top five holding. Tyco was a top five holding in *many* of their funds. And you're saying that they've gone back to being more of a *growth*-oriented, rather than a momentum, hyper-growth, shop?

Nygren: Right. That's my belief.

We don't think we have a corner on the right way to invest.

Shareholder: It seems surprising that you would invest in a company like Stilwell given that their investment philosophy is diametrically opposed to your value-oriented approach. Would you comment on that?...

Nygren: Well, something we have always said is that we don't think we've got a corner on the right way to invest. We've adopted an approach here at the Oakmark family that suits *our* personalities — which is trying to identify undervalued companies, where business values grow, where managements are on the side of the table that the shareholders are on, and then being extremely patient. That works for us because of our personalities.

The Janus fund family has used a very different approach. They've ended up owning very different portfolios than we have. However, over the long term, they've also achieved very good performance numbers. And I don't have a problem believing that they will *continue* to generate good performance numbers and, based on that, believing that their equity is very attractive at this level of valuation.

NOTHING HAPPENED AT YUM BRANDS — EXCEPT ITS STOCK BECAME A BETTER BARGAIN.

Yum Brands was frustrating. We didn't get anything wrong.

Shareholder: Can you talk a bit about Yum Brands — last quarter, I believe they had some problems at KFC — and just kind of your take on what's going on there?

Nygren: Of all the stocks that we had that made the "Top 10 Loser" list on any given day, Yum Brands [the old Tricon] was the most frustrating one for me, because I still don't believe we got anything wrong in our analysis. Basically, despite the old Tricon name (which would suggest that there are three divisions), there are four divisions that they report results on separately: the three domestic franchises — KFC, Taco Bell and Pizza Hut — and then their international operations.

Throughout its history, what has generally happened is that two to three of those companies are doing very well at any given point in time, and one of them is struggling. In the second quarter, they'd told us that KFC was struggling somewhat and Taco Bell had been dramatically improving their results.

When the results were reported, Tricon [now Yum Brands] announced they'd earned a penny more than expected; they told people not to raise their estimates for the year because they'd probably end up giving back that penny in the fourth quarter; and KFC's sales, instead of being down the expected 6-8%, I believe were down 10%.

That was offset, however, by International, Pizza Hut and Taco Bell all being modestly *above* expectations. I just think people get way too bent out of shape over any decline in any one of these four business units. When you combine the package that they have, the results have been both very strong — good growth — and quite consistent. And the history is made up of one division coming in below their targets most of the time.

To me, it's just an opportune time to buy *more*.

Nygren: We didn't think that their stock was especially expensive. It was trading at something like $29. It's supposed to earn just short of $2 next year. That put it below a market multiple for a business that's growing about 15% a year with more consistency than the S&P 500 — something we believe deserves a premium. Yet when they made their announcement of the shortfall at KFC, the stock went from $29 down to $21.

As much as I'm frustrated by that, with our approach, we have to use that opportunistically. And I don't think the business environment is any worse for Yum Brands today than it was three months ago. And the stock price is *dramatically* lower. So to me, it's an opportune time to increase the weighting.

WE THINK SUN'S OUTLOOK IN SERVERS IS BLEAK. BUT THAT DOESN'T KEEP IT FROM BEING A BARGAIN.

On average, I'd say tech stocks are *appropriately* valued.

Shareholder: Do you think the technology rebound is for real and will shift some assets into technology?...

Nygren: For many years, our firm has believed that technology stocks were significantly overvalued — and we've had almost no exposure to that area. In the last several months we've fine-tuned our language there. And instead of saying tech stocks are overvalued, I'd say, on average, we think they're about *appropriately* valued.

You do get a stray name here and there — such as a Sun Microsystems — that becomes very out of favor, where we think investors are overlooking some of the positives the company has going for it, and are too much focused on the

(continued on next page)

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

fact that the stock used to be at $65 and at $3 looked like it was on its way to zero.

So overall I'd say we are *not* positive on technology. But where we can find specific companies that meet our criteria we will continue to make those investments.

The stock price sets which questions are important....

Shareholder: Regarding your recent acquisition of Sun Microsystems, are you concerned about the erosion of market share that IBM has taken away from them?

Nygren: Sure, I care a *lot* about the share that they're losing to both IBM *and* Dell in the server market — IBM at the high end and Dell at the low end. But I think a case like Sun Micro points out that the stock price really sets which questions are important to answer relative to your decision to buy or hold a stock. When Sun was selling at $20, $30, $40, $50 or $60 a share, the market share question versus IBM was key. You obviously had to believe that Sun was going to ... *grow* share and that the market was going to continue its dramatic growth to justify those prices.

But we were buying Sun at just over $2-1/2 a share with half that value in cash. So that provided us with a *very* large cushion for share erosion in servers. In fact, at that price, Sun could even exit the hardware business, just be a software company and be worth more than $2-1/2....

We may be the only fund family in the country that if Sun gets back to $5, we will view it as a very successful investment and be struggling with whether or not we should still be holding the stock.

We think Sun's a bargain *despite* a bleak outlook in servers.

Shareholder: So you're looking at Sun as more of a short-term play rather than a long-term play...?

Nygren: We never look at *anything* as a short-term play. We look at what we think the pieces of value are at Sun — their existing hardware business, their existing software business and the pipeline of new products that they have plus the cash — and we think the combination of that is worth more than $5 a share. And at $2.60± last quarter, it was at less than 60% of business value.

I think Sun has the unique possibility of randomly going up to that number without any change in opinion of the company. And if that happened, we probably *would* sell the stock short-term.

But in terms of what we think the different pieces of Sun's business are worth, we think that number is north of $5 today. We think that number will grow over time. And we think that that's going to occur despite the fact that they'll continue to lose share in servers.

WE'VE ADMIRED DISNEY FOR A LONG TIME, BUT WE'D STILL LOVE TO SELL IT THE NEXT DAY.

To value Disney, we just add up the value of the pieces.

Shareholder: I have a question on your buy and sell methodology — how black and white is it? For example, take Disney. You go in at a 60% discount to intrinsic value. Is it really at that 60% number — or is it a little more vague?

Nygren: Our basic approach is that we try to estimate what the business would be worth to a cash buyer of the whole business today. And sometimes we can get to that number by a multiple of book value and sometimes it's a multiple of earnings.

In the case of Disney, the various businesses are so different. So we look at Disney piece by piece — putting a valuation on the theme parks that is at a premium to other theme park valuations because Disney's franchise, we believe, is stronger. We look at their cable channels — primarily the *ESPN* family and the *Disney Channel* — and again put a premium relative to other cable TV channels because we think the franchise is stronger there. Those channels are much more "must have" channels for the cable operator than are many of the other cable channels.

[Editor's note: For more on Disney in general and *ESPN* in particular, we refer you to comments by Longleaf's Mason Hawkins and Staley Cates on pages 5 and 6.]

Nygren: So we sum up the pieces, deduct the debt, and come up with an estimate of what we believe the business is worth. Disney is a company we've admired for a long time. We think it's a great business. It just hasn't sold at prices we thought were less than 60% of its value. But during the third quarter, it did pierce the 60% level — and we started purchasing it.

We don't wait around to get 100% of our value.

Shareholder: Where would your exit point be if it just increased up to 100% of your valuation? Would you get out even if that were to occur over a couple of weeks?

Sell disc

Nygren: Our sell discipline is that we sell a stock if either we think we've made a mistake and we're not aligned with the management or the business value isn't growing — or, preferably, we sell it when it exceeds 90% of our business value estimate. We don't wait around for 100%. And that's a recognition (1) of the lack of precision in the estimation process of the value, and (2) the fact that we believe that we make more money selling at 90% and putting it back into something at 60% than we do holding on from 90% to 100% of value.

The faster the market recognizes the value, the better.

Nygren: The faster the market recognizes the value, the better for us. I'd *love* for it to occur over a couple of weeks. We'd be more than happy to sell it and move on.

In fact, I'd *love* to be explaining to you some quarter why we had an incredible portfolio turnover rate because *all* our stocks magically appreciated very quickly to 100% of their business value.

WE'RE NOT BUYING REITS — NOT ENOUGH GROWTH. AND PRIVATE PLACEMENTS? NOT ENOUGH LIQUIDITY.

REITs? We prefer companies that reinvest their earnings.

Shareholder: Does the mortgage REIT industry have any appeal to you as an investor with its substantial yields and depressed P/Es?

Nygren: I am not aware of any names in the

(continued on next page)

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

mortgage REIT industry that have come up on our analysts' research list. Many of those companies don't have a large enough market cap to be of interest to us.

Secondly, I prefer a company that's growing its business to one paying out its earnings to its shareholders in the form of dividends. In theory, you could be indifferent to that in a tax-free account. But as a tax-sensitive manager, I would rather see the business grow than see the company paying out more. So I don't fall into the camp of the managers that have newly discovered dividend yield as a positive attribute to a company.

Private placements? Never say never, but they're unlikely.

Shareholder: I have a question about some of your competing value firms. People like AllianceBernstein have bought ... private placements — and maybe Marty Whitman or perhaps Mason Hawkins at Southeastern. Are we going to see positions like that in any of your funds?...

Nygren: I think we've got the ability, as most funds do, to put something like 5% of our assets in those if we were to so choose. My thought process would be that there would have to be a *tremendous* reward versus public securities investing to make it worth taking on the illiquidity risk. Generally, I *don't* think the rewards are there to justify that. So I would say that it's very unlikely.

There's nothing we've seen in the private area that's even tempted us. But never say never. If the right thing were to come along on our terms... I don't ever want to exclude something that I think would be in the interest of our shareholders to own. I just think it's really unlikely.

Shareholder: So you just pay a huge amount of attention to the [lack of] liquidity where others might not?

Nygren: I can't speak for what Warren Buffett or Mason Hawkins saw in the private placements that they did. But I do consider the illiquidity to be a significant negative. So there needs to be a reward to offset that.

NOT LONG AGO, THE MEDIA FORGOT ABOUT RISK. NOW THEY'RE FOCUSED ON RISK & IGNORING RETURN.

Investors are selling first and asking questions later.

Shareholder: I guess this is a sign of the times — not so much specifically about Xerox, because you've said that you think the worst is behind it. And yet they came out with yet another restatement, or adjustment, early in the second quarter — in April, I believe.

I'm sure nothing surprises you. But do you feel that with all of these investigations going on that in some of the things you own or that you're looking at, all of a sudden there's this investigation that can have a tendency to be a black hole that you really don't know what's going to happen on the other side?

Most recently, obviously, is AOL. They're investigating *everything* these days. Have you been scared on any of these things that have even maybe caught *you* by surprise?

Nygren: I'd say more frustrated than scared. It's an environment where the media is out to make headlines — and investors, with the scars of the last two years, are selling on the news and then trying to figure out what might be happening.

Today, people are anxious to find problems.

Nygren: I think the case of Xerox is quite instructive. Here's a company that acknowledged that the prior management had accelerated some revenues — that they should have been deferred over a longer time period than the old management had reported them over. They said they might have to reclassify $2 billion. It turned out they reclassified $1.9 billion.

But the way the press reported it, instead of looking at the net difference between the pluses and the minuses, they summed up the pluses *and* the minuses and came to a *$6* billion number — and you had it reported as if this company had created $6 billion of revenue that didn't exist.

The reality was that they went beyond the gray area into an area that was wrong in terms of what time period these revenues should have been booked over. But again, they reported basically what they told us months ago was likely to be reported. Yet the press turned it into a story of a restatement three times as large as what they said they'd done. That just tells you how the environment is and how anxious people are to find problems.

The scary part is volatility, but it also spells opportunity.

Nygren: Unfortunately, with Xerox, the stock reacted very sharply. It fell to something like $5. And now, it's slowly climbed back up to about $7. I guess the scary part is the volatility that this puts into stock prices. But I think that it also creates the potential for very high *rewards* for investors that are really doing their analysis and are ready to step *into* situations like this.

Politicians and journalists are giving people what they want.

Shareholder: Well, I'll agree with you on the media. But what scares me even more is that — I think this is the case with Andersen and the prosecutors and Spitzer in New York — is that some of these guys are out to make a name for themselves.... Their being very aggressive is more threatening than maybe the short-term media impact. For example, taking down Andersen —I don't know if that was the best result there. But I think the prosecutors wanted to make a name for themselves. I don't agree with what Andersen did, but I think the prosecutors were very aggressive in that regard. And the same with Spitzer jumping all over Merrill Lynch.

Nygren: I don't disagree. A lot of the population is upset about money they lost in the stock market — largely lost because they bought overvalued stocks, lots of times not even knowing what businesses they were in. And they don't like to blame the person they see in the mirror.

Politicians are susceptible to going after anything they think might be a reelection issue. And right now, a lot of the population would like to see more scandals reported, more executives in jail, whatever. But I just don't know how to change an investment approach based on the fear that there could be a couple of people who are unfairly made an example of....

(continued on next page)

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

Media forgot about risk before. Now they're ignoring return.

Shareholder: In the media, the doom and gloom forecasters are really making the case that the market should be priced *significantly* lower than whatever we might expect the reasonable low to be. Do you think that's just simply a matter of screaming fire, so to speak — that it's just another overreaction, and perhaps just a justification for a prolonged bear market perspective?

Nygren: I do think so. Just as the media forgot about risk when returns were so high, the focus today is *purely* on risk and not on what returns might be.

One bearish argument that makes *some* sense to me....

Nygren: The only bearish people that manage to put things into a quantitative argument that make some level of sense to me are the ones who want to predict that interest rates will return to levels that were average for the last generation. And they say you shouldn't be comparing a market multiple of 18 to a 4% government bond. You should look at more like the 6% or 7% that's been average for the last 25 or 30 years.

We haven't tended to do very well making those kinds of forecasts on what *may* happen with interest rates. Yeah, if interest rates go back up dramatically, that would reduce theoretical multiples. And it would take away one of the strong arguments about stocks being undervalued here....

EDS' ILL-TIMED SHARE BUYBACKS GOT ALL THE PRINT
WHILE A BIGGER POSITIVE GOT ALMOST NONE.

EDS overpaid for share buybacks, but *lots* of companies do.

Shareholder: I'd like to ask you a couple of questions about Electronic Data Systems.

Nygren: [Groans].

Shareholder: I understand that they used a put option that I believe cost them something like $225 million. And the way I feel ... is that it's difficult enough to predict what your earnings are going to be over a short period of time. It seemed to me they were gambling with our money on what they thought the stock would be a year in the future to offset their costs on exercising stock options. How do you feel about what they did with that option?

Nygren: First, I think the tactic of using put options as a way to reduce the cost of repurchasing shares is something that we've seen *lots* of companies do. So I don't think it's fair to single out EDS in the use of that strategy.

It really didn't cost them anything more — in fact, it cost them *less* — than it would have cost them to have just repurchased shares in the open market. In hindsight, the stock was selling at a price at which they shouldn't have been buying it back. However, lots of companies have made that mistake of buying back stock that in hindsight looks overvalued.

A more significant positive gets almost no print....

Nygren: The offsetting factor almost nobody pays attention to is that EDS issued a large convertible bond that has a forced conversion into equity, forcing people to buy the stock, I believe, at $59-and-change. My belief is that at the treasury department of EDS, they looked at this as a package: They were issuing convertible debt that was a forced conversion into equity, and they were offsetting the dilution of that with the put option strategy.

When you look at that as a package rather than just looking at the put options, I think the shareholders of EDS ended up being benefited by the overall plan.

Shareholder: So you don't think it was that big a deal, basically?

Nygren: I don't, no. It was a significant negative. But the issuance of the debt that is forced to convert into equity next year is a more significant positive than the put options were a negative. And yet it gets almost no print....

WE'RE IN THE GOTCHA ERA OF FINANCIAL JOURNALISM.
IT'S MUCH ADO ABOUT NOTHING AT AOL TIME WARNER.

AOL accounting issue is much ado about nothing.

Shareholder: Many of us have read about the investigation into AOL's accounting — and I'm worried.... Does this concern you — or is it more smoke than fire?

Nygren: As the *Washington Post* pointed out, there is an issue at AOL of between $200 and $300 million of revenues that AOL called "advertising income" which is a gray area and some people think should have been called "other income"....

I'd point out that $270 million, or whatever it is, comes to about 6¢ per AOL Time Warner share. It's not 6¢ that they invented. It's 6¢ that some people think should have been classified differently than it was. But it would have been a revenue item either way.

The idea that anyone invested in AOL or AOL Time Warner based on misinformation is preposterous. There's no way that degree of potential misstatement could have caused anyone to come to a different investment conclusion than had that revenue been booked differently.

But we're in the Watergate era of financial journalism.

Nygren: And the concern there does nothing to change our estimate of the value of the assets that are held by AOL Time Warner.... Unfortunately, we're in an environment that reminds me of the environment in politics when I was growing up, when Woodward and Bernstein broke the Watergate scandal and then every other reporter started trying to find another scandal, if not *create* one. I

(continued on next page)

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

think that's the way the media is approaching all of these additional accounting disclosures today....

[Editor's note: As evidenced by the company's flagship magazine, in the midst of the most significant geopolitical events of the past 50+ years, concluding that three whistleblowers were their most significant persons of the year.]

How I keep my perspective amidst the media hype....

Shareholder: I have a relatively easy question for you. Having been in the business the last four or five years — some of the best of times for some people and some of the worst of times for others — as far as periodicals or readings go, what are things that you would read from time to time to give you some perspective or outlooks that are not chocked full of just media hype?

Nygren: [After a long pause] That's a harder question than you thought.

Shareholder: Either magazines, books — perhaps historical books pertaining to some of the manias we've gone through — just to get back to some of the basics. What might you recommend?

Nygren: I would recommend anything written by Roger Lowenstein — any of his work about Warren Buffett, about the collapse of Long-Term Capital Management, even his monthly columns in *Smart Money*. I think Roger brings a long-term perspective to his writing that very few financial journalists do.

My favorites tend to be the books about successful investors and what they feel they learned through their lifetime of investing — whether it's the books on people like Mike Steinhardt or John Templeton, and especially anything that Warren Buffett writes. I think those things are all worth reading when you want to kind of sit back and try to regain your perspective.

WE'VE *ALWAYS* FACTORED IN OPTION DILUTION. BUT IT'S NOT SOMETHING I WORRY ABOUT MUCH.

Unreported options expense distorted, but not that much.

Shareholder: Do you think the significant increase in stock options granted over the past 25 years and the fact that most companies are not expensing these options may skew comparisons with earnings then and earnings today? Might it not be a slight apples to oranges comparison without adjusting for the impact of options?

Nygren: Academically, I don't disagree with you. It's a fact: stock options have become a higher percentage of management compensation over the last few years than they were 15 or 20 years ago....

And if you look at total stock option compensation being expensed, you're talking about a difference of 5-10%. So had the historical numbers also been charged for that, there would be *some* charge against them. It wouldn't have been quite as high. So maybe our P/E is misstated by a point or two based on that. But I just don't think that's a big enough number to get too bent out of shape over.

And we've *always* factored options into our analyses.

Nygren: And in terms of our looking at stock options on companies that we own, we've always considered the dilutive effect of options that are outstanding when we consider business value per share. And we've always, at least *qualitatively*, looked at how large the current year stock option grants are and whether or not there would have been a need for a significant amount of additional cash compensation had those options not been given.

Our largest holding — Washington Mutual — I think disclosed their EPS would've been 4¢ less on a $4-ish base had the current stock option proposal been mandated rather than voluntary. So I don't worry too much about the stock option issue.

EBITDA AND PRO FORMA ARE TOOLS. YOU JUST HAVE TO KNOW WHEN TO USE 'EM.

There's a time for everything — even pro-forma....

Shareholder: I'm really confused — because it seemed that, as of a couple of months ago, "EBITDA" and "pro-forma" were terms not to be used. They were the new dirty words. And you just used EBITDA when you were talking about cable. And Mario Gabelli was quoted in *Barron's* talking about companies that he liked in EBITDA and pro-forma terms. Would you explain why there seems to be this division amongst some on Wall Street as to whether they will or will not follow EBITDA or pro-forma?

Nygren: Well, I think like almost any other tool in trying to figure out what a business is worth, there are times that one statistic *is* appropriate to use and there are other times that it's *not* appropriate.

Think about something like pro-forma. What we're trying to do when we make a guess of a business value is to estimate the present value of the future cash flows the company is likely to achieve. And historical earnings and cash flow levels are an important guide. But lots of times there are onetime items in historical numbers that would make projections based on those numbers relatively meaningless. The idea that, occasionally, you subtract out those onetime items and look at a pro-forma number instead as a better approximator of what the company is likely to earn in the future makes a lot of sense to me.

When pro-forma's *usually* different than actual, watch out.

Nygren: That got misused over the last few years to where basically every company started reporting pro-forma numbers assuming they hadn't made some of the major mistakes that they'd made in the past year. And when a company reports pro-forma numbers different than actuals year after year after year, you have to get suspicious that the future can look anything like their pro-forma numbers — because they will continue to make mistakes.

For some companies, EBITDA is an *appropriate* metric.

Nygren: EBITDA has some similar characteristics. In some businesses, a line other than the net income line gives you a better comparison within an industry — because

(continued on next page)

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

capital structures or depreciation and amortization levels are different, based on some companies having built the assets and others having purchased them. And in the cable industry, EBITDA became a very good short cut to try to estimate how one company was priced versus another.

Unfortunately, EBITDA started to gain very broad acceptance as a way to make multiples look lower. If the P/E was 25 times and that was getting too high for some people, they'd instead say, "It's only at 11 times EBITDA" — which didn't sound quite as expensive.

But again, for some specific companies, I continue to believe that EBITDA is a very good metric for estimating business values. There are lots of other companies though where I wouldn't even *think* of using it.

I'm *not* in favor of using pro-forma or EBITDA for everyone.

Nygren: The problem with an EBITDA number is that you're looking at the value of the business based on a line on the income statement before they reinvest in the business. So if you're going to capitalize an EBITDA line, then you have to deduct expected future capital spending. And again, in the desire to support valuation levels that had gotten far beyond fundamental business values, I think people misused the EBITDA measure as just a way to make multiples look not quite so high.

So we continue to use it in selected situations, as we continue to use pro-forma in selected situations. However, we would *not* be in favor of broadly utilizing either of those concepts for all companies.

MOST FINANCIAL DEBACLES WERE AVOIDABLE.
INVESTORS JUST STOPPED DOING THEIR JOB.

A lot of the financial debacles were quite avoidable.

Shareholder: In the wake of so many accounting restatements and financial statement blowups, I heard a fund manager say, "As part of our due diligence, we've always looked for issues in financial statements." There were questions about Washington Mutual's accounting, for example. But you looked at it and were comfortable with it. I'm just curious as to whether you've reviewed your portfolio for exposure to these sorts of problems.

Nygren: I think the *real* problem is much less with the accounting statements that are being prepared by the companies than it is the fact that during the bull market, investors stopped doing financial analysis. A lot of the issues that have come up so far that have involved accounting questions have been things that, had all the work been done, the right questions would've been asked — one of the examples being a company that was reporting some of its ongoing expenses as a capital item instead of an income statement expense. [But that issue should have surfaced much earlier — because investors should have raised questions about why the company's capital expenditures were so much larger than its depreciation.]

We continue to do things the way that we *always* have.

Nygren: We're pleased at the companies' reaction to requests for increased disclosure. The data that we have is generally *more* than adequate to get a good feel for the position of the company.

We've always utilized an intensive research process based almost solely on fundamental analysis. And a big part of it has always been analyzing financial statements. Our belief has *always* been that there is not one line to look at on a financial statement that can give you the clear picture of what's going on in the company — that to get an understanding of what's going on, you need to look at all three statements: the income statement, the statement of cash flow, and the balance sheet. And you have to review them over a period of time. It's only by getting that thorough a picture of the company — in addition to reading the footnotes — that you can really extract enough information out of the financial statements to have an informed opinion about the financial position of the company.

So we continue to do things the way we *always* have — which includes extensive review of financial statements.

WE PAY ALMOST *NO* ATTENTION TO MACRO FACTORS.
OUR EXPERTISE IS IN STOCKS, NOT INTEREST RATES.

Some *always* think prices should be higher and some lower.

Shareholder: Earlier, you said that you could make a case for interest rates being higher or lower a year from now. Could you say a little more about that?

Nygren: If the economy is a lot stronger than expected, it's likely interest rates would be higher. If the economy is *not* as strong as expected, interest rates would be lower. Just like in stocks, where an earlier caller had said he was confused because some people think prices should be lower and some think they should be higher — in my judgement, that's the way it *always* is. There's always a camp that thinks prices should be lower and some that think they should be higher. That's why they are where they are — because prices have to be at kind of a midpoint level.

We don't try to outthink the bond market, just beat it.

Nygren: Likewise, if you look at the bond market, the long-term bond has to be priced similarly — where lots of bond market professionals think rates are likely to go higher and lots think they're likely to go lower.

My expertise is in stocks. The people I work with day to day have an expertise in stocks. And we prefer to take the bond rate that's the collective wisdom of those who spend all day trying to guess where bond rates belong rather than override that with our own prediction of where bond rates are likely to go.

Shareholder: So you don't make bond rate predictions, then, when you decide whether to buy or sell?

Nygren: No, we do not. We use current interest rate levels — both of government bonds and of corporate debt — as part of our decision making with the basic academic idea that to accept the risk level of an equity, you need to have the reward of an expected return that's higher than what you could get if you were higher up the balance sheet as a creditor or secured creditor of the company.

So we have never invested in an equity if we thought the equity was offering an expected return less than we could get on the bond of that same company.

(continued on next page)

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

One factor we look at — what a company's bonds yield....

Shareholder: When you use discounted cash flow to do your valuations, what kind of discount rate do you use? And have you varied it over time based on changing rates — like interest rates or borrowing rates?

Nygren: We use a *lot* of different ways to come up with our business value estimates. One is a discounted cash flow model. When we do that, we start with the idea that a typical company is going to have to borrow money. So we have to discount the cash flows at several percentage points above the long-term government bond.

In the current environment, in many cases, that was leading us to a risk premium on the equity that was not as large as we felt was appropriate given where debt of the same company was selling. So that's another thing we look at — where the bonds of each business are selling. And we want to discount the cash flows to the equityholder at a higher rate than the bonds for the same company.

For the average company today, we might use 8%.

Shareholder: Where would that take you today in terms of what discount rates you would use?

Nygren: All over the map. But I'd say for the market — for an average company in the market — we'd probably be using something like an 8% discount rate.

The interest rate cuts? Yeah, I heard about 'em.

Shareholder: Would you comment a little on the Fed's interest rate cut today [November 6th]?

Nygren: I think [pauses].... At least I'm *aware* of it. [Snickering] We pay almost *no* attention to macro factors. And I don't think the move in interest rates — which today was a 50-point reduction — does much to change the economic outlook. It certainly doesn't do anything to change our estimate of business values.

Where we do discounted cash flow analyses, we base them off *much* longer-term rates than the discount rate. So to the extent the discount rate change doesn't change the 10-year bond, it's not having an effect on our estimate of business values.

But in the world I live in, it's much ado about nothing.

Nygren: I've been a believer for probably two years that interest rates in general are low enough that most projects that are on the table for corporations that *deserve* to get done will get done — and that lower interest rates are not going to be the driver to step up capital spending for corporate America. And I continue to believe that. I just can't imagine there are things out there that are worth buying if you can finance it at 1% that aren't worth buying if you have to finance at 1-*1/2*%. So in the world I live in, it's sort of much ado about nothing....

(continued in next column)

THEY'RE USUALLY OUT OF OUR LEAGUE PRICE-WISE.
BUT RECENTLY, GOOD GROWTH COMPANIES GOT CHEAP.

Growth's usually great — if we don't have to pay for it.

Shareholder: Even in the down periods when the market was correcting, growth was probably doing as well, if not better, than value. Do you want to be more into growth versus value? Does that ever enter into your decision-making process?

Nygren: ...I kind of bristle when somebody talks about growth and value as opposing styles. I think growth is a positive characteristic in most cases. In most cases, growing companies are worth more than companies that *aren't* growing. Obviously, it can depend on how much capital it takes to create that growth. But in most cases, growth is a good thing — and growing companies deserve to sell at premiums to companies that don't grow.

We tend to get queasy projecting above-normal growth for extended periods of time long enough to justify paying significant premiums to a market multiple. We're generally much more comfortable saying the companies we're buying are average companies that deserve to sell at average multiples and buying them when they're at large discounts.

Lately, some great companies have been in the bargain bin.

Nygren: I think what's changed in the opportunity set that the market has provided us over the last year is that many above-average companies that are above-average growers have sold at unusually large discounts to the market multiple. And it has allowed us to add positions to our portfolio of companies that we very much admire, that typically are priced out of our league — selling well above 60% of value.

If you look at some of the names we've added recently — AOL, Comcast, Fannie Mae, Merck, Bristol-Myers, Echostar — it's a long list of names that two years ago would have been considered growth companies, both because of their growth rates and the valuations the market was putting on them. I think most people would *continue* to call them growth companies now. However, at below-market multiples, we think they meet the criteria of less-than-60% of value.

Most of the new opportunities are above-average growers.

Nygren: But we never have a predisposition of what percentage of our portfolio we want to have invested in companies that are above-average growers. It's just that we try to take advantage of the new opportunities that the market creates for us all the time. And today, we happen to believe that most of the *new* opportunities that are being

(continued on next page)

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

created are companies that are above-average growers.

WE SEE UNDERVALUATION IN *ALL* THE STYLE BOXES.
WHAT MIGHT MATTER MOST IS JUST BEING THERE.

Post March 2000, we actually went *up* substantially.

Shareholder: ...I would generally be surprised for a fund like Oakmark Select to go down as much as the market because you have a little valuation cushion. Was that the result of a couple of your meltdowns?

Nygren: I don't think that it really was a result of stock-specific problems. If you look back at the market since its peak in March of 2000, I think what we saw for a little over two years was people selling *over*valued equities to buy *under*valued equities. It was a rotation within the equity market. That was incredibly positive for our results. We had a portfolio of companies that we felt was very undervalued at a time when the market looked overvalued because large-cap names were so overpriced. And in that two-year period, the stock market went down substantially. We went *up* substantially.

But this year, the baby was thrown out with the bathwater.

Nygren: Starting around May of this year, the decline resumed. But I think it was much less rotation in the equity market than people selling stocks to buy bonds. And in the last five months, it really doesn't seem to have mattered much how undervalued or overvalued the names in your portfolio were. Most everything went down and the spread in return distributions was not all that broad.

So within the very short term — like the last five or six months — I don't think the valuation cushion that we would expect to be there did us much good. But if you look at a little longer time period, the valuation cushion has done *exactly* what we'd have hoped it would have done — and that is, allowed us to create very good and actually *positive* returns in a market that's been down sharply.

I'll be very pleased if we can earn double-digit returns.

Shareholder: Do you have a long-term goal for compounding in Select such as inflation-plus-10%?

Nygren: In Oakmark Select's first quarterly report, I said my long-term goal was to be among the top performing mutual funds in terms of after-tax return to shareholders — and that looking back over the prior decade, to be in the top 10% of mutual funds, you needed to outperform the market by something like 2% per year.

Looking forward today, the 10-year bond returns something like 4%. Hopefully, equities will do say 3-4% better than that. And I hope that through stock selection we can do a couple of points better than that. Therefore, in a world where the government bond option is providing a 4% return, I'd be very pleased if we could compound at — ballpark — a double-digit level.

At the last market peak, it was *very* easy to find new ideas.

Shareholder: As far as finding opportunities, how does this time period now relate to periods in the past?

Nygren: Well, oddly, I think one of the easiest times for us to find opportunities was 2-1/2 years ago back when the S&P was near a peak because of the overvaluation in large-cap companies and technology names, but most traditional companies were available at *very*, very large discounts to the market multiple. You could have taken away my favorite 50 ideas in March of 2000, put in a different 50 instead, and our performance probably wouldn't have suffered all that much. So, again, while it's weird to say, the market peak was one of the easiest times we've ever had to find new ideas.

Prior to that, I think you'd probably have to go back to a time period in the very early '90s around the time that the Oakmark Fund was started. Again, that was a period where a lot of mid-cap and smaller companies were undervalued — both relative to bonds and their larger-cap peers.

We see undervaluation in *every* category....

Nygren: What's unusual about where we're at today is, if you look at *Morningstar* style boxes, I think you can find a lot of undervaluation in *all* of them. You can find it in big cap, in small cap, in above-average growers and in below-average growers. After five years of your percentage exposure to the equity asset category almost not mattering — because everything that mattered was whether you were in growth or value — I'm kind of guessing that we might be entering a period where what really matters is how much you have exposed to equities.

Leaders in the next bull market? We don't think that way.

Shareholder: Could you give us any guidance as to what sectors of the economy are likely to lead us into the next bull market when it occurs?

Nygren: I don't think I've got a strong opinion there that would be very helpful. As I had said earlier, I think some of the best *values* in the market today are in the pharmaceutical and media industries, in addition to some financials including Washington Mutual. But that thought is more based on where their current stock market value is rather than that those will be industries that will lead us into an economic recovery and a stock market rally.

We just don't think much top-down. We spend all our time at the company level thinking about how we think a business is likely to change over the next five years and, if we're right on that, how the valuation level of the company might change. So when I think about the leaders over the next five years in the next bull market, I'm thinking about the most undervalued companies and industries that are likely to get revalued over that time frame....

—OID

The excerpts which follow were selected from the prepared remarks of Bill Nygren and Henry Berghoef and their answers to attendee questions at an Oakmark Funds Breakfast which occurred December 12th in Manhattan. Incidentally, the by-invitation-only press event was an unusually intimate affair with only about six attendees (not counting our correspondent and Oakmark representatives).

(continued on next page)

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

However, one of those attending and participating was the much-admired Carol Loomis — *Fortune*'s uber-editor and assistant editor of Warren Buffett's annual letters to shareholders of Berkshire Hathaway.

We hope that you'll find their comments as valuable as we do.

SOME TREAT TIME AS THE GREATEST RISK, BUT IT ISN'T. IN FACT, IT'S THE *LOWEST* RISK.

Working to our advantage is a lack of focus on time.

Henry Berghoef: ...We really try to approach investing in as businesslike a fashion as we can. We focus on what individual companies are worth. And we want to buy them at a significant discount to what we think they're worth. The market is nice enough periodically to let you buy businesses at significant discounts to value and then, on the other hand, often to let you sell them at fair value and sometimes more.

Something Bill has said is that one of the things that works to our advantage, we think, is a focus on time — or perhaps more accurately — a *lack* of focus on time. Whenever I read analysts' reports, which I do occasionally, or listen to them, they always talk about, "Well, we think stock XYZ is dead money for the next six or nine months." And whenever I read that, I think, "Thank you very much. That might well give us another opportunity."

Time risk is really your *lowest* form of risk.

Berghoef: If you think about the panoply of risks in investment — economic risk, interest-rate risk, industry risk, management risk or time risk, etc. — Wall Street often treats time as the highest form of risk, which it *isn't*. In fact, it's just the reverse — it's really your *lowest* form of risk. If you've got the other things right, you'll be OK.

If we can achieve a double every five years, we'll be dancing.

Berghoef: It's kind of funny: Sometimes I'll say to somebody, "We think this stock can double in five years." And they'll go, "That's the *best* you can do?!" I'm thinking, "Wait a minute. That gives me a 15% annualized return."

Nygren: [Laughing] Lock it up.

Berghoef: If we can manage to do that regularly, we'll be dancing full time. So we try to take advantage of what we see as a misplaced emphasis on time in the market to give us an opportunity to buy stocks at significant discounts to intrinsic value....

And we put a lot of emphasis on free cash flow.

Berghoef: And then finally, we pay a lot of attention to management — not only how they run the business, but also how they allocate capital.

We put a lot of emphasis on cash flow — more so than stated earnings. We like to see strong free cash flow. And the fewer reinvestment opportunities internally that a company has, the stronger we'd like that free cash flow to be. So those are the three primary things that we look for....

AT TIME WARNER, THERE'S A LOT TO LIKE. AND AOL'S WORTH MORE THAN NOTHING.

AOL is really the tail there. Time Warner is the dog.

Berghoef: One company that we've bought significant amounts of — and one that's near and dear to *your* heart, Carol — is AOL Time Warner.

Carol Loomis: That was certainly going to be my first question — to ask you about that. [She laughs.]

Berghoef: It's just amazing. Every day there's another headline about AOL Time Warner. I mean, it's like *The Wall Street Journal* and *The New York Times* have become the local gossip sheets when it comes to that company. And what continues to amaze us is about the only thing they ever talk about is the AOL segment. But AOL is really the tail there — it's not the dog.

And that's not what we're focusing on. In fact, we're waiting for them to change the name so we don't have to say "AOL Time Warner" anymore. I'm sure it'll happen.

This stock was what, $60, a few years ago? And I don't know what it was after the merger — maybe $70? Well, it went all the way down to $8.70 recently.

What we like most about AOL Time Warner is the traditional Time Warner businesses. There's the networks — from HBO to Turner to Warner Brothers. The cable systems are almost as important as the networks. And then you've also got the music business — where they're having a lot of problems right now due to piracy. But I have a feeling they may be able to figure that out technology-wise. And then there's the publishing business — which is also still a terrific business.

And when we put a value on each of those segments and add it up, we think the value of the non-AOL segments is something approaching $20.

Incredibly, we think AOL will be worth more than nothing.

Berghoef: What is AOL worth? We don't really know. And most people these days seem to be very skeptical that it might ever be worth anything. And I don't know *what* it's going to be worth. But my gut says it's going to end up being worth more than people now are giving it credit for....

We're not figuring on it. We don't need it. But the point is that we've got a call there on something good that might happen — and we're not really paying for it.

Nygren: We do think it's *ridiculous* to think a business like AOL with something like 25 million subscribers paying close to $20 a month, the strongest brand name in the industry and positive cash flow generation, is actually worth zero. That seems silly to us.

I'm not worried about the debt. The company can handle it.

Loomis: How about the very large load of debt? Does that worry you?

Berghoef: It doesn't really worry me — because the company can handle it. I expect to see some asset sales. [CEO] Dick Parsons pretty much has said as much. He'll

(continued on next page)

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

probably raise a few billion from asset sales. The company has *very* strong free cash flow. And they should be able to pay down debt over time. I'd like to see it lower. But I'm not really worried about them being able to handle it.

Nygren: I think the debt level there is pretty traditional for the cable TV industry. Cable service providers tend to have very high debt levels. So if you look at that piece of it, it doesn't look that out of line.

We like the people and the businesses....

Loomis: And it sounds like you think Parsons is a pretty good guy?

Berghoef: What I've seen him do overall, I like. However, I should ask *you*.

Loomis: [She laughs].

Berghoef: But we do give Parsons credit for hiring [Don] Logan and [Jeffrey] Bewkes.

[Editor's note: Jeffrey L. Bewkes is Chairman of the Entertainment & Networks Group, and Don Logan is Chairman of the Media & Communications Group.]

Loomis: I absolutely think that those two guys are really *good*.

Berghoef: I'm glad to hear that.

Loomis: That's a great thing that he's [done]. I know Logan *very* well — and he's *good*! And I don't know Bewkes. But I do know that his reputation is excellent.

Berghoef: Agreed.

Nygren: And our small-cap manager, Jim Benson, worked under Dick at Dime Savings Bank. And Jim was assistant to the chairman there. So he knew Dick very well and spoke *extremely* highly of him [in terms of] ethics, business acumen — all of the things we care about most.

Berghoef: He's sort of a plain speaker from what I've heard. I heard him speak the day before yesterday at a conference here. And he's kind of saying, "Folks, forget all this other stuff. Let's just get down to business. Let's run this thing. Let's take care of the debt levels. Let's *fix* AOL."

And he brought in Jon Miller as chairman and CEO — who looks like a pretty good choice there. So we're optimistic about how the management team is shaping up.

Plus, they've got a *well* above average group of businesses ... which is a nice thing to have — and pretty darn good *growth* rates. So we're pretty happy with that.

It pays to be flexible....

Berghoef: And I think that's a good example too, of what Bill was talking about [in terms of] our flexibility. We'll go to different areas of the market — wherever the values are. Three years ago, we wouldn't have touched AOL Time Warner with a 10-foot pole. But it's come *way* down — *way* down. And we try to be as agnostic as we can when we look at these things. Rather than thinking about the merger per se or what the price was three years ago, we just try to go in and say, "What is this thing worth now? And what is the asking price in the market?" And if those are in our favor, we'll try to take advantage of it....

Wait until it's more obvious? To us, that's silly.

Berghoef: By the way, on AOL, there's an issue of time, too. Everyone says, "Let's wait six or nine months 'til we get a better view on how the AOL segment's going to work out." To us, that's silly. There's no reason to do that.

[Editor's note: They're not the only ones who've backed up the truck. In the third quarter, *Portfolio Reports* estimates AOL Time Warner was not only Oakmark Select's largest purchase, but the third largest purchase in the Clipper Fund, sixth largest for GAMCO Investors and the largest for Oak Value Capital Mgm't. Smaller positions were also reportedly taken by Loews Corp. and Duquesne Capital Management.]

TOYS "R" US' TURNAROUND SLOWED BY 9/11.
— AND AN ADVERTISING SNAFU DIDN'T HELP.

Toys "R" Us can finally tout its new format nationally....

OID: How far along is Toys "R" Us in the process of revamping their stores?

Nygren: At least in their NFL markets — the major city markets — they're done. And that's allowing them to do national advertising about their new store format for the first time. However, I'm not certain on whether every one of the smaller markets has been done at this point or not. But if they're not completely done, they're close to it.

Last year they were ready to do a national advertising campaign focused on the opening of the Toys "R" Us store in Time's Square. And it was this thing of Geoffrey the Giraffe running down Broadway with lots of loud noise. However, after 9/11, they felt that it was too scary for kids. So they pulled the campaign. And they basically weren't able to advertise the changes they'd put in place in the way they expected to. So that slowed them down. However, I don't think that's changed the likelihood of success.

And 9/11 didn't help.

Nygren: They expected 10 million visitors a year past the Time's Square store. But with New York tourism down last year, the amount of traffic past the store just isn't what they expected it would be.

It hasn't affected their sales numbers. The store's above plan in sales and profitability. But [with the lower than expected] number of visitors — who then go back to their home markets and say, "Wow, Toys "R" Us has really changed. You've got to go check out the local store. The coolest store I've ever been in was the Toys "R" Us Time's Square store." — the word of mouth just hasn't been quite as powerful as they'd hoped because there haven't been as many impressions.

CAN A SPECIALTY RETAILER SUCCEED IN TOYS?
OUR BET IS THAT THE ANSWER TO THAT IS YES.

Can a specialty retailer succeed in toys? We think so.

OID: Following the upgrade, has the competitive threat

(continued on next page)

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

from Wal-Mart proven to be more or less of a factor than you thought it would be two years ago?

Nygren: The whole issue for the toy industry is the fact that Wal-Mart and Target can undercut just about everybody else on price. And the question is do the same characteristics that attract people to specialty stores rather than discount stores in other industries also apply to the toy industry? We believe that they *do*. However, to date, we haven't seen a good example of somebody operating a toy specialty chain well since Toys "R" Us a decade ago.

Toys "R" Us brought discount retailing to the toy industry. When they started out, most toy sales were in department stores or small specialty stores — and I mean *really* small stores — a couple thousand square foot stores, almost hobby shops. So Toys "R" Us was the one who originally brought discounting to the industry.

But to compete, Toys "R" Us ceased being a specialty store.

Nygren: But as Wal-Mart, Target, Kmart, etc. grew, they were able to take advantage of the fact that they could increase the square footage they gave to toys at Christmas time and then scale it back the rest of the year. Also the advantage of the size that they had meant that they could acquire products in *all* industries — including toys — more cheaply than their competitors could.

So Toys "R" Us fought the battle for years of: "Can we out-Wal-Mart Wal-Mart? We'll try and make people more efficient, we'll cut whatever corners we can, we'll narrow our assortments, etc."

In the process, they took away all the reasons why you might possibly want to go to a toy specialty store: There was no service in a Toys "R" Us store, they were dirty, they were out of stock on product — and they were carrying the same things that the Wal-Marts and Targets carried.

We think Toys "R" Us will recover with the economy....

Nygren: And when John Eyler came a couple of years ago, he put the brakes on that completely and said, "Wait a minute. If we're going to succeed, we've got to give people a reason to want to be in our stores. And we can't win the price battle. We can come *close* to them in pricing. And that ought to be good enough *if* we provide the customer with better service, have more depth of product, and generally have a more entertaining shopping experience." And I think they're accomplishing that.

But as we've seen ... in a lot of other specialty stores, when times get tough, it's very good for the discounters because people trade down. And I think we're seeing that occurring within the toy industry despite what Toys "R" Us has been doing.

What we don't know yet is when the economy recovers whether or not Toys "R" Us will recover the same way the other speciality stores do. Our bet is that the answer to that is "yes".

But even if it doesn't, we should *still* be fine.

Nygren: But even if we're wrong, one of the things we like about the Toys "R" Us story is that Babies "R" Us has done so remarkably well. They continue to grow their same store sales at about 10% a year. They provide an incredibly convenient shopping experience for people shopping for baby merchandise. And we think on its own, Babies "R" Us would come awfully close to getting you the current market value of Toys "R" Us.

That's something you'll hear us talk about frequently when we talk about our ideas. We think about what we believe is the *likely* case. But then we also think about what happens if we're wrong? How badly do we get hurt?

You heard Henry talking about that with AOL — that if AOL ends up worthless, we think the media assets alone are worth more than the current stock price of AOL. So if they can't succeed with the toy turnaround, we think our downside is covered by Babies "R" Us and the real estate.

PEOPLE JUST LOSE PATIENCE IN TURNAROUNDS.
WE DON'T *EXPECT* IMMEDIATE GRATIFICATION.

Toys "R" Us' shopping environment is *so* different today.

Nygren: I took another walk through the Toys "R" Us Time's Square store yesterday. And you might ask — and it's a reasonable question — what can you possibly learn from walking through a Toys "R" Us store? Well, it was crowded. That's a blinding glimpse of the obvious — that two weeks before Christmas it was crowded.

Berghoef: Thank goodness.

Nygren: However, if you've got memories of being in Toys "R" Us stores two or three years ago before Christmas, they looked like war zones. And while I was in this store yesterday, I must've had four different people come up and ask me if they could help me find something. The store was clean. All the cashiers had lines, but they weren't unmanageable. I can't imagine that any of them were long enough that somebody put a product back on the shelf that they wanted to purchase. The shopping environment is *so* different than it used to be.

TOY is making progress even in *this* environment....

Nygren: The whole story of why we own Toys "R" Us is we think there's room for someone who doesn't have the absolute lowest prices to sell a better shopping experience with reasonable prices. In a stronger economy, we think that we'll see *very* significant earnings progress for this company. Yet even in what's still kind of a subpar year for them, the stock's at about 12 times earnings.

That's what we're hoping to learn when we get out of the office and go visit our managements or the properties that they have. It's [our way of asking], "What is changing long term? And how does that change the odds of the business becoming what we expect it to be looking out three to five years from now?"

We'll see shortly if Eyler's model works. I think it will.

Nygren: People always lose patience in turnarounds. It's one of the reasons we end up owning so many of them. If you talk to a CEO who does turnarounds, he'll tell you that it'll take five years to accomplish it. It takes a year or two to put the people in place. It takes a year or two to figure out what they need to change and to change it. And it takes another year or two to get the results from those changes. It doesn't happen at the snap of the fingers even

(continued on next page)

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

though that's the way Wall Street wants it to happen.

Toys "R" Us is in year three of their turnaround now. The key people have all been replaced that John thought needed replacing. The facilities have basically been changed to the model that he wants. The merchandise has been changed. The last piece of the puzzle, I believe, is customers understanding the change that's happened, and a reasonably strong economy.

Hopefully, in another year, we'll see both of those pieces — and we'll see if the model that he's put in place is a workable one or not. I happen to believe that it *is*.

We think it's just a question of time frame.

Nygren: Toys "R" Us is a good example. You've got Wall Street analysts saying, "This turnaround obviously isn't working the way that had been expected." But I think it's a question of time frame. Like Henry said, the time frame that most analysts have is so short. And maybe that makes sense on a *career* basis for them rather than an *investment* basis — because they don't feel like they have the luxury of appearing wrong for a year.

But that's what we *live* off of. We don't *expect* our stocks to work the minute we put them in the portfolio.

YES, JANUS DID TEMPORARILY LOSE ITS WAY. BUT NOW, THEY'RE GOING BACK TO THEIR ROOTS.

Stilwell's stock is down 75-80% since the peak in 2000.

Attendee: Do you guys still like Stilwell?

Nygren: Yes.

Attendee: What's attractive about it?

Nygren: Stilwell basically has two significant assets: First and most important is the Janus family of funds. Second, they own a large minority interest (something around 30% I think) of DST, the mutual fund processor. At market, that's about $4 a share.

Stilwell sells at maybe $14-ish. So you're paying about $10 for the money management part of the business. By comparison, at the peak — back in 2000 — the stock sold in the $50s.

Janus got away from its roots....

Nygren: Their assets came down dramatically. Janus was featured in some national business magazines as the fund family of the next century — or the fund family of the '90s. And they got away a little bit from their roots of being fundamentally-based growth investors — and went more to this style of if you identified truly superior companies, it didn't matter what you paid for them.

We think they've made a move back toward their roots of being a strong, research-based fundamental growth shop.

At Janus, there's a lot to like. We don't worry about a run.

Nygren: And we admire them as competitors. If you look at almost any *non*-investment-related area of running a mutual fund company, we think Stilwell does it exceptionally well. Their customer communications are good. The way they've diversified their distribution channels gives them more stability in assets. And the stock's only gotten down to this *very* low multiple because people are afraid that at some point, there's likely to be a massive outflow from the Janus family. We don't see that as a strong likelihood — at least one that would be large enough that it'd eliminate the discount that we see today.

A higher market would mean higher earnings for Stilwell....

Nygren: Secondarily, I'd say that with the increase in the market since early October, Stilwell is about the only company where we've had to go back and make significant *upward* revisions in our earnings estimates. The earnings are directly tied to the stock market. And as the market has rallied, the likelihood is much higher that their earnings will go up — whereas with most of our companies, the move that we've seen since October has been a change in *valuation* level. The market increase actually increases the business value at Stilwell.

PORTFOLIO REPORTS estimates the following were Oakmark Select Fund's largest equity purchases during the 3 months ended 9/30/02:

1. AOL TIME WARNER INC
2. STILWELL FINL INC
3. KROGER CO
4. TOYS R US INC
5. FIRST DATA CORP
6. SPRINT CORP

We think, in the end, it ought to sell at a premium to other money management companies. And currently, it's at quite a large discount. They've just got a stronger franchise than most of the other public money managers.

People think it's ironic that we own a growth manager....

Attendee: And how do you like the idea of folding Berger into Janus — and the whole reorganization that they unveiled?

Nygren: I think it makes business sense. Berger was *so* small anyway... One way we often looks at things is, "How important would it be if it *doesn't* work?" And if they were to lose a lot of the Berger assets, it really wouldn't change our business valuation at all.

If it's successful and you can create a more value-oriented side of Janus — [laughing] not that we really *want* them to be successful at that — but that would be a significant positive for Stilwell.

People think it's ironic — we kind of epitomize the value investor in mutual funds and they epitomize the growth investor. And they find it ironic that we would own stock in their company. But we certainly don't think our method of investing is the only successful way to invest.

And the *odd* thing is that our portfolios are converging now. If you had looked at the top 20 holdings of Janus and Oakmark three years ago, I don't think there would've been one name that overlapped. Now you get a *handful* of 'em.

(continued on next page)

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

DESPITE THE EVER PRESENT POLITICAL PRESSURES, DRUG INDUSTRY SHOULD REMAIN VERY STRONG.

An above-average industry at a below-average price....

Nygren: We talked earlier about how we think the set of opportunities the market is providing today is changing. A lot of the names that are getting to attractive prices seem to be larger-cap names that were selling at prices that we thought were *way*, way too high a couple of years ago — and have come down now to below-market multiples.

I think *all* of our healthcare names fit that characterization. The healthcare industry — certainly historically — has been an above-average growth industry. And it's traded at better than average multiples because it's had stronger than average growth, stronger than average cash flow generation and better than average predictability.

We think it's just a matter of time.

Nygren: But as concerns have come up recently on the political side, a lot of the pharmaceutical companies have gotten to below-average multiples. Guidant is another great example of a company that used to be in growth portfolios that now has more value-like pricing.

But we think it's only a matter of time until these companies get back to premium valuations to the market.

Despite the politics, industry should continue to be strong.

Berghoef: The drug industry has relied a lot on price increases over the last two or three years — and we think those days are over. But when you look at what's going on with the population, there's going to be very, very strong volume growth in the pharmaceutical industry.

The other thing is that the pipelines of late have been fairly dry in the industry. But if you look historically, new drug discovery has not been a straight line. It's been more of an undulating line with a generally upward slope. And we think at some point, there's going to be a breakthrough of *lots* of new drugs. And a lot of that's going to be driven by gene engineering and those kinds of technologies.

So fundamentally, despite the political pressures, we think the industry broadly should continue to be a very strong one.

Industry's always succeeded despite the political outcry.

Nygren: I think that the attacks on the pharmaceutical companies are generally misplaced. The economics of pharmaceutical pricing suggests that it's more effective than almost any other method of healthcare. So I think any answer to slowing the rising rate of healthcare expenditures has to include better use of pharmaceuticals.

It's a hot button politically because most people's insurance plans don't cover pharmaceuticals as well as they do hospital stays. If you had people paying for half of their hospital stay rather than half of their prescription drug refill, they'd be complaining about hospital prices. But the insurance company covers *all* of that, and then makes the individual pay much *more* on what is the most cost-effective treatment. It's kind of backwards. However, I think that's why the politicians make such an issue out of it — because that's what their constituents complain about.

This has happened a couple of other times including when Hillary Clinton had her healthcare reform plans in front of Congress. The industry's always succeeded despite the political outcry. And that's our expectation again.

A FANTASTIC BUSINESS IN THE MIDST OF CONTROVERSY — WE'RE VERY HAPPY TO OWN GUIDANT TODAY.

Cardiac rhythm management is very much an oligopoly.

Attendee: Could you tell us about some of your healthcare holdings?

Berghoef: Oakmark owns Guidant — which is a device company. They have two segments: The first is cardiac rhythm management — which would include implantable defibrillators and pacemakers among a few other things. And that's a fantastic business. The second, and controversial, part of their business is stents — which are the things you use to clear clogged arteries.

The first business, cardiac rhythm management, is a participant in an industry that's very much an oligopoly. You just don't go out, invent a pacemaker — or an ICD, a cardiac defibrillator — and start putting it in people. The players are Guidant, Medtronic and St. Jude. And they have different market shares in different specific items. But they're all very solidly entrenched.

The industry is *extremely* profitable and growing *very* fast.

Berghoef: Furthermore, the industry is showing *tremendous* rates of growth. I don't know if you've followed it at all, but there have been several studies that came out within the last year that show these kinds of instruments as being more and more beneficial for more and more different kinds of indications. For example, heart failure is a very big new indication today. So the growth rate for these devices is very, very strong — strong double-digit.

And they're *extremely* profitable. So we're very happy about that with Guidant.

Guidant's locked out of U.S. stent business temporarily....

Berghoef: In the stent business, what's happening is that coated stents are coming along. They're *much* better than bare metal stents. There Guidant has had a problem — and that is that they haven't had legal access to a coating that they can use. So for the time being — at least in the U.S. — they're shut out of the coated stent market.

We think they *will* get into the coated stent market, but we're not exactly sure when that'll be. It might be toward the end of '04 or even '05 before they get there. But regardless, we think that that stent business has value.

And we're getting the stent business for free.

Berghoef: And as we look at that company right now, we think that the cardiac rhythm management business is worth at least the current stock price. So while we don't know exactly how the stent business is going to work out, we're confident that it has value.

Another interesting thing (I don't want to get into too

(continued on next page)

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

many technical details) is that they have a new bare metal stent coming out. It's actually made of cobalt. And it looks like that could be very promising. And it might work for a certain class of patients on whom they don't want to use the coated stent for some reason.

We think it's selling at a significant discount to value.

Berghoef: Guidant has a very high intrinsic growth rate — at least in its cardiac rhythm management division. It generates a *tremendous* amount of free cash flow and [it has] a *very* strong balance sheet. And overall, we think it's selling at a significant discount to value.

Finally, we wouldn't rule out the possibility it could be an acquisition candidate here at some point. We're not figuring on that. And I wouldn't run that up the flagpole — I wouldn't tout that possibility. But it could happen.

So here's an example of a business that you'd never think of as a traditional "value" company. But because of the controversy around coated stents, there was an opportunity for us to buy it. And we're very happy to own that business.

Today, six of our 50-55 names are in the healthcare area.

Nygren: In addition to Guidant, we own Merck, Bristol-Myers, Schering-Plough and Abbott Labs. Am I missing anything in healthcare?

Berghoef: Chiron.

Nygren: Chiron — that's a biotechnology company. So six of the 50-55 names that we own are in the healthcare area.

Attendee: And those are fairly recent buys?

Nygren: We've owned Chiron for a couple of years. They had some company specific issues that we think they've overcome with new management. Of the other names, Guidant was the first we started buying — because 18 months ago, its stock went through a disappointment and the price fell way down. So that's when we got into it. The other names we went into pretty much over the course of the last year — kind of one a quarter has gotten down to the price level that we wanted to buy it at.

WHY NOT PFIZER? IT WAS JUST A MATTER OF PRICE.
TENET? HEALTHCARE SERVICE ISN'T OUR CUP OF TEA.

Pfizer just never got cheap enough for us.

Loomis: Why haven't you bought Pfizer?

Berghoef: It's really been more of a price issue on that one. We've been interested in owning it, but haven't been willing to pay the price.

Nygren: While Pfizer's a great company, we haven't believed that it deserved as much of a multiple premium as it now has over the others we own.

And healthcare service companies tend to live on the edge.

Loomis: And Tenet?... [After a long pause, Nygren and Berghoef look at each other and crack up]. I heard [Legg Mason's] Bill Miller say yesterday that he was buying Tenet. That's why I ask.

Nygren: I saw that. And I've got a lot of respect for Bill. It's just that I've tended to have a bias against the healthcare service companies — because being successful in that business has tended to mean living on the edge of the regulations. And I think that it's hard as an outsider to make an effective judgement of how close to the edges the various companies are playing.

Plus, you can go from prosperity to famine in a hurry.

Berghoef: They're also very dependent on lots of arcane and complicated Medicare and other governmental reimbursement rules. And those things can change in ways that you can't always anticipate.

Nygren: And they change after the fact.

Berghoef: That's right. And [in terms of] margins, you can go from prosperity to famine in a hurry in that industry. And I personally don't have a great deal of confidence in my ability to forecast exactly how all of that's going to play out.

A RARE OPPORTUNITY TO BUY A GREAT BUSINESS
AT A SIGNIFICANT DISCOUNT TO THE MARKET P/E.

A great company that's broke — "only" growing 15%/year.

Loomis: How about Home Depot where you *do* agree with Bill Miller. He's been buying Home Depot. What do you think about it?

Nygren: I think Home Depot is a *great* company — one of the few companies you can read a research report on that talks about growth being "only" 15% and what they can do to fix it.

Lowe's has done better recently. But there's room for both.

Nygren: The concern with Home Depot, I think, is twofold: One concern is over a housing bubble, which has kind of affected everything in the home space — whether you're talking about mortgage lenders, building products companies, homebuilders or home improvement stores.

We think the market is big enough for both....

Nygren: And the second concern is the success that Lowe's has had. But both companies are dominant within their category. And both have a *very* strong history of growth and *very* strong franchises.

And I think that the market is certainly big enough for both companies to be successful — especially since they're pursuing different courses and going for very different segments. Home Depot is going for the price-sensitive individual and the professional, whereas Lowe's is going more the speciality store route — in effect, saying: "We want a better assortment, a better display and a better shopping experience."

Lowe's has done better recently. Their comps are stronger. But part of that may be that Home Depot was expanding too fast. We'll see over the next couple of years — because they're slowing down their expansion.

But we think they're *both* excellent operators. It's just

(continued on next page)

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

that there's a certain kind of customer who prefers a Lowe's store to a Home Depot store, just as there are customers who prefer a Home Depot to a Lowe's. And much like Target and Wal-Mart seem to attract different types of customers — and both continue to be extremely successful — we believe Home Depot and Lowe's will coexist with their differences.

Even if it's not the same company, 75% of the market P/E!?

Nygren: It's *possible* that it's not the company it was three to five years ago. We actually think it *is* still the company it was three to five years ago. But even if it's not, there's a lot of room between growing 30% per year and selling at 50 times earnings and growing so slowly that you justify selling at 75% of the market multiple.

Home Depot, on almost *anybody*'s projections, continues to grow substantially faster than the S&P 500. And it's got a P/E multiple now that's substantially *below* the S&P 500. Home Depot is selling at something around 14 times estimated earnings for next year in a market that's at almost 19 or 20 times. We believe that Home Depot deserves a premium. And we think the results that they'll achieve during the next couple of years are likely to demonstrate that. We think it's a rare opportunity to buy such a great business on the terms we like to buy stocks.

Some are uncomfortable with their new focus on cost....

Nygren: There's been a management change that has concerned investors. Bob Nardelli came over from G.E. Bob's focus is more, as is typical at G.E., on figuring out how to use their size advantage to better their cost position. And investors aren't as comfortable paying for growth that comes from cost savings as they are for growth that comes from top line growth. But we think they have equivalent value to the investor.

And finally, there's the opportunity for a cap shrink.

Nygren: The other part of the Home Depot plan is that with slower store expansion — so that they don't cannibalize their existing stores quite as much as they were doing — for the first time in a long time, they will be significant excess cash flow generators. And with the stock at this price, they've got an opportunity to shrink their capitalization at below fair value — which is obviously good for all the rest of us who own stock.

SOME EXPECT GROCERS TO BE KMART REVISITED, BUT THEY'RE MISSING IMPORTANT DIFFERENCES.

Some think the operative model is Wal-Mart versus Kmart.

OID: I think you own both Kroger and Safeway. Any thoughts on supermarkets vis-a-vis tough times?

Nygren: Of course, Wal-Mart is coming into the supermarket industry. And they're utilizing the same kind of cost advantages that they had in the discount business in the supermarket industry. It's making it *very* difficult for the independent grocery store today — like it wasn't difficult enough already with both Safeway and Kroger going after their customers.

OID: And you haven't mentioned deflation.

Nygren: I'm not as worried about that. I don't see that as a long-term structural threat. There is some trading down. There is some food deflation. However, in a normal economy, I think that comes back.

But there's a school of thought on the supermarkets that says if you want to see where the industry is going over the next decade, look back a decade at Wal-Mart versus Kmart.

Wal-Mart doesn't have the information advantage it did....

OID: It sounds like you disagree.

Nygren: I do. I think the *most* important difference between the outlook for the supermarkets today and the results for Kmart over the past decade is that Kroger and Safeway already have a culture of cost control and a focus on being cost-minimizers. They already have state-of-the-art computer systems. Shortly after I first got in the business, I remember vendors coming in who dealt with both Kmart and Wal-Mart — and Sears for that matter — saying, "It's unbelievable the information that Wal-Mart has access to at their fingertips compared to what's available to Kmart or Sears." Well, you don't see that kind of advantage for Wal-Mart versus Kroger and Safeway.

And not everybody wants to buy the low-price spread.

Nygren: I think the other thing investors are ignoring is that in markets where Wal-Mart supercenters have been for a long time, they tend to peak out at a market share of somewhere in the 20%s. I think that just says that there's a certain segment of the population who is interested in the most price-sensitive shopping experience that they can achieve. All they care about is lowest cost. And there is another segment that is willing to pay a fair price, but a bit *higher* price, for a more pleasant shopping experience. And I think the Safeways and Krogers provide just that.

They give you better breadth of product, probably a cleaner shopping experience — and you can ask the butcher to cut a piece of meat for you if you're not happy with the selection you see on display. Well, that's a service level you don't get in a Wal-Mart supercenter.

So at less than half the market P/E, we see opportunity.

Nygren: So with these stocks at single-digit P/Es and less than half the market P/E — and both *very* focused on how they reinvest their excess cash with significant share repurchase programs underway — we think it's an opportunity to take advantage of a misperception.

WE THINK FON'S ASSETS ARE WORTH MORE — *SUBSTANTIALLY* MORE — THAN TODAY'S PRICE.

Local phone assets significantly exceed today's stock price.

OID: What's your rationale with Sprint?

Nygren: Basically, the Sprint story is kind of like the AOL story. AOL only accounts for 15% of the cash flow, but it seems to get more like 80% of the attention. The long distance business at Sprint represents a *very* small percentage of their cash flow, and yet there are still a lot of people who are unaware of what a large local phone company Sprint is. We think Sprint's local phone assets

(continued on next page)

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

are worth more — *substantially* more — than where the stock is currently selling.

If they can turn things around in the long distance business and make that more valuable, that's a bonus.

One risk: If PCS fails, FON pays the price.

Nygren: There are concerns that Sprint utilizes a tracking stock structure: We own the traditional phone assets — FON. And then there's PCS — the cellular phone business — which is a highly-levered business. PCS has performed *very* poorly over the last year, as has the entire wireless sector. Its stock price used to be in the $40s or $50s — and I think it's now down around $5 a share.

And there are some concerns in the market that the assets on PCS may not be worth more than their debt. If that's the case, there's potential for some of that debt to back up on us as FON shareholders. So if Sprint PCS can't meet its financial obligations, then the other piece of the tracking structure would have to absorb them.

But not only is that unlikely, it wouldn't be so bad.

Nygren: Our belief is that Sprint PCS is worth more than its debt and that it's an unlikely, although not impossible, outcome that FON will have to reabsorb PCS and take that debt onto their balance sheet. So we've done some modeling of that. And at very conservative valuations for cellular subscribers, we believe the worst case outcome is that the discount that we believe we're buying FON at winds up getting eliminated.

But we *don't* see an outcome where it destroys the value to the point where it's below the current stock price. Again, that's a scenario people are really worried about. But I think it's unlikely....

YUM IS CHEAPER THAN MCDONALD'S — AND WE LIKE ITS PROSPECTS BETTER, TOO.

There are things that we like at McDonald's....

OID: Any quick thoughts on McDonald's? I see that it's in the big fund, not Select. So I'm guessing that you like Yum Brands a little better?

Nygren: We like the new management at McDonald's and think it's a great global franchise. And to be able to buy it at the discount to the market that it's currently at we think is attractive.

OID: So you took the management change at McDonald's as a positive?

Nygren: As a positive, yes.

But here's why we like Yum Brands better....

Nygren: But the reason why I like Yum Brands better than McDonald's is largely because its multiple is lower and their international growth prospects are better — largely because they're behind McDonald's in saturating non-U.S. markets. I also like the variety of the food that they have at Yum as compared to the concentration in burgers that you have with McDonald's.

WHAT HAPPENED WITH EDS? WE *BLEW* IT. HOWEVER, IT'S BEEN TOO CHEAP TO SELL.

When we bought EDS, we thought it deserved a high P/E.

Loomis: Could you say a few words about EDS?

Nygren: We *blew* it. [He chuckles.] We bought EDS a couple of years ago thinking that ... with it growing 15% a year with almost no variability around that number — and the consistency that their long-term contracts could provide to that earnings stream — it would be deserving of a significant premium multiple. In round numbers, we thought within a couple of years, they could earn $3.50 and that a P/E of 30 wasn't ridiculous. So we were targeting the stock to be worth $100+ a share.

Was that a truck that just hit me or an earnings release?

Nygren: In the third quarter in late August, EDS' management went on the road to talk to their large investors and tell us "business is great and we're still comfortable with the numbers that we've previously guided you toward". And then out of the blue about three weeks later, they came out with a press release saying, "We're going to have to cut the current quarter number by 40%."

Any time a company has that big a change in their forecast, you're kind of left with three options — none of which are real comforting as an investor. Maybe management didn't know. Well, that's not good. That they truly could be that far off on what they were going to earn with only a couple of weeks left to go in the quarter...

Maybe they *did* know — and they told us otherwise. Well, I don't know if that's worse, but it's not good either. And the third possibility is maybe the business model is a worse model than we thought it was.

And what caused the disaster? A combination of things....

Nygren: Having had a couple of months to reflect on EDS, I think it's a combination of all three. Management had probably seen a very slight decline in their business that they had hoped would reverse. Instead it got worse. And the industry really *did* fall of a cliff in that last month of the quarter. So EDS was certainly not alone. Many of the other MIS [Management Information System] consulting and outsourcing firms had very similar problems in the last month of the quarter....

And I think they did *not* have everything at their fingertips that people in the field knew. So they need to improve their reporting systems to get a better information flow.

Most important of all, we didn't understand their business.

Nygren: However, the *biggest* problem is that we'd felt that the strong base of long-term contracts EDS had would almost guarantee that they enjoy consistently rising earnings. The problem was we were unaware of how much of its profitability came from add-ons to those contracts. What do I mean by that? Well, basically, EDS accepts a significantly below-average margin on its base business. But once their people are in your shop, you find other things that you'd like them to do. And their profit margin

(continued on next page)

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

is extremely high on that add-on business — because they don't need more bodies to take care of it.

It's kind of like when you build a house. You might have a base rate that looks very reasonable. But once you start making changes, they get a much higher margin on those changes than they do on the original proposal. And those are extremely profitable for the builder because the people are there anyway.

So we misunderstood the importance of their add-on business and how much of their profitability comes from the less predictable part of their business.

We have less confidence in EDS, but it's too cheap to sell.

Nygren: So instead of thinking EDS could be earning \$3.00-3.50, we're thinking of it as earning \$2. Instead of thinking it deserves a premium P/E, we believe it deserves a discount multiple. And we have less confidence today that management's as high quality and as shareholder-aligned as we previously thought.

After the announcement, the stock opened up at \$22, down from \$34 — and we started to sell. I compounded the mistake by asking our traders to go slowly because I felt the stock was overreacting. Two days later it was at \$10. We stopped selling when it broke through \$20. And despite all the disappointment and frustration, I just didn't feel like we'd be doing our shareholders any kind of favor by selling the stock at 5 times earnings. It just seemed like *way*, way too cheap a price.

[Editor's note: The folks at Tweedy, Browne say something similar in their September 30th report: "With [EDS] now selling at 5 times last year's earnings, we think a sale would only be saving us the embarrassment of why we bought it in the first place."]

When one of our holdings goes down, we usually buy more.

Nygren: On the other hand, uncharacteristically for us, I didn't have the confidence to *add* to the position. Normally when something falls like that, our normal mode of operation is to restore it to a normal position size — or sell it. We don't usually allow much room for that middle ground of keeping the position the same size it was even though it's become a smaller weighting. But in this case, the questions about trying to understand what was going on with the management kept me from being comfortable adding to it.

If we can't reestablish our confidence, EDS will be sold.

Nygren: And that's kind of still where we are on the position. It's still a below-average position. It's gotten closer to that \$20 price that we think is more appropriate. And we're still trying to develop — or perhaps I should say restore — our confidence in both the business model and the people to have us comfortable owning the stock if it were to get back into the \$20s. However, should we fail at that, the stock will be sold.

EDS is pursuing short-term contracts for a reason....

Loomis: They announced the other day that they were going to go more for short-term contracts that have produced quick cash flow rather than long-term. Do you have any feeling about that?

Nygren: I think in the past, the longer-term contracts that had the larger cash outflow at the beginning made some sense for EDS — because their cost of borrowing was often less than the cost of borrowing for their customers. That's no longer true with the cloud over EDS today. In most cases, their cost of borrowing is *higher* than it is for their customer. So I think it's just following the economics that it makes sense for them to pull away from those front-end-loaded contracts.

EDS is restoring its credibility a little bit at a time....

Nygren: I think the announcement yesterday — where the stock was up \$1.80 on a \$17 stock — shows how skeptical the market had become. Basically they announced that they had been "down-selected" — where a certain number of bidders gets cut to a smaller number of bidders — for a seven-year Bank of America contract which I think would represent \$300 million a year in revenues. And the stock was up in market cap something like \$400 million yesterday on that announcement.

But even if they had been *awarded* it, as opposed to just being in a smaller group of survivors, I have a hard time believing that contract is worth \$400 million.

I think that shows the skepticism that had been out there, and that people are reading much more into that down selection than just that specific contract — that it's kind of restoring some credibility to EDS that has been lost by the way management handled the disappointment.

Will its chairman/CEO survive? I don't know.

Loomis: Do you think [Chairman/CEO] Dick Brown can survive all this?

Nygren: I don't know. [Long pause.] One of the reasons we bought EDS (and we bought it before Dick was named CEO) was that we felt it had been mismanaged, the search committee was in place for a new CEO and we liked the structure of the search committee. We thought it was likely that they would bring in a high quality CEO.

And we certainly felt Dick was that person when they brought him in. But I don't know if he survives it or not.

OF *COURSE* THE BROKERS HAVE THEIR CONFLICTS — BUT INDEPENDENT RESEARCH FIRMS MAY BE *WORSE*.

Of *course* the brokerage firms have their conflicts.

OID: My question is about litigation risk as it pertains to the investment environment. I know that you guys suffered through USG — and asbestos seems to be its own particular nightmare. But with H&R Block, there was a flap over a lawsuit in Texas recently. Didn't they resolve that?

Berghoef: The Texas one — yes.

OID: It seems to be an attribute of down markets that this legal activity increases as people lose money in the market. I'm just curious about your thoughts on that?

Nygren: I'll make some brief comments on litigation generally. And Henry's the analyst who covers H&R Block,

(continued on next page)

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

so I'll let him talk about that one specifically.

I think we're in an environment today led by people like Eliot Spitzer that is focused on, "What are the conflicts that people have who are publishing research?" It's been very focused on the large investment companies and the investment banking conflict. Well, that's a real conflict — and a well known conflict. So you shouldn't be surprised when you see a firm's report on a company that's an investment banking client have a more positive spin than one on a company that's *not* an investment-banking client.

You think *brokers* are conflicted? The independent firms....

Nygren: But there's a whole set of *other* conflicts out there that aren't attracting nearly that level of attention today. Independent research firms have been vaulted — they've been put on a pedestal — today because they're independent of investment banking relationships. However, they might be very dependent on relationships with others — like short-sellers, for example. As a result, their reports probably tend to be more negative in the spin and misinformation that they put out than are even the brokerage firms with their investment banking conflicts on the positive side.

Independent ≠ quality. Don't believe everything you read.

Berghoef: Yeah. The quaint thing about Wall Street is that it always takes things to excess — good ideas become bad ideas fast. Just because something is independent research or it's not from an investment bank doesn't mean it's quality. It doesn't mean it's credible. And it doesn't mean it ought to appear on the front page of the business section of *The New York Times*.

But that's where we get a bit of an edge, I think — because some people read those things and it scares the heck out of them. And as a result, they do things that aren't necessarily rational.

Touting with high pressure sales techniques in reverse....

Nygren: And H&R Block is a perfect example of that. This so-called independent firm comes out and puts out a report saying that, "We talked to the plaintiff's attorney — and there could be $2 billion of damages. And that's more than the net worth of H&R Block."

And then they get a bunch of salespeople on the phone who use high pressure tactics telling you that you're imprudent if you don't sell the stock immediately. Well, obviously, that can have a *tremendously* negative impact in the short term on a stock's price.

You know it's out of control when....

Nygren: We weren't specifically concerned about the H&R Block litigation, although Henry can get into that. But in terms of litigation in general, we don't like to get into stories where the outcome is tremendously dependent on litigation. That stems a lot from my fear of USG — where I thought that a few states with a very unlevel playing field took advantage of the fact that USG had some capital and basically milked them dry. There were only something like six states where the company lost almost all of their cases. But the cases from those six states ended up putting them into bankruptcy.

And it put them into bankruptcy over an issue that we felt had been handled reasonably well by the company. As soon as there was evidence that asbestos was harmful, they stopped producing it. But USG was losing cases involving people who were sick before the company even started *making* a product containing asbestos. So it was a *ridiculous* outcome.

That's why we tend to shy away from those cases — except in a case like H&R Block where we believe it's confined and the history has been so much on their side.

IN A WORD, THE MARKET REACTION WAS ABSURD.
THE LEGAL ISSUE JUST ISN'T THAT BIG OF A THING.

The market's reaction to the Texas case was absurd.

Berghoef: Like Bill said, we really weren't worried about the litigation exposure at H&R Block. They've had a number of suits. But the first thing to remember is that this has to do with practices before 1997. So we're not talking about it affecting the value of the business going forward. It has to do with practices that existed in the past. They had many of these suits in the past. And they never paid out anything. They were all dismissed or thrown out or whatever.

But without going into too much detail, they just had this case in Texas — which they settled. And what was interesting was that the stock went from about $40 to $30 on the news of this thing. And there are 180 million shares out there. So just to use round numbers, the market took a quick $2 billion off the quoted value of H&R Block. And we kind of looked at it and said, "This is totally absurd. There's no way in the world that this company is going to pay out $2 billion for this kind of thing."

They never had to pay out anything. And you weren't talking about asbestos litigation where there was a clear link between some compound and death. You were talking about not disclosing exactly properly what the relationship was between a lender and a borrower. And these kinds of suits exist all the time.

The issue in Texas....

Nygren: Maybe we should back up and explain what the case was about. It was refund anticipation loans. People come in, H&R Block prepares their taxes and they find out that they're going to get $100 income tax refund. And H&R Block says, "You can either wait for it in the mail or you can walk out of here with a check."

If you think about that as a loan for a very short time period, the interest rate on it is very high. If you think about it as a convenience for a fee, it's quite reasonable. When I send a wire out of my checking account, I pay $25 to do that. If you think about that as an interest rate, it's usurious. But it's a service that's being provided and a fee.

That's kind of the context of these lawsuits. The issue is exactly how much of what H&R Block is charging represents a fee for a service and how much of it represents interest expense.

The legal issue just isn't that big of a thing.

Berghoef: So, again, the Texas case was settled for,

(continued on next page)

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

let's call it, $50 million. And frankly, I think a lot of this publicity that came up put extra pressure on the company to settle for that kind of number. I would have guessed it might even have been less. And yet the market took about $2 billion off of H&R Block's market cap.

There's also a nationwide class action lawsuit that had been settled for $25 million. And for various reasons, that settlement is being renegotiated. But I'd be shocked if it was a number that was a lot larger than that $25 million — again, for exactly the same reasons. You have to remember that you're talking about alleged violations of disclosure regulations — that H&R Block didn't adequately disclose that it was getting a fee from the lender for acquiring the loan for its clients. So again, in context, it's not that big of a thing either.

AND *WHAT* A BUSINESS! VERY RAPID GROWTH, VERY HIGH MARGINS AND SHARE & NO COMPETITION.

Block's business is awesome today and very improvable.

Berghoef: We're much more focused on the fundamental business. And at H&R Block — whew! — that tax business is just a terrific business. It's growing very rapidly, has very high margins and very high market share and no competition, really. The competition is basically people doing it themselves.

And as well as that tax business has done over the years, we think it can do a lot better. A new management team came in — what was it? — three years ago. And they're starting to apply the kinds of management techniques to this company that never had been applied before — like demand-based pricing (charging more during peak periods).

And they're trying to take Block a little more upscale. The average income of a Block client is very, very low — I believe something like $35,000. So if they could move the average income up to $50,000 or something like that, it would be tremendously meaningful for them.

The other thing they have: Like a lot of businesses, the people that come into their door *de novo* — new clients — have a very high churn rate. People that stay with them for three years are likely to stay with them for many years. And those are very valuable clients. However, new clients have a very high churn rate.

Well, they're focusing on that now. And if they can reduce that churn rate just by a percentage point or two, it's going to be *very* meaningful to the bottom line for them.

Even when Block's earnings decline, its value will grow....

Berghoef: And there's another controversy at Block that fits in with what we've been saying about trying to look at things in a common sense way. They have a wholesale mortgage business that because of the refinancing boom has been just going like gangbusters. This year, the earnings in the mortgage business could approach the earnings in the tax business. And the market's very worried about that right now.

The way *we* look at it, while the mortgage earnings are approaching the tax earnings, the value in the company that's generated by the tax business is *much*, much higher than the value that's generated by the mortgage business.

At some point, the mortgage business is simply going to decline and there's nothing they can do about it. So at some point, it's not inconceivable that they might have a reduction in EPS. However, you're likely to see, even in that case, a continuing increase in the per share value of the stock. And the reason for that, to use round numbers, is we value the tax earnings at let's say 18 times. We value the mortgage earnings at let's say 5 times. So they're simply not as valuable as the tax earnings.

Nygren: Both of those are pretax, incidentally.

Berghoef: That's right. Mortgage might even be worth a *little* bit less than that. So what you're going to have happen is a fairly significant decline in earnings that are worth 5 times, and continuing strong double-digit increases in earnings that are valued at 18 times.

So the market right now seems to be saying, "Oh gee, what's going to happen to EPS?!" What *we*'re focusing on is what's likely to happen to the per share value over time, not just what happens to the EPS.

Worries about loan losses are much ado about nothing.

Berghoef: The market's also worried about their potential exposure to loan losses. But the fact of the matter is that they sell all their loans either as whole loans or in securitizations. So their only exposure is the residuals that they have on their balance sheet. They tend to securitize their residuals as rapidly as they can.

And the value of the residuals on their balance sheet today is, ballpark, $250 million. Given 180 million shares outstanding, their total exposure on the balance sheet is about $1.50 a share. And this is a stock that's at $40.

Even if they were to have to write that whole thing off, which we don't think is likely, it's not very important — not very meaningful — for the company. So that's another point we look at differently than much of the market does where we think we're taking a common sense approach.

Tragically, in its core business, growth is "slowing" to 23%.

Nygren: That's another one where there's an example of a press report by a major daily financial newspaper that will go unnamed [laughs] that referred to growth "slowing" in the tax preparation business to, what was it? 23% or something like that...

Berghoef: Yeah, right. It was totally [ridiculous]...

Nygren: If all my companies could have growth slow to 20%, [chuckling] that would be a nice day.

—OID

For additional information
you may contact:

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

(312) 621-3806

FIRST EAGLE SOGEN FUNDS'
JEAN-MARIE EVEILLARD & CHARLES DE VAULX

"Twice in the past 15 years, we've declined to participate in what we saw as a speculative bubble. First in Japan in the late '80s, then in the U.S. and Europe in the late '90s. On both occasions, we were told we were making a big mistake, i.e. we were taking the risk of doing worse than our peers and our benchmarks for as long as the bubble lasted.

"Indeed, that's what happened. Between the spring of 1995 and the spring of 2000, your First Eagle SoGen Global and First Eagle SoGen Overseas Funds were still making good money, but nowhere near as much as aggressive 'momentum' funds. So, many shareholders abandoned us. However, for us to have knowingly participated in what we saw as a bubble would have subjected our shareholders to undue risk, to the risk of losing much money in absolute terms. And that is the real risk. As our colleague Edwin Olsen put it, 'we would rather lose half of our shareholder base (which we did) than half of our shareholders' money (which we didn't).'

"Today, the mutual fund industry may be at a crossroads. Most equity funds turned into index 'huggers' in the late 1990s, and so now they're down 35%, 40% or 45% in less than three years. Mutual fund shareholders are not amused, and that's putting it mildly. Unless equity markets come back quickly enough strongly enough, many individuals may become disenchanted with equity funds. And hedge funds are a dubious solution: it's not difficult to be long and wrong some securities as well as short and wrong other securities. Add leverage and some hedge funds can be a wipe-out.

"Some see us as quirky. So be it. And it's true that sometimes, as in the late 1990s, shareholders have to bear with us. However, those who did — the happy few — have been well rewarded, at least so far in the twenty-first century.

"[We had some] stocks such as Lotte Confectionery Co., Ltd (a successful food manufacturer) [that] rose significantly, but still trade at a considerable discount to what we believe is their respective intrinsic value. The stocks that were down include CONSOL Energy, Inc. (coal), McDonald's Corporation and Tyco International Ltd, two situations which we currently find very undervalued — even though we've had to lower our initial estimates of the intrinsic value of those two companies.

"As someone once quipped, 'a bear market, if properly prepared for, can be a value investor's best friend.' Over the past year, we have been finding bargains in unlikely places. We have been able to find value among some bigger names (e.g. Vivendi Universal S.A. and Liberty Media Corp.). We have also been looking at sectors that are not normally associated with value, for instance in the pharmaceutical industry (e.g. Schering-Plough Corp. and Merck KGaA). Finally, we have found some value in distressed debt (Lucent Technologies and Level 3 Communications).

"In addition, we have been able to add to existing positions. Although we have revised downward the intrinsic values of some of our companies, the discounts at which our holdings are currently trading have expanded considerably, thus increasing our perceived 'margin of safety.' We also derive great comfort from the fact that some of our holdings currently offer somewhat generous dividend yields, sometimes in excess of ten-year bond yields. We like to get paid while waiting...."

Letter to Shareholders — December 7, 2002

Dear Subscriber,

A significant number of our contributors report finding bargains much greater in quantity and quality than they have in some time. Longleaf's Mason Hawkins says, "Over two thirds of our assets are ... in ... companies with dominant, low-cost, competitively entrenched businesses.... It's clear that we have a larger margin of safety than we've had historically.... The implication is for higher returns than the average that we've managed historically."

Oakmark's Bill Nygren says, "The severe decline in high-quality, large-cap growth companies has allowed many of them to be purchased on value terms" — more than he's seen in a couple of years.

Third Avenue Value Fund's Marty Whitman talks about buying distressed debt with yields to maturity of 25% and stocks that he thinks may be future five-and-ten baggers.

Jean-Marie Eveillard and Charles de Vaulx report, "finding bargains in unlikely places [in] sectors that aren't normally associated with value...." And other managers have recently told us much the same thing.

Interestingly, managers who go short are telling us about an unusual abundance of attractive opportunities to short *over*priced stocks. Who's right? Perhaps both.

But who cares? As proven by the historic success of the aforementioned managers, among others, disregarding "the market" altogether — in other words, being an agnostic — when you can find companies you want to own at prices that you're excited to be paying tends to eventually prove to be very rewarding indeed.

And, we're pleased to note, we believe this edition includes at least a few of those. Happy hunting.

Until next edition,

Henry J. Emerson

Your Editor

P.S. Happy Holidays to you and yours.

P.P.S. Thank you for your patience and your support.

Outstanding Investor Digest is published bimonthly, more or less (usually less) by Outstanding Investor Digest, Inc.
Outstanding Investor Digest, 295 Greenwich Street, Box 282, New York, New York 10007 Telephone: (212) 925-3885