

# Outstanding Investor Digest

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

Volume XIX Numbers 1 & 2

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OID POTPOURRI: CHRIS STAVROU, SETH KLARMAN,  
MARTY WHITMAN & BILL NYGREN

We're pleased to bring you the following assortment of perspectives from *OID* contributors. First, Chris Stavrou parts the clouds hanging around a couple of *OID* favorites. Then Seth Klarman discusses how quickly investors have forgotten the lessons of the still very recent bear market and the case for holding cash today. Third, Marty Whitman (after whom Syracuse University recently renamed its business school the Martin J. Whitman School of Mgm't),

(continued on page 2)

CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG

"IF PAST BUBBLES ARE ANY INDICATION,  
THIS ONE'S AFTERMATH WILL BE A DOOZY."

Since founding Century Management back in 1974, Arnie Van Den Berg has handily beaten all of the indices. Through March 31, 2004, he's managed to earn returns of 17.6% per year before fees versus 13.9% and 12.8% per year for the S&P 500 and the NASDAQ, respectively. And interestingly, he's done far better still the last five years — actually managing a return of more than 25% per year versus declines of 1.2% and 4.1% per year for the S&P 500

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CLIPPER FUND'S

JAMES GIPSON & MICHAEL SANDLER

"THIS IS NOT A GOOD TIME TO OWN LONG-TERM ASSETS.  
IT'S UNCOMMONLY HARD TODAY TO FIND CHEAP STOCKS."

Jim Gipson has often pointed out that in a world of increasingly high turnover among mutual fund managers, Clipper Fund — which he and Michael Sandler have managed since 1984 — is an anomaly. No less anomalous have been its returns. For the three, five, ten and 20-year periods ended March 31st, it has outperformed the S&P 500 by 6.6%, 12.3%, 4.5% and 3.35% per year, respectively. And its returns relative to its peers have been no less impressive.

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WESCO FINANCIAL'S CHARLIE MUNGER

"THE BEST WAY TO GET SUCCESS?  
IT'S VERY SIMPLE — JUST DESERVE IT."

In the foreword to Janet Lowe's excellent biography — *Damn Right! Behind the Scenes with Billionaire Charlie Munger* — long-time partner Buffett says Charlie's mind is "breathtaking" and that "[h]e's as bright as any person that I've ever met and, at 76, still has a memory I would kill for." Lowe goes on to add that Buffett's eldest son, Howard, says his father is the *second* smartest man he knows — that

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OID POTPOURRI  
STAVROU PARTNERS' CHRIS STAVROU  
(cont'd from page 1)

says that although it may be getting tougher, he's still finding a few things to do. And finally, Bill Nygren questions whether the bubble is really back, and discusses some of his rationale for things he's bought and sold lately.

We hope that you'll find their ideas and perspectives as valuable as we do.

STAVROU PARTNERS, L.P.'s  
LETTER TO PARTNERS  
MARCH 1, 2004

A PRIMER ON FREDDIE'S (AND FANNIE'S) BUSINESS....  
U.S. HOUSING MARKET IS THE ENVY OF THE WORLD.

Freddie's under a cloud — a good place to find value.

Here's a little castor oil for Freddie Mac — quickly written without looking up numbers. Pros in the audience may decry my license to oversimplify but it gets to the heart of what I as an investor think is important.

Freddie Mac is under a cloud — which is a good place to find value at a discount.

The two parts of Freddie Mac's business....

Freddie is involved in two different business activities: First, it securitizes and guarantees mortgages. For example, it buys your 20%-down-payment, 30-year fixed-rate mortgage, packages it with many similar mortgages from geographically diverse areas to spread the credit risk, and sells it as part of a mortgage-backed security (MBS).

It guarantees the timely payment of interest and principal in exchange for a sliver of your monthly payment. So Freddie assumes the *credit* risk of the MBS; and the MBS buyer assumes the *interest rate* risk — i.e., the interest rate fluctuation that makes the MBS price go up and down.

Second, Freddie buys mortgages — mostly securitized — and holds them. This "owned portfolio" business is more profitable than the guarantee business since it receives all the interest income from the mortgage (after servicing fees). Unlike with the guarantee business, in this activity, Freddie assumes the interest rate risk.

How Freddie deals with interest rate risk....

Now in theory, you could completely eliminate the interest rate risk by simultaneously selling a 30-year piece of debt paying a lower interest rate than the mortgage.

(continued in next column)

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Since that's virtually impossible, Freddie Mac does the next best thing. It sells debt that is shorter-term or somehow adjustable, so that if interest rates rise, its cost of money stays fixed — and if interest rates fall it, can somehow renegotiate its debt to pay a lower rate.

It can do this by making the debt "callable", or it can undertake interest-rate swaps. For example, it can swap contractually fixed-rate interest payments for variable-rate ones. Or it can buy options in order to achieve a similar result (so-called "swaptions"). Each of the preceding operations may be used in order to match the duration of Freddie's liabilities to that of its assets.

U.S. housing finance system is the envy of the world.

Fannie Mae and Freddie Mac were created by Congress to promote housing. They are publicly-traded Government Sponsored Enterprises. That "sponsoring" was invaluable in lowering their cost of money. However, they'd probably never be what they are today if it weren't also for the highly-compensated, non-governmental talent they attracted.

In housing finance, they are the envy of the world. What country has a housing market like that of the U.S.?

THE WISE HAVE BEGUN TO WORRY —  
AND THERE ARE THINGS TO WORRY ABOUT.

The wise have begun to worry about Freddie (and Fannie)....

However, as the owned portfolios of Freddie (and its sister Fannie Mae) have gotten bigger, and as its interest income/expense management has become more esoteric, the wise have begun to worry: It has become locked into the world financial system; too big to fail or easily regulate. It has become more dependent on the financial strength of counterparties. It's increasingly dependent on the use of derivatives and their dealers.

Changes in the accounting rules have transitorily divorced reported earnings from the economic earnings that are the true determinants of value. Management appears to have been too aggressive in expanding its owned portfolio, and occasionally wandered outside its known and deserved circle of competence in mortgages by buying non-mortgage-related securities. And because of its leverage, its capital adequacy may be insufficient in the event something goes wrong.

Does Freddie have enough capital? Almost nobody does....

I'm concerned most about its derivative portfolio and its capital adequacy. As outsiders, we can't know all that we'd like about the proper pricing of their derivatives. Capital adequacy in one sense is not necessary: If you are long and short what is essentially the same security, capital adequacy is something of a formality. But we want capital adequacy in the event that management trips up or a remote risk becomes a reality.

For example, if there's an earthquake in California worse than anything that we've seen for the last century, it's nice to know that Freddie, which in effect writes earthquake insurance — suffered \$50 million in multifamily housing losses and less than \$1 million in single-family losses as a result of the Northridge earthquake in 1994 — has excess capital. And the more the better, I say. Only Fort Knox is good enough.

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OID POTPOURRI  
STAVROU PARTNERS' CHRIS STAVROU  
(cont'd from preceding page)

TOP FOUR GUYS AT FREDDIE WERE FORCED OUT.  
HERE'S WHAT THEY COULD'A/SHOULD'A DONE....

Mgm't got caught futzing with the rules and was forced out.

Freddie Mac used "principles-based accounting" to egregiously "transact around" the new Generally Accepted Accounting Procedures promulgated a few years ago. It did so because perhaps 90% of all "analysts" consider as desirable only a steady progression of quarterly reported earnings per share. Freddie chose to hide giant profits (generated by the new rules) on derivatives — which economically were formerly a hedge to be amortized over many years, but under the new rules were considered current income, while losses on hedged items were not.

Via legerdemain, Freddie "back-ended" these profits because it felt that most analysts would not pay up for front-ended earnings that would result in back-end losses later on.

Alas, this is America: If a businessman is caught futzing with the rules he, or she, is history. So the top four guys at Freddie were forced out.

What management should have told shareholders....

To management's credit, it did say that it thought that the new accounting rules were kaffoey, and it managed by more realistic metrics. But management forewent the all-important, courageous next step — they should have emblazoned the following statement on every document they published:

"Most Wall Street analysts thoughtlessly prefer to see a steady progression in reported earnings. They're too busy to understand the paradoxical aspects of complex accounting. We will not be a part of this "Steady Freddie" behavior. We will conform to the new accounting rules because we must even though they lead to large, albeit transitory, inconsistencies in reported earnings compared to economic earnings. And those economic earnings can grow soundly. We will disclose and explain it all. We will manage the company according to your best interests and those of the nation. Most analysts will abandon us because of our newly-volatile quarterly reported earnings even though our value may not change by one dime. So be it."

They should have improved practice and disclosure....

"We'll also immediately respond to the following areas of weakness: We will disclose all counterparties to swaps, swaptions [options on interest rate swaps] and all other derivatives. We'll no longer park money in corporate bonds to earn extra basis points. We will not package any securities other than single-family fixed-site homes and small multi-dwelling units. We will disclose insider transactions and quarterly fair value."

And they should have improved their capital ratios.

"We'll also increase capital by no longer repurchasing our stock until we reach stronger capital ratios." (They

started buying their stock in 1995 and stopped when the scandal hit and management was ousted.)

"We think we don't need stronger ratios because we are dealing with fully-collateralized (or insurance-enhanced) home mortgages, but we'll raise them to show the world we are financially bulletproof. We'll even depress reported earnings by spending more on management information systems instead of stinting as we have in recent years to hype earnings."

Had they said these things, I believe they would still have their jobs and that their stock would be a lot higher.

EVEN WITH MORE CAPITAL AND SLOWER GROWTH,  
FREDDIE MAC'S P/E MAY RISE — PERHAPS BY A LOT.

On economic earnings, Freddie was selling at a P/E of 7.

Freddie's stock is now \$61.92. Our cost going into this year was \$8.66 per share. It rose to \$71, but fell in recent months to the high \$40s, where we bought a little more at \$49.66. At that price, it was selling at very close to 3-1/2 times (its restated) 2002 earnings [of \$14.18] — and perhaps 7 times its ongoing economic earnings of \$7+ a share in 2003 (versus the \$7.95 originally reported for 2002) — which were still growing. By comparison, the market P/E multiple was about 18.

For a \$50 share price to be justified for Freddie at an 18 market multiple, the earnings would have to fall to about \$2.80 a share, and stay there, where its earnings yield of 5.6% would support a price as something more attractive than a long-term bond.

I think Freddie's P/E may rise — perhaps by a lot.

Mind you, we aren't sure what Freddie is earning now because after the management shakeup, they stopped reporting earnings. (They only published their 2002 annual report three days ago!) But I assume they will probably eventually have something around \$7 a share in economic earnings for 2003 — which will thereafter grow only slowly. However, with the mess behind them, their price earnings multiple will improve — perhaps by a surprising amount.

And Alan Greenspan agrees....

Alan Greenspan said last week that if Freddie and Fannie constrain their growth (by limiting debt to the amount of, or some fraction of, their guaranteed portfolio) and improve their capital ratios, their earnings won't grow as fast as they have in the past, but they will have much higher P/E multiples. (O fellow balance sheet wonks, think about that elegant solution! And that's why Greenspan is history's best Fed chairman, or close to it along with Paul Volcker, and we mere acolytes.) But at least there we're on a par — because he agrees with me. However, only time will tell if we are right.

—OID

(OID POTPOURRI continues on next page)



OID POTPOURRI  
BAUPOST GROUP'S SETH KLARMAN  
(cont'd from preceding page)

BAUPOST LIMITED PARTNERSHIPS'  
2003 YEAR END LETTER  
JANUARY 23, 2004

LESSONS FROM THE RECENT BEAR MARKET  
SEEM TO HAVE BEEN FORGOTTEN ALREADY.

A rising tide has lifted our cash balances....

A rising tide lifted virtually all ships in 2003 — our own assiduously researched and painstakingly accumulated holdings, as well as the flotsam and jetsam of the financial markets.... Relatively few new bargains emerged amidst the growing euphoria. As a result, cash balances grew significantly over the course of the year.

While harvesting profits is not unpleasant, the real enjoyment in investing has always been identifying and accumulating the bargains that will generate tomorrow's returns. In that respect, this past year has been a downer. The exhilaration we experienced the previous few years buying bargains from panicked sellers has now yielded to a less rewarding and necessarily very patient search for opportunity across considerably less fertile terrain. There is not nearly as much financial distress or investor pessimism as in the past several years. There are few urgent sellers.

The securities of companies that do run into trouble paradoxically continue to reflect investor optimism. With a heady burst of speculation re-entering the markets, nearly all of the egregious mispricings we currently identify involve over- (rather than under-) valuation.

Nearly all reap and little sow made for splendid results.

In investing, there's a bittersweet juxtaposition between opportunity and gain that is confusing for many people. At the risk of sounding like Chauncey Gardiner in *Being There*, opportunity is the seed that is sown and gain is the result of a successful harvest. Without the planting, there can be nothing to reap. The cycles of investing, like those of farming, are inevitable and necessary.

This does not make them easy. Every harvest, whether bountiful or disappointing, is followed by a fallow period and the vicissitudes of another cycle. Many people notice the profits from a successful harvest and project them to continue in the future, even as their attention would be more appropriately focused on the availability of opportunity.

Baupost has benefited the past several years from favorable conditions and a particularly fertile crop of opportunity. Much of the time, harvesting and planting were able to take place almost simultaneously, as successes in one area were rapidly replaced by new opportunities in another. This past year has been nearly all harvest with very little planting. Current results are splendid; prospects for future harvests, for seeds not yet sown, are unknowable....

How soon investors forget....

A year ago, it would have been easy to come up with a lengthy list of valuable and enduring lessons you'd have thought investors had learned after three painful years of market decline. These lessons would have fallen into several categories:

*Technology and Internet Stock Lessons:*

- Technology and internet stocks should be valued, like other businesses, based on the present value of future free cash flows; companies without eventual free cash flow have no value other than in liquidation.
- Technology businesses are particularly competitive and thus, despite possible rapid growth characteristics, are not usually worth a high multiple of current results.

*Federal Reserve Lessons:*

- The Fed is neither omniscient nor omnipotent.

*Momentum Investing Lessons:*

- Day trading is a fool's errand.
- Momentum strategies are really greater fool strategies.

*Corporate Accountability Lessons:*

- Caveat emptor.
- An overextended stock market, misaligned incentives and lax oversight can lead to corporate greed and criminality.

*Wall Street Lessons:*

- Caveat emptor.
- Did we mention caveat emptor?

*Universal Lessons:*

- Buy low, sell high.
- What you pay matters.
- Trees don't grow to the sky.
- Things are usually neither as good, nor as bad, as the crowd thinks.
- It is better to hold cash than remain fully invested in overvalued securities.

If this isn't another mania, it's a fairly good facsimile.

Shockingly, these lessons seem to have been completely forgotten in only a year. The stock market is resurgent and animal spirits abound. As Yogi Berra once said, "It's *déjà vu* all over again."

The Dow Jones Industrial Average climbed 28.3% for the year and a whopping 7.0% in December alone. The S&P 500 gained 28.7% during 2003 and trades at over 27 times 2003 earnings. For the year, 91.8% of the stocks in the S&P 500 posted gains. Even more illustrative of the ferocity of the market's resurgence is the performance of the unweighted S&P 500 Index. Unlike the traditional S&P calculation, where the number one market cap stock, GE, has more impact on the index than numbers 393 through 500 [combined], the unweighted tally is unadjusted for market capitalization and gives all 500 stocks equal

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**OID POTPOURRI**  
**BAUPOST GROUP'S SETH KLARMAN**  
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weighting. This more egalitarian tabulation posted a breathtaking 39.6% gain for the year that, with a buying crescendo on December 29, lifted the unweighted index to a new all-time high. The S&P 600 Small-Cap Index also reached a record high level in late December. The Russell 2000 Index posted its best year ever in 2003, a gain of 47.3%. The Nasdaq Composite Index gained 50.8% in 2003 and trades at an astonishing 137 times latest twelve month earnings. If this is not another full-blown mania, it's a fairly good facsimile.

**ASTONISHING AS IT MAY BE,  
 EXCESSIVE OPTIMISM IS BACK.**

Quality didn't pay in 2003....

Without question, the most speculative securities performed the best in 2003. Morgan Stanley has published a table showing that from October 9, 2002 to August 31, 2003, the lowest price stocks, those trading below \$5 a share, on average gained 208%. Stocks trading between \$5 and \$10 surged 101%; those between \$10 and \$15 rose 73%. The higher the nominal share price (which, of course, has absolutely nothing to do with the true attractiveness of an investment), the less robust the stock market performance. The highest price stocks, those over \$60 per share, did not appreciate at all.

Barron's recently pointed out that daily trading volume on the Bulletin Board, a quotation service for unlisted securities that do not qualify for listing on a securities exchange, is currently twice the previous record level experienced in 2000 when, as we all recall, the stock market was in a certifiable bubble....

Interest in China (and India) has reached a fever pitch.

Speculative interest in China has reached a fever pitch; on January 2, 2004, eight of the fifteen highest percentage gainers on the NYSE were China-based, surging an average of 14.5% for the day. (Three of the other leading gainers were India-based.) Emerging market debt experienced record issuance of \$88 billion in 2003. Heightened interest in speculative securities is exactly what you would expect at or near a market top.

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Despite everything, excessive optimism is back.

After the litany of corporate scandals and accounting frauds that came to light over the past three years, investors were apparently looking for a sign — any sign — that it was safe to get back in the water. Their appetite for speculation had somehow not diminished. The combination of a less negative news flow, an astonishing degree of Federal Reserve easing, and large tax cuts that put cash into investors' pockets was enough to turn the tide. Investors first stuck a toe, then a foot, a leg and then their entire bodies back in (and, possibly, let the water lap over their heads).

As the market turned upward and speculators started to make money again, the temptation to plunge in became irresistible. Recent scandals that would have tanked the market a year or two ago, involving both corporate misdeeds and mutual fund and hedge fund trading abuses, have failed to dampen renewed investor enthusiasm for speculation. Astonishingly, mutual fund inflows have remained robust in the face of a growing investigation of wrongdoing in that industry; 2003 inflows into mutual funds were the second highest on record. Since excessive optimism lay at the root of the market excesses of the '90s, it's truly astonishing that it's been so rapidly restored.

I DON'T KNOW WHAT SPECULATORS ARE THINKING,  
 BUT I DO THINK I KNOW WHAT WILL CURE 'EM.

We don't know what today's speculators are thinking.

A generation or two ago, investors contentedly maintained and gradually added to their shareholdings; they waited patiently for dividend checks to arrive in the mail. Today's investors own stocks that pay meager dividends or none at all; in any event, they frequently don't hold on long enough to collect any dividends that might be paid. Fewer and fewer investors (in public equity and debt securities, and even venture capital and private equity) concern themselves with what a prospective investment is worth; instead, they attempt to gauge whether (or simply pray that) valuations will remain high long enough to profitably exit investments that are very richly priced the day they're made.

Perhaps most alarming, today's speculators maintain their positions on a hair-trigger, intending to sell at the first sign of trouble. Of course, what is possible for any one seller is obviously not possible should everyone decide to exit at once. We truly have no idea what today's speculators could possibly be thinking.

But we do know their instincts have always been lousy.

Perhaps they imagine that they're due — that the market owes them. Possibly they believe the debacle that they experienced from 2000 to 2002 was the result of poor trading tactics rather than a fatally flawed approach and that this time they'll be able to get out before the decline. They seem to be emboldened by their own survival; despite a serious bear market, they were not wiped out and thus live to trade another day.

Perhaps speculating on the market is a form of compulsive gambling, and they cannot stop on their own. The fever pitch of CNBC gets their pulse racing. They believe Alan Greenspan when he tells them you can have

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OID POTPOURRI  
 BAUPOST GROUP'S SETH KLARMAN  
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strong economic growth, low inflation and 1% short-term interest rates. Ultimately, speculators cannot overcome who they are. They like stocks better when they're going higher, less when they're falling. But their instincts are — and always have been — lousy.

It seems only truly excruciating circumstances will do it.

How much pain can today's speculators tolerate? How much more must they lose before they stop? What will make them quit for good? We will never know these answers in prospect, only in retrospect. Our challenge is to ensure that the eventual pain certain to be visited upon the speculators does not become ours as well.

When you fall from a horse, it is generally recommended that you get right back on. But if the horse has only three legs, getting back on will fail to restore confidence or produce an enjoyable ride. Repeated falls may be necessary to change behavior and cause the rider to more closely examine the animal. History suggests that a market bottom will not have been made until investors turn truly bearish — and not only in their words but in their actions. If three years of losses did not extirpate investor greed, then it seems likely that only truly excruciating circumstances will do the job.

INVESTORS HAVE LEARNED THE WRONG LESSONS  
 AS ALL ASSET CLASSES HAVE BECOME OVERVALUED.

But what's been painful recently has been shorting.

In today's overheated environment, where the daily "new low" list has virtually ceased to exist, value investors face a dearth of compelling opportunity. Loud whining emanates from long-short hedge funds, as they lament monstrous losses on their shorts; that their short positions enable them to hold onto their increasingly expensive, but currently profitable, longs is very conveniently forgotten. The short sellers are again aging in dog years, as many of their promising short positions have doubled or tripled against them this year.

The strange, and almost certainly flawed, strategy of bidding up the prices of whatever dreck short-sellers have targeted is again popular and, for now, quite profitable.

Investors have chased yield and disregarded risk.

Government bonds offer little value; for example, yields on the 10-year recently touched 46 year lows. And high-yield bond spreads over U.S. Treasuries have narrowed sharply as investors chase return without a commensurate focus on risk. And meanwhile, real estate has become increasingly popular with investors despite generally dreadful fundamentals, because it provides a higher current yield than most alternatives.

Could all asset classes be overvalued? We think so.

This prompts an interesting question: Could virtually all asset classes currently be overvalued? In their desire to put the past three years of decline behind them, to outperform a benchmark (which typically requires them to

think from a relative, and not an absolute, valuation perspective), and to do something with all the capital at their disposal, is it possible that investors have bid up just about every asset class to excessive valuations? For the moment, we believe this is exactly what has occurred.

A COMMON MISPERCEPTION AMONG INVESTORS  
 — TO OVERVALUE UPSIDE AND UNDERVALUE RISK.

Perhaps investors don't know what they want...

One possible explanation for the resurgence of speculative activity can be found by extrapolating from a recent *New York Times Sunday Magazine* article profiling Harvard psychologist David Gilbert, who's studied whether people are able to accurately predict how future events will affect their happiness. Will buying that new sports car or winning the lottery make them happy? According to Gilbert, people are lousy at making such assessments; when it comes to predicting exactly how you will feel in the future, you are most likely wrong. People can distinguish favorable events from unfavorable ones; we know we would rather get a raise than have a car accident, for example. But we overestimate the intensity and duration of our emotional reactions to specific future events, both favorable and unfavorable.

There is a gap between what we predict and what we ultimately experience that is called "impact bias." Would a large raise or bonus result in contentment? Just before it happened, you might think so, but it won't. Worse still, these mistakes of expectation can lead to errors of choice that Gilbert calls "miswanting." The Rolling Stones sang, "You can't always get what you want." Gilbert insists that the problem is instead that you can't always *know* what you want.

They're overestimating probability of gain and pain of loss.

As we try to understand the resurgence of speculation in the markets, we wonder whether people who don't know what will make them happy might err not only in their consumption but also in their investment decision-making. Most investors consciously or unconsciously focus on increasing their capital; they seem to believe that having more money will make them happy. This leads them to buy equities, as investors consistently overestimate the long-term returns available from owning stocks. Observing others profitably speculating exacerbates the desire to participate.

Investors don't seem to consider whether simply preserving their capital might make them happy or whether losses would render them miserable. Possibly, they dismiss serious diminution of principal as an unlikely outcome; perhaps they are unable to accurately gauge how painful it is to incur substantial losses. They fail to consider that their own panicky reactions in the face of investment adversity are likely to compound their suffering.

They focus on the high and ignore the risk of the hangover.

Undoubtedly many investors believe that owning growth stocks will meet their goal of high returns, consequently making them happy. They seem confident that the steady, predictable revenue and profit increases they expect from growth companies will materialize and be

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**OID POTPOURRI**  
**BAUPOST GROUP'S SETH KLARMAN**  
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matched by steady, predictable share price appreciation. They gain strong reinforcement from an upward trend in the prices of growth company shares (although they seem to confuse share price growth with growth of the business).

Because of its potential for immediate positive reinforcement, speculators may find momentum investing enhances short-term happiness. Momentum investors, in a gross oversimplification of the investment process, focus on the short-term directional impact rather than the importance of each new piece of news. Meanwhile, they completely fail to consider valuation levels or the possibility ongoing developments may have already been discounted by the market. In this oversimplified world, euphoria prevails until momentum stops and reverses direction....

Value investing may just be too hard emotionally for most.

It is easy to imagine that people find it difficult to be value investors. While it seems certain that investors would be happy with the limited risk and higher return this discipline ultimately delivers, perhaps value investing makes people unhappy in the short run, so they refrain from practicing it. Perhaps standing apart from the crowd, as value investing requires, makes people feel as though they, and not just their investments, are out-of-favor. Perhaps holding cash for what seems like forever, awaiting the emergence of investment opportunity, is simply too emotionally difficult for them. Maybe exposure to criticism or second-guessing as a result of standing apart from the crowd is more than they can comfortably bear. Maybe it is the continued price erosion one can experience from buying corporate misfits and rejects — the relentless drain of out-of-favor securities continuing to melt away — that turns investors off. Perhaps it is hard to sound cool or even sane at cocktail parties when you don't own the hottest IPOs, and when no one has heard of the unpopular and obscure holdings that comprise your net worth.

Almost everyone compares how their investments are doing to the performance of one or more market index. It feels great, after all, to beat the market. And significantly beating the market over a very long period of time would undoubtedly be a good result. But does long-term outperformance derive from consistent and instantly pleasurable periods of short-term outperformance strung together, or does it more surely require periods of painful underperformance? People who cannot know what will make them happy tomorrow might be unable to resist short-term oriented investment strategies today.

**HEDGE FUND TREE WON'T GROW TO THE SKY.  
 TO THE CONTRARY, WATCH OUT BELOW....**

Hedge fund train may already have left the station.

An ongoing trend has been enormous investor interest in hedge funds. Money is continuing to pour into both established and nascent funds, as well as funds of funds. Illustrating the growing interest in this asset class, the *New York Sun* now lists daily hedge fund performance alongside the usual mutual fund tables. Some investors in

hedge funds are hoping to achieve outsized returns from aggressive trading strategies and substantial leverage. Others are seeking reduced volatility. Still others are hoping to earn positive returns with downside protection through successful execution of market neutral strategies. Many seem to be mindlessly imitating the acclaimed "thought leaders" among the endowment universe without truly understanding why some of these stalwarts have performed so well.

Investors, in their inimical way, may well be attempting to board after the hedge fund train has already left the station. In a very un-fiduciary process, allocators of capital are using the rear-view mirror to estimate future returns. They are failing to look beyond the strong past performance records of funds they are considering to the lackluster opportunity set currently available.

Hedge funds seem almost certain to disappoint.

While today's speculative activity and high valuations have created attractive short-selling opportunities, there is little of value to buy. Event-driven situations that might typically sop up excess hedge fund cash are both scarce and unattractively priced. Aside from the effect of leverage, hedge funds can earn only what their positions (both long and short) can deliver, less fees; they cannot produce performance out of thin air. Given massive capital inflows, greater competition, and few pockets of undervaluation, hedge funds, unless they make large and successful directional bets on the market, seem almost certain to disappoint the hordes of investors currently throwing bundles of money at them.

Hedge fund tree won't grow to the sky. To the contrary....

This is a heady time for hedge fund managers, as they collect large management and performance-based fees on truly staggering amounts of capital. They're today's masters of the universe. But when large numbers of 30 and 40 year olds in any profession become wealthy beyond imagination, a contrarian would expect an adverse change in conditions.

Some of the most prominent hedge funds may be in the process of growing too large, stretching beyond their mandates and/or accepting insufficient return for the risks they bear. While some hedge fund managers will choose to do the right thing for clients even if they themselves are made worse off financially, others will take actions that maximize their personal expected value in the short-term even when those actions involve enormous risk for their trusting clients. When performance deteriorates, many of those managers will experience redemptions.

Newly established hedge funds also face serious challenges. In their desire to get off to a good start, some will chase performance and eventually suffer the fate of all momentum-based strategies. A number will be unable to distinguish themselves amidst a crowded field; these will fail to reach critical mass and fold. Failure to perform will drive a new cycle of disillusionment, reassessment and, potentially, disinvestment in hedge funds. Because numerous funds operate with similar mandates, those with portfolios that resemble their competitors' positions will be vulnerable not only to their own clients' actions but to those of their competitors' clients as well.

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 BAUPOST GROUP'S SETH KLARMAN  
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We're willing (and able) to wait for compelling opportunities.

While our returns are likely to be lower than in the past several years as we wait for opportunity to become more prolific and potentially for competition to abate, we believe Baupost will continue to distinguish itself among the increasingly crowded field of investment partnerships and hedge funds. Our long-term orientation (enabled by a truly long-term-oriented client base), willingness to incur illiquidity, discipline to invest only in compelling opportunities, flexibility to move into and out of diverse asset classes, securities types and geographic settings, and important relationships built during our 21 years in business continue to produce what we believe will be a sustainable competitive advantage for Baupost.

Our highly capable and collaborative team is another strength; our people are experienced, strongly motivated, and extremely patient. We remain determined to size the assets of our firm appropriately over the years ahead, which includes the possibility of returning capital to partners should we conclude that doing so would benefit the firm and its clients. In sum, we believe that we have the determination, resources and staying power not only to survive but to continue to thrive in the years ahead.

IN ORDER TO BE A SUCCESSFUL INVESTOR,  
 YOU DON'T NEED TO DO THE IMPOSSIBLE.

Markets, like baseball games, are only obvious in hindsight.

While watching a Red Sox game last September, a friend observed to us that he believes every baseball game has a distinct pattern to it, but you cannot tell what it is until after the game is over. This insight is obviously not very helpful while watching a game. Unfortunately, the financial markets share this attribute. Technical analysts study market patterns, ascribe names to them like "head and shoulders" and "double bottom," and make predictions based on them.

But we're not aware of any technical analyst who has beaten the market over time. As in baseball, the portion of the pattern about to be unveiled stays cloaked in mystery until it lies behind and not ahead of you. It is hard to see events with clarity while you are living through them. They become clearer, like our friend's baseball patterns, only after they are in the past.

But the longer time frame creates a challenge for investors.

One essential difference, however, is baseball games end — usually after nine innings. So their patterns are quickly revealed. By contrast, the market has no such finite ending. It is instead a continuum of days turning into weeks, weeks into quarters, quarters into years, years into cycles, and cycles into careers. Thus, one of the greatest challenges for investors is learning to look beyond the market's patterns to the underlying companies in order to ascertain financial truth.

While investing has some clear truths, such as the

stated yield to maturity of a bond, it actually has depressingly few of them. What is the value of a business? If it is the sum of future cash flows discounted back to the present at the correct rate, then what are those cash flows and what is the appropriate discount rate? What is the risk of owning a stock? Academics would give one answer (beta, a measure of volatility) and we would give another (the amount and probability of potential loss) but neither answer provides a simple, specific, and reliable measure.

The market has been aberrant. The only question is when.

Believers in efficient markets find their truth every day in the closing price tables of the *Wall Street Journal*. Everything that is knowable is reflected and justified, and truth is measured in incremental eighths and quarters (pre-decimalization). Value investors have no such belief; their truth is found in balance sheets and income and cash flow statements. Opportunity, not truth, is found in closing prices.

How could anyone believe in efficient markets when the Nasdaq Composite has fluctuated from 1201 in April, 1997 to a high of 5048 in March, 2000 to 1114 in October, 2002 to over 2000 at year-end 2003? It is hard to imagine anyone could believe that the value of the underlying businesses fluctuated to this extent.

If you, like we, think that faulty perceptions of value have been driving securities prices, then what is the proper valuation for the market? As with a baseball game, must we wait until later to tell?

To put it another way, if you don't believe the business value of the companies in the Nasdaq Composite could decline nearly 80% over three years and then almost double in just over a year, either the tremendous rise of the 1990s and 2003 was an aberration or the three year decline from 2000 through 2002 was.

And only time will tell...

In early 2000, as the Nasdaq surged past 5000, everyone wished they had thought of buying tech stocks a few years before, and only a handful of skeptics regarded the entire rally as a mania awaiting a nearly full reversal. By 2002, nearly everyone believed the previous rally had been a fantastic bubble — an astonishing overreach based on the false perception that we were in a "new economy" and on the illusions orchestrated by managements, investment bankers and analysts and perpetuated by the financial media and Alan Greenspan.

Now, in early 2004, with the Nasdaq Composite back above 2000, the financial truth is less clear. Was the decline a necessary correction from severely overvalued levels; was the 2003 rally a bear market bounce that will soon reverse? Or was the decline a mistake, a temporary hiatus from the greatest bull market ever? No matter how strongly we believe that last year's rally was unjustified by fundamentals, it is hard to say so with absolute assurance. A significant piece of the valuation puzzle is dependent on the future which remains unpredictable until it is upon us.

We've been lousy market prognosticators. But that's OK...

One of the ways that investing is a great business is that you can achieve very successful results even if you are mostly wrong about the market. If you had followed our often overly pessimistic market view each year for the past

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OID POTPOURRI  
 BAUPOST GROUP'S SETH KLARMAN  
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21 years, you would probably have lost more frequently than you would have won.

Fortunately, our firm's investment philosophy is based not on forming market outlooks but rather on the much more reliable discipline of bottom-up, event-driven, value investing. It is relatively easy to make an accurate assessment of the value of some specific businesses and the likelihood of specific events occurring that will affect the value of those businesses.

It's far more difficult to gauge the confluence of factors that will cause the entire market to trade at a particular level. Market overvaluation, for a while, can be self-reinforcing. In the short to medium term, money flows often dominate valuation as a causal factor in security prices. And money flows are hard to predict.

Most investors focus more on the market and less on the companies within it. When they do focus on specifics, they monitor stocks like the numbers on a roulette wheel rather than analyzing the underlying businesses. This means most of them spend their time and effort trying to spot patterns that, if they exist at all, can only be identified in hindsight, while failing to analyze the single thing that actually is analyzable, which is the value of underlying businesses relative to the prices of their securities.

No crystal ball is required for investment success.

Smart investors stick to investments within their circle of competence, with which they are comfortable whose businesses they have the capability to understand. This does not require accurately divining the meaning of the market's patterns. You don't need an opinion on every security. And you don't need to know which way to lean following every single news development. You simply need to be meaningfully correct several times a year in order to earn a solid return on your capital without excessive risk.

The challenge is to avoid the temptation to speculate, to have justifiable but not unreasonable confidence in your analytical judgments, to demand adequate return for the risks you incur, and to control risk through prudent, but not excessive, diversification and appropriate hedging while avoiding the use of leverage.

UNTIL THE LEVERAGE SPIGOT IS TURNED OFF,  
 YOU CAN'T UNDERSTAND ITS ENORMOUS IMPACT.

I learned the impact of easy money early....

When I was a teenager, my friends and I used to play a lot of board games. A perennial favorite was Monopoly. After hundreds of trials, Monopoly became tedious and needed spicing up. So we introduced leverage. This made the game much more fun — as leverage is apt to do. Inadvertently, we created a mini-Fed — and the Fed was in a perpetual state of easing. Property prices shot higher, and rapid building ensued. There was an extreme shortage of houses and hotels; so, in a hyperinflationary devaluation

of game tokens, the little green houses eventually came to represent hotels and the larger red hotels each came to represent five hotels. The railroads and utilities failed to benefit from the bubble (as usual).

Was this merely a way for economically advanced but slightly twisted adolescents to have some fun, or are there broader lessons to be realized? We believe the latter.

Today, even recent immigrants buy their own homes.

Recently, we were surprised to come across a bit of research commenting on the buoyant effect on the housing market of immigrants to the U.S. purchasing their own homes. *Immigrants purchasing their own homes!* (Like many in their generation, my father and all my grandparents came to these shores seventy-plus years ago with little more than the clothes on their backs; they considered themselves fortunate to share a room in a relative's tenement.) Since our country's immigration policy is not targeted exclusively to the wealthy, we take this as one small example of the remarkable laxity of credit conditions and the enormously powerful effect of leverage on asset prices.

As with any form of debt financing, until the spigot is turned off, you cannot understand the enormous impact readily available leverage has on prices and psychology. Increase the leverage available to an asset class and prices will rise. Immigrants (and everyone else) will gladly put a few dollars down and take out non-recourse mortgages to own the American dream.

Few consider the potential impact of a credit squeeze....

The ready availability of leverage is quickly taken for granted and is not recognized as causing the appreciation. Many enjoy the gains — and experts find reasons to justify the trend and predict a continuation. Few consider the heightened risks and possible upheaval should the leverage suddenly becomes less available.

Today, widespread availability of credit enables people to increasingly leverage their home buying and consumption. While we are greatly troubled by this, many observers ... view these trends as signs of economic health.

It is, of course, never clear in advance what could cause leverage to become less available. Consider that house prices across the U.S. have risen 38% over the past five years; in the Northeast and California, the appreciation has run between 50% and 80%. Since 1980, average U.S. home prices have nearly tripled, with Massachusetts up almost five-fold. Most homebuyers are offered 80% or higher mortgage financing at very low interest rates (mostly variable interest rates, by the way; many homeowners could not afford to make their monthly payments if interest rates moved up appreciably).

With such financing in place, a decline in the price of houses — whether because of changes in supply/demand, higher interest rates, or less availability of financing — would quickly cause losses for lenders. A return to housing prices of only five years ago would result in sizable write-offs on today's "rock-solid" home mortgage loans.

A similar chilling impact would result were consumer credit to become less readily available. A credit contraction would undoubtedly create investment opportunities for Baupost — although getting from here to there could be extremely challenging for our heavily indebted society.

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**GREATEST BUBBLE EVER MAY HAVE BEEN REINFLATED,  
 BUT I SERIOUSLY DOUBT THAT IT'S BEEN RESOLVED.**

We don't believe the greatest mania ever has been resolved.

The Fed has jumpstarted the economy while concomitantly reinflating the stock market bubble. Yet it is hard for us to believe that the greatest mania of all time and the ensuing massive misallocation of our country's resources has been resolved by a relatively mild recession. The national savings rate is at an all time low, while household debt is at a record high. The trade deficit is enormous; and the dollar has started to fall precipitously.

The only reason these conditions fail to shock is that (other than the declining dollar) they have prevailed for many years. As a result, all of those who expressed concern in the past have been effectively discredited by the apparent lack of consequences to date.

Deficit spending today will have to be repaid tomorrow....

The gaping federal budget deficit is similarly shrugged off, even though several years ago markets applauded the previous administration's feat of balancing the federal budget. Taxes have been repeatedly cut; and a "guns and butter" policy of government spending prevails, where we're forced to make neither hard choices nor any choices at all. When a government borrows money and mails it back to taxpayers, the recipients gratefully spend or save the apparent windfall. The offsetting accounting entry — government debt — does not appear on their books, only the government's. When the debt markets fail to extract a price for this activity through higher interest rates, the illusion of free money is created — good times for all with no offsetting pain.

But, of course, debts do need to be repaid. Markets extend credit one day, but may decline to renew it the next. Recipients of a debt-financed tax cut are indirectly but collectively responsible for the debt that enabled it....

I'm not a fan of our esteemed Federal Reserve chairman....

We also believe that Federal Reserve Chairman Alan Greenspan has become an increasingly dangerous man. He has concluded, according to a speech he gave on January 3, 2004, that the Fed was correct in its decision not to try to prevent the stock market bubble of the late 1990s, instead preferring to react to its consequences. This is the same man who identified the stock market's irrational exuberance in a speech he gave in 1996. This is the man who inexplicably failed to raise margin requirements to attempt to dampen in a relatively painless way the speculative atmosphere of that era.

The truth is that it is far too soon to tell what the long-term consequences will be of the Fed's unprecedented easing in the aftermath of the bursting of the stock market bubble of the late 1990s. It is hard for any reasonable person to make projections from a sample size of one. Worse still, the moral hazard of a Federal Reserve Chairman essentially giving a green light for future bubbles to develop is alarming when, if anything, the government should be

doing the opposite. What kind of policy is it for the Fed to aggressively lower interest rates during periods of financial market distress and asset price decline, but not to raise them amidst euphoria? Indeed, in 1966, this same Alan Greenspan said, regarding the bubble of the late 1920s:

"The excess credit the Fed pumped into the economy spilled over into the stock market, triggering a fantastic speculative boom. Federal Reserve officials belatedly attempted to sop up the excess reserves and finally succeeded in breaking the boom. But it was too late: By 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenchment and consequent demoralizing of business confidence."

This is the exact opposite of the policy which the Federal Reserve chairman is advocating today. Intellectual honesty is one of the most essential qualities any public servant possesses — a characteristic which the revered Federal Reserve chairman is sorely lacking.

Our macroeconomic concerns make us more cautious.

We believe that the economy is balanced precariously between a resurgence of inflation resulting from massive budget deficits and a falling dollar, and deflation caused by low-priced imports and worldwide excess capacity left over from the bubble years. It seems doubtful that the U.S. can continue to walk a tightrope that allows both 8.2% quarterly economic growth (as in the third quarter) and 1% short-term interest rates to co-exist.

We suspect that all is not well with the economy. And while we cannot predict when or where the train will run off the tracks — and we would not base our investment decisions on our macroeconomic views in any event — we'll continue to employ extreme caution when analyzing prospective investments.

**NOT EVERY TERRORIST EVENT CAN BE PREVENTED.  
 IT WON'T BE A PLUS FOR THE ECONOMY OR STOCKS.**

Don't forget terrorism. Not every attack can be prevented.

We must also not forget the ongoing and high risk of terrorism. Islamic militants remain intensely focused on attacking America, and undoubtedly will eventually succeed. Our country has taken only limited measures to prevent such an attack; complete security is unattainable in any event.

Moreover, the expense of the security measures and the frictional costs to our economy (such as searching every incoming shipping container) are expenses that must be incurred, yet which will leave us no better off than before the terrorist threat emerged. In effect, we've been hit with a large "security tax" that makes us poorer; the stock market has almost certainly not yet discounted this effect.

These terrorists are highly committed, willing to sacrifice their lives for their cause. They will not ultimately prevail. However, they will experience successes along the way. And some of their victories may even involve weapons of mass destruction.

[Editor's note: The reason, in a nutshell, why those terrorist organizations and the regimes which harbor and support them must be ripped out along with their roots

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anywhere and everywhere they exist. The potential loss of life from such an event — were it to involve biological or nuclear weapons — could easily make 9/11 look like a walk in the park. We're amazed there *hasn't* been one.]

Such attacks wouldn't be a plus for the economy or stocks.

Each such victory seems likely to raise doubts about future economic prospects. The damage from successful attacks should be measured not simply by the lives lost and property destroyed, but also by the diminution of economic activity as people avoid travel, public events or shopping malls.

Given today's very high market valuations and the number of speculators holding securities on a hair trigger, the next major domestic terrorist attack would seem likely to have an extremely unsettling effect on securities prices....

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IT'S ONE THING TO *KNOW* YOU SHOULD HOLD CASH —  
 AND ANOTHER THING ALTOGETHER TO *DO* IT.

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You're *not* paying us to hold cash....

Cash and cash equivalents comprised approximately 50% of partnership assets at year-end. Perhaps some of you will soon be asking why you are paying us a management fee to hold so much cash.

Let us preempt you by saying that you are not. You're paying us to decide when to hold onto cash and when to invest it — to determine when the expected return from a prospective investment justifies the risk involved and when it does not.

At times, investors loathe cash....

In a short-term, relative-performance-oriented world, earning next to nothing on cash creates a compulsion to invest even when all investment alternatives appear overvalued. Choosing their poison, most investors prefer to hope that something expensive becomes even more expensive, especially when it has recently been doing exactly that.

Holding cash, which they find barely tolerable when markets are falling, is anathema when markets are rising.

But sometimes it's the best alternative. Witness Japan....

The Japanese bond market is an extreme case. With Japanese overnight deposits paying literally nothing, investors moved out on the yield curve to pick up return. This past June, they accepted an annual yield of only 0.44% on the Japanese 10-year bond.

By October, this bond had fallen from above par to below 90 — yielding over 1.5%. Importantly, an investor lost (on a mark-to-market basis) in four months more than twice the total return they would have earned if they'd held onto that ludicrously mispriced bond for an entire decade. The summertime pricing of this bond can only be explained by the pressure of a zero yield on cash — the globally despised investment alternative.

An unacceptable risk associated with cash — career risk.

Today's investors remain almost singlemindedly focused on relative performance — their results compared to the market's. Their behavior is certainly understandable in an environment in which, for most professional investors, short-term underperformance is often rewarded with client redemptions.

This is especially the case since "long-term oriented" looks a lot like "being wrong" until proven otherwise. Since no one can know if it is your long-term orientation or your incompetence that is causing poor current results, it is hard for disappointed clients to stay the course. Thus, career risk for individual managers adds to the pressure. So in order to avoid underperforming in a rising market, many professional investors have a mandate to remain fully invested.

After three years of a grueling bear market, one might have thought that investors would have developed an appreciation for an absolute return focus consistent with capital preservation. However, old habits and ingrained tendencies die hard. If keeping up with an overvalued and rising market is your goal, cash is an unacceptable anchor to drag around.

Absent compelling opportunity, cash is king....

By contrast, we've always believed successful investing involves recognizing and correctly choosing among a series of trade-offs. Cash (in the form of short-term U.S. Treasury bills) is a way of safely doing nothing until compelling investment opportunity arises. It offers positive albeit very limited yield, complete safety of principal, and full and instant liquidity. A low positive return with virtually non-existent risk is not a bad proposition in the absence of better alternatives.

Our view is that investors should choose to hold cash in the absence of compelling opportunity, not because they are making a top-down asset allocation into cash, but based on the result of a bottom-up search for bargains. Baupost will make the decision to hold cash, even if it becomes a very large percentage of partnership assets, until better opportunities arise. Every investment must be compared to the alternative of holding cash. If an investment is sufficiently better than cash — offering a more than adequate return for the risk involved — then it should be made. Note that the investment is made not because cash is bad, but because the investment is good. Exiting cash for any other reason involves dangerous thinking and greatly heightened risk.

Doing nothing can be grueling, humbling and demoralizing.

It is one thing for a value investor to know that in the absence of opportunity you should hold cash, quite another to actually do it. It is particularly difficult to sit on your hands when others are profitably speculating. We find that it is not a temptation to speculate that pulls at you, so much as a desire to be productive. Doing nothing is doing something, we have argued again and again; doing nothing means prospecting for potential investments and rejecting those that fail to meet one's criteria. But emotionally, doing nothing seems exactly like doing nothing; it feels uncomfortable, unproductive, unimaginative, uninspired and, probably for a while, underperforming.

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BAUPOST GROUP'S SETH KLARMAN  
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One's internal strains can be compounded by external pressures from clients, brokers and peers. If you want to know what it is like to truly stand alone, try holding a lot of cash. No one does it. No one knows anyone who does it. No one can readily comprehend why anyone would do it.

Also, believing that better opportunities will arise in the future than exist today does not ensure that they will. Who can tell what investors will be willing to pay for securities tomorrow? Waiting for bargains to emerge may seem like a better strategy than overpaying for securities today. However, tomorrow's valuations may be higher still. And standing apart from the fully invested crowd for significant periods of time can be a grueling, humbling and even demoralizing experience.

Chasing yield is a fool's game....

Many investors compare the current yield on cash (lousy) to the current yield on longer-term bonds or the dividend yield (or historic long-term expected total return) from stocks. Cash nearly always loses in this comparison, and investors feel quantitatively justified in doing what career and client pressures cause them to do anyway ... no matter how overvalued these alternatives may be in an absolute sense.

Never limit yourself to the opportunity set of today.

Investors' immediate problem is being too short-term-oriented. One of the biggest challenges in investing is that the opportunity set available today is not the complete opportunity set that should be considered. Limiting your investment opportunity set to the one immediately at hand would be like limiting your choice of spouse to the students you met in your high school homeroom. Indeed, for almost any time horizon, the opportunity set of tomorrow is a legitimate competitor for today's investment dollars. It is hard, perhaps impossible, to accurately predict the volume and attractiveness of future opportunities; but it would be foolish to ignore them as if they will not exist.

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THIRD AVENUE'S MARTY WHITMAN  
(cont'd from preceding column)

THIRD AVENUE VALUE FUND  
LETTER TO SHAREHOLDERS  
JANUARY 31, 2004

MOST OF OUR RECENT SALES WERE TECH RELATED.  
BUT WE'VE BEEN FINDING THINGS TO BUY, TOO.

New purchases in distressed credit and natural gas....

The last quarter was an active one. New positions were acquired in two distressed credits — Mirant and Parmalat. One new common stock position was established in a Canadian natural gas exploration and production company — Encana. And one common stock of a homebuilder — Levitt Corp. — was acquired as a result of a spin-off by Bankatlantic Bancorp.

Common stock positions increased were Investor AB, Hutchison Whampoa and Toyota Industries — large, quite well financed, blue-chip companies. Each was acquired at prices that appear to reflect meaningful discounts from readily ascertainable Net Asset Values ("NAV")....

Most of our sales were among the high techs....

Thirteen common stock positions were eliminated and three reduced. Ten of the thirteen eliminated, and two of those reduced, were those of high-tech companies whose market price performance was spectacular in 2003. Going forward, the fund expects to reduce its diversification among high-tech issuers.

Instead, TAVF will concentrate its high-tech investments into the common stocks of a lesser number of larger, extremely well-financed, high-tech companies. The three most important high-tech common stock positions held by TAVF are Applied Materials, American Power Conversion and AVX Corp.

The other three common stock positions eliminated — BKF Capital Group, J&J Snack Foods and Kendle International — were sold based on price considerations.

Two distressed credit investments that seem interesting....

The two distressed credits acquired — Parmalat Senior Notes and Mirant Corporation Bank Notes — seem interesting. Parmalat, a massive fraud, is an Italian-based worldwide company essentially selling dairy products. The Fund established a toehold position based on the view that Parmalat seems reorganizable because it is likely that many of its businesses are well entrenched and profitable. These good businesses are those around which Parmalat would be reorganized.

Given the fishbowl in which the Parmalat reorganization is taking place, it seems likely that TAVF will be in a position to be well informed about Parmalat and its potential. It is impossible at this time to state whether, or not, the fund will participate in Parmalat in a meaningful way, or at all.

Third Avenue could either continue to buy Parmalat

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THIRD AVENUE'S MARTY WHITMAN  
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Senior Notes at huge discounts, participate as a DIP lender (i.e., enjoy a post-petition super-priority), or both. If TAVF does participate, it would hope to become a significant holder of common stock in a reorganized Parmalat.

Mirant is one of the largest U.S. generators of electricity; and it also has a presence in the Philippines and the Caribbean. TAVF expects much of the Mirant Bank Debt to be converted to Mirant Common Stock on reorganization. The Fund's committed to acquire \$17,500,000 principal amount of Mirant Bank Notes: but as of January 31, 2004, the transactions had not closed. It's probable that the transactions will be reflected for the first time in the April 30, 2004 TAVF financial statements.

WE COULDN'T HAVE BEEN MORE WRONG ABOUT JAPAN.  
FORTUNATELY, THE PRICES WE PAID WERE RIGHT.

Three investments that remind us of our Japanese foray....

TAVF has been steadily increasing its positions in Hutchison Whampoa, Investor AB and Toyota Industries. All three are relatively large, well-financed, blue chip common stocks which seem to be selling at meaningful discounts from readily ascertainable NAVs. All are basically long-term wealth creation entities, not companies striving to maximize near-term earnings per share or cash flows.

I love to invest in these types of businesses — especially because TAVF's experience in acquiring Japanese non-life insurance equities proved to be so satisfactory. Those Japanese common stocks had been acquired at discounts from NAV of at least 50%. The comparable discounts for Hutchison Whampoa, Investor AB and Toyota Industries today range from 10% to 40%.

Most of our Japanese non-life investments were made in 1997 when the Nikkei 225 Stock Average hovered around 20,000. That index now is about 10,700. Nonetheless, at January 31, 2004, the Fund's Japanese non-life portfolio had a market value of approximately \$302 million, versus a cost basis of approximately \$205 million.

In our Japanese holdings, what protected us was price.

Furthermore, these satisfactory results were achieved even though I could not have been more wrong in 1997 in my macro outlook for these companies. Never in my wildest dreams did I think the Japanese business recession-depression would last as long as it did or be as deep. Neither did I dream that Japanese interest rates would stay as low as they did over the past seven years — thus hurting insurance companies' profitability because of the dearth of interest income from their loan portfolios.

Obviously, the Fund's okay results in Japanese non-life insurance equities stem from being price conscious rather than outlook conscious.

[Editor's note: Incidentally, Whitman's non-life insurance holdings compounded at roughly 6% a year for those seven years versus a *decline* in the market value of the Nikkei 225 of roughly 8% per year in that same period.]

And that's what we're relying on w/Investor, Toyota, etc.

And so it is with Hutchison Whampoa, Investor AB and Toyota Industries. The pricing is attractive relative to NAV; and perhaps I will be a lot less wrong about how the future unfolds for these companies than I was about Japanese non-life insurance.

As to outlooks, Hutchison Whampoa seems a free speculation on the prospects that 3G (i.e., third generation) telephony will take off. Investor AB is a way of getting into a number of large European businesses, and Toyota Industries seems to be a free speculation on the possibility that Toyota Motor (Toyota Industries is Toyota Motor's largest shareholder and Toyota Motor is Toyota Industries' largest customer, as well as Toyota Industries' largest shareholder) might become the Wal-Mart of automobile assemblers on a worldwide basis....

EXCERPTS FROM WHITMAN'S COMMENTS

AS A PARTICIPANT IN THE PANEL DISCUSSION ENTITLED  
"DO EXPLOITABLE INEFFICIENCIES EXIST IN THE MARKET?  
ARE THERE SYSTEMATIC WAYS TO BEAT THE MARKET?"  
AT COLUMBIA BUSINESS SCHOOL'S  
7TH ANNUAL INVESTMENT MANAGEMENT CONFERENCE  
HELD ON FEBRUARY 6, 2004:

ALL MARKETS TEND TOWARD EFFICIENCY.  
BUT THE PROCESS CAN TAKE A DECADE OR MORE.

Are markets efficient? Well, define a "market"....

**Thomas Brock [Moderator]:** ...The investor on my right has somehow managed to be an anomalous manager who has consistently beat the market.... So one must ask, how do you do it? Martin, do you want to talk a little bit about the things you look for?

[Editor's note: Brock is currently Adjunct Professor at the Columbia Business School where he teaches a course on money management. He was formerly chairman and CEO of Salomon Brothers Asset Management, the managing director of Solomon Brothers, Inc. (SBI), a member of the SBI management board and a director of the SBI Global Research Department.]

**Marty Whitman:** ...If we're going to talk about whether or not there are exploitable differences in markets, we need to first define a market. A market is any financial or commercial arena where participants reach agreement as to price and other terms which each feels is the best that can be reasonably achieved under the circumstances. That's the definition of a market.

There are *many*, many markets besides outside passive minority investor markets — like the New York Stock Exchange and Nasdaq. There are takeover markets, there are Chapter 11 reorganization markets, and there are management compensation markets. There are merger and acquisition markets for strategic buyers. And indeed, if you give it two minutes — even two *seconds* — of thought, you will see that what is an efficient price in one market may very well be an inefficient price in another.

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OID POTPOURRI  
THIRD AVENUE'S MARTY WHITMAN  
(cont'd from preceding page)

Next you need to define "efficiency"....

**Whitman:** Now having defined a market, let me say that all markets do tend toward efficiency. What the academics like Burton [Malkiel] are talking about is that all markets tend to achieve an *instantaneous* efficiency. And that's just not so.

Instantaneous efficiency is a special case. But again, all markets will tend towards efficiency. However, sometimes that process can take as much as 10 years.

One war story.... I've always known beyond peradventure of a doubt (although there's always *some* doubt) that the senior mortgage bonds of utilities would never miss a payment — even in Chapter 11. So in 1988, I headed a group that bought up most of the Public Service Company of New Hampshire second mortgage bonds, knowing that we were going to get adequate protection payments. We bought those at a yield to maturity of 23%.

A few years later, Tucson got in bad trouble — and we bought its bonds at a yield to maturity of 15%. And then El Paso Electric was in trouble — and we got 11%. And a few years ago, Pacific Gas & Electric got in trouble and its bonds yielded 9%. So the market got efficient, but it took 12 years.

CONSISTENT OUTPERFORMANCE IS A STRAW MAN.  
LONG-TERM OUTPERFORMANCE IS WHAT IT'S ABOUT.

And "consistent" outperformance is a straw man.

**Whitman:** When academics define a special situation rather than markets in general, the market to them is one where outside passive minority investors strive to maximize a risk-adjusted total return *consistently*. And "consistently" is a dirty word. It means all the time.

Nobody in their right mind would ever try to outperform markets consistently. Be like us: We outperform markets most of the time, over the long term, on average. We certainly don't do it consistently. By the academics' definition, even Bill Miller probably doesn't do it consistently. It's just wrong to think that people want to do that. Most of you would be happy with performance where on average and over the long term you perform well. And that ought to be the test — not that this guy was good in the '70s and bad in the '80s, but how'd he do overall?...

The academics are referring to traders on margin — short-run-influenced people on margin — not most people involved in financial processes. They're certainly not talking about managements. And they're not talking about venture capitalists, value investors, or control investors.

Some markets *are* relatively efficient — but most aren't.

**Whitman:** Let me talk about market efficiency in terms of managements and venture capital — a market which some of you participate in. All of you know that access to capital markets on a long-term basis is notoriously capricious and inefficient. And therefore, what you do as a management or venture capitalist is wait until prices are utterly inefficient and take advantage of the capital markets.

And guess what? That's called the IPO boom in equity where, if you're a venture capitalist and you've provided the seed capital, you bail out by tapping the public market at super-attractive prices. Or in the real estate business where the market is basically inefficient to you, you wait until interest rates get like they are today so that you can get access to capital on a long-term basis at low, fixed interest rates on a nonrecourse basis....

That, I think, by most definitions, would be taking advantage of an inherent inefficiency — even though all markets do tend toward *long-term* efficiency.

And outside passive investor *trader* markets *do* seem to be characterized by near instantaneous efficiency. However, it's just not true for most markets.

The proof has been in our pudding — and that of others.

**Whitman:** At Third Avenue, as I've said, *all* of our funds have outperformed on a long-term basis, on average, all of Vanguard's index funds — with the exception of emerging markets.... Again, we don't do it every day, but just look at the record. We do it most of the time. And they only have an expense ratio of 0.18%, while we have an expense ratio of 1.1%. And I promise you, based on the past record, any one of you would rather have invested with us, with Legg Mason's Bill Miller, or with Tweedy, Browne's Chris Browne than be in one of these indexes....

WHATEVER EFFICIENT MARKET THEORISTS SAY,  
THESE STOCKS ARE DEFINITELY BARGAINS TODAY.

Whatever efficient market folks say, it's all about price.

**Whitman:** Efficient market theorists have no idea of the importance of price.... To them, price is always at equilibrium. They're in a straightjacket and can't even *begin* to do most analysis — because in their view, the price is always right to begin with. That's efficient market theory — that's Markowitz and efficient portfolio theory. And it's utter *nonsense*.

Some growing companies at large discounts to value....

**Whitman:** Today, as an outgrowth of our experience [in non-life insurance companies] in Japan, we're investing very heavily in common stocks of extremely well-financed, growing companies at ... large discounts from conservatively estimated, readily ascertainable net asset values.... And among those are Toyota Inds., Investor AB, St. Joe Corp., Forest City Enterprises, Brscan and Hutchison Whampoa. Those are things worth buying now.

But the important point ... is you can do what I did and read the academic literature ... about how closed-end investment funds can't sell at a discount. (And each company I mentioned is really an investment company masquerading as something else.) The literature is unbelievable in that it says a situation where these companies trade at a discount can't exist. So their explanation is some nonsense like investor anticipation — something that's meaningless. But anybody can examine them and perform their own estimate of net asset value.

Meanwhile, the efficient market theory will tell you that these prices can't exist....

**Brock:** So these are examples of companies that you believe are currently trading significantly below their net

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OID POTPOURRI  
THIRD AVENUE'S MARTY WHITMAN  
(cont'd from preceding page)

asset value.

**Whitman:** That's right — in many cases, like in Toyota Industries, measured by the market value of the portfolio of securities they own....

WE'RE NOT THE ONLY LOUSY MACRO FORECASTERS.  
OTHERS ARE, TOO. IT'S JUST THAT WE ADMIT IT.

Safe and cheap also usually means a lousy outlook.

**Attendee:** Marty, do you take into consideration *any* outlook issues? You have many more nondollar earning companies in your portfolio now than you have in the past. For example, Investor AB is primarily euro-based. And you have a lot of other things like it. Do you ever think about whether or not the U.S. dollar is overvalued when you're selecting your investments?...

**Whitman:** We concentrate on buying what *is*, safe and cheap. We don't ignore outlooks and forecasts. But we're lousy at it — and we admit it. By the way, I think that everyone else is lousy, too, but most people don't admit it.

Let me say, in buying what is, safe and cheap, ... we try to never pay more than 50-60¢ for each dollar we think the common stock would be worth were the company a private company or a takeover candidate. So suppose we achieve that. Well, the market has enough tendency toward efficiency that we're only going to achieve that most of the time if the near-term outlook *sucks*. You know — [he chuckles] the market isn't *that* irrational.

**Brock:** Is "sucks" a technical term?

**Whitman:** Obviously, buying what is, safe and cheap, for us means not giving that much weight to the outlook.

An old dog's associates) apparently can learn new tricks....

**Brock:** He also asked about currencies and whether you're thinking about what's happening with the dollar.... Is that something you consider?

**Whitman:** Oh, *boy* — and how. It's sort of back door, but we're so glad we're in Toyota Industries, Investor AB and Hutchison Whampoa because of the weak dollar. And we sort of lucked out on our huge Japanese investments.... Up until about six months ago, we completely hedged the Japanese yen. And my research people, who are a lot smarter than I am, said, "Take that hedge off." Well, I was too much of a coward, but we did take *half* the hedge off.

And I don't know — the next time the hedge matures on the yen, we're probably not going to hedge it.

**Brock:** I hope you gave that guy a bonus.

**Whitman:** I should. However, it's a common sense consideration for us. That said, if we do take the hedge off, we're probably going to be wrong.

WE WILL GET DEFRAUDED FROM TIME TO TIME,  
BUT WE'RE NATURALLY FRAUD RESISTANT.

It's not how big your file is, but how you use it.

**Attendee:** In determining the inefficiency or efficiency of markets, how do you handle differences in information? I've seen many, many times where you buy a company at a discount to tangible assets, and the company announces, "Gee, we never really owned that building" — or some other similar fraud...

**Brock:** As was the case at Parmalat.

**Attendee:** ...or you find that the stock price tends to drop ahead of very bad news. Does that play into your notion of risk? And how does that play into your notion of efficient or inefficient markets?

**Whitman:** Well, first let me talk about information — compared with the academics who mostly don't know what information is. They think it's next quarter's earnings. We don't have superior information, but our trick is to use the available information in a superior manner.

We don't expect GAAP to tell us the truth.

**Whitman:** Because we are a mutual fund and not control investors, we require a modicum of diversification. Diversification is merely a surrogate for knowledge, control and price-consciousness. And since we're not in control, we do have a need for some diversification.

I would say even today, audits are extremely reliable. Disclosures generally have never been better — even though there are more frauds than ever existed before. And when I say audits are terrific and the financial information is terrific, if you have an I.Q. over 50, you don't expect GAAP to tell you the truth. It gives you objective benchmarks which you then use to determine the truth.

Despite everything, we will get defrauded from time to time.

**Whitman:** That said, as an outside passive investor, we're going to get defrauded and fooled.... It's important with individual issues. And we are fooled sometimes. But we've found it *hasn't* been important in our portfolio.... Within our overall portfolio, I don't think that it's been a big problem.

**Brock:** Certainly in instances of fraud, there's not much you can do to protect yourself. You can rely on audits and public accounting firms, but if there's fraud involved, there's not much you can do to protect yourself. You'd need to be a superior analyst to see through some of these things.

**Whitman:** Because we insist on such strong financial positions, we're probably fooled less than most. I mean, there's no way that people like us — for better or worse — would ever own the common stocks of Enron or Parmalat. They just don't get on our radar screen....

[Editor's note: Emphasis on the "common stocks of"... See page 12.]

Equity investing for us was a natural extension....

**Whitman:** I got into the mutual fund business through the back door. I completed a hostile takeover of a closed-end fund, open-ended it and there I was in the mutual fund business with a license to steal. Prior to that,

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THIRD AVENUE'S MARTY WHITMAN  
(cont'd from preceding page)

I'd been in distress. I'd spent many years investing mostly in bankrupt credits. And when I was investing, my swamp was, and it still is, trying to buy into the most senior issue that's going to participate in the reorganization at a fraction of the claim — at some discount to what the workout will be. It's sort of a risk arbitrage business.

And when I started doing common stocks — after I got into the mutual fund business in 1984 — I woke up to the fact that if a company had an extremely strong financial position, guess what the most senior issue to participate in the reorganization is? It's called "the common stock".

So it was sort of a seamless transition, if you will, from what I'd always done.

But we naturally screen out most of the bad actors.

**Whitman:** The nature of our investments is that we tend to invest in companies that are financially strong. And we tend to be in bed with very conservative managements who, if they need access to capital markets, control the timing.

So we just don't get involved with the Enrons.... A lot of them might be very good. It's just not what we do.

ARE MARKETS GETTING MORE EFFICIENT? SURE.  
BUT THAT'S NOT KEEPING US FROM FINDING THINGS.

There is a tendency towards increasing efficiency.

**Attendee:** Most of the debate today has centered around whether markets are efficient or whether inefficiencies exist. I would be curious, if you presume for a moment that inefficiencies *do* exist, Mr. Whitman, given your decades in the business, is it getting harder to find inefficiencies — the proverbial 50¢ dollar? As time goes by, there is certainly evidence in other markets where there *were* opportunities — where formerly inefficiencies did exist — that they have disappeared over time.

**Whitman:** Yeah, I would say it's tougher. But the problem with that is that if you'd asked me that question any time in the last 30 years, I would say that it's tougher. So it's *always* been tough.

But we're still finding stuff. Heck, I just gave you a list.

**Whitman:** However, I really think you've got a point. With very, very low interest rates, you've got a lot of credit risk when interest rates go up. And common stocks are generally selling at high prices. So I think it's tougher now than it's ever been before.

But what do *I* know? We act from the bottom up. But to answer your question, from the top down, yeah, I think it's tougher. Are we finding stuff? *Yeah*. I gave you a *list* of stuff that we've just found recently.

Graham and Dodd could use an update....

**Attendee:** Years ago, Ben Graham said that statistically-cheap stocks were available — net-nets, etc. And although it seems that they're much more difficult to find, you're still finding them. The way you look at the

world, do you differentiate at all between asset plays versus earning-power plays where it requires much more understanding about the industry and the business? And are you willing to pay a higher multiple to assure some degree of certainty of high growth and the ability of a company to reinvest capital at those high returns?...

**Whitman:** I think one of the real problems in finance is that Graham and Dodd wrote the last big volume [of *Security Analysis*] in 1962 and *The Intelligent Investor* in 1973. Since that time ... there has just been an explosion in disclosure. So things are so much easier for fundamentalists today.

But there's been very, very little scholarly literature on the subject because everybody embraced the efficient market — which didn't have to do with fundamentals, but rather with people who were stock market technicians and chartists disguised as Ph.D.s. So nobody did it.

It all depends on how you define net-nets.

**Whitman:** So regarding your specific question in looking at net-nets, Graham and Dodd just looked at accounting numbers. They looked at current assets versus current liabilities versus long-term debt to see if they were net-nets. But the truth is that if you're in business in a going concern, a lot of current assets are anything *but* current.

For example, just take a department store's inventory. In the nature of fixed assets, that's the worst kind if it's a going concern because it's an asset that has to keep being replenished. On the other hand, a company whose assets consist mostly of AAA income-producing real estate, it's called a fixed asset, but you can go sell a building in Manhattan over a telephone. So there are a lot of net-nets. But you have to redefine what a net-net is today from how Graham and Dodd defined it when they were doing their great pioneering work long before this disclosure explosion.

As we define 'em, we're finding plenty....

**Whitman:** So we find a lot of net-nets. What are they? We're very heavy in income-producing real estate. And we're one of the biggest stockholders of Legg Mason. Our idea of net-net is net current assets plus 2% of assets under management in a cash flow business.

So yeah, we find a lot of net-nets. They aren't the classic net-nets. But I think there *are* a lot of them. You just have to bring different tools of analysis to find 'em....

We don't have what it takes to be good shorts....

**Attendee:** What do you think about shorting stocks and other securities...?

**Whitman:** We are so terrible at that. And here's why: You can't use the word "risk" without putting an adjective in front of it. There is no general risk. There's market risk, there's investment risk, there's currency risk, there's failure-to-match-maturities risk, but there is no plain risk.

And the only risk that we ever guard against is investment risk — the risk that something's going to go wrong with the business or with the particular security. We absolutely *ignore* market risk.

I actually had this great idea that we were going to have a program of shorting bonds selling near the call price where we thought there might be a downgrade coming. But neither I, nor my great analytical team, to this day

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THIRD AVENUE'S MARTY WHITMAN  
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have had the guts to pull the trigger. We just don't short.  
I think it's essentially that we're bad market people — and you better be market conscious if you're short. And our whole thing is trying to guard against investment risk.

I DON'T KNOW ABOUT THE FORBES HONOR ROLL,  
BUT I THINK OUR SHAREHOLDERS ARE VERY HAPPY.

I think we've had extremely happy shareholders.

**Attendee:** I write for *Forbes*. And for 25-30 years, we've been doing the annual mutual fund survey. And it's kind of interesting that if you go back 25 years, there were big names like Mutual Shares and Nicholas Fund and Magellan Fund — they were all on our *Forbes* honor roll. But if you look today, there's virtually no name of a single mutual fund that existed 25 years ago. Does that not support Burton Malkiel's basic thesis?...

**Whitman:** My answer to that would be that we've been in the mutual fund business since 1984. And we've had extremely happy stockholders — at least to the best of my knowledge. I don't know what it's been since 1984, but it's just been huge returns.

[Editor's note: What we come up with for Whitman's Third Avenue Value Fund and its predecessor, Equity Strategies Fund, is a not-too-shabby 16.3% per year versus 11.2% for the Russell 2000 and 13.4% for the S&P 500 for the 19 years ended December 31, 2003.]

Even great managers don't keep going forever.

**Brock:** It would also be interesting to see who are the managers of those funds — because over that time frame, manager turnover obviously becomes an issue. And the original owners might have sold the company. I'm thinking of Mutual Shares, for example — where Michael Price doesn't run those funds anymore.

[Editor's note: ... although 14-year Mutual Shares veteran, David Winters, has very ably taken over the reins.]

**Whitman:** Except, I think, when they get rid of me, Third Avenue [chuckling] will have better managers.

**Brock:** I think it's pretty hard to move up in that regard, Martin. I don't know. I think that there may be some people who might disagree.

**Whitman:** I don't think the *insiders* would.

—OID

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(OID POTPOURRI continues in next column)

OID POTPOURRI  
OAKMARK FUNDS' BILL NYGREN ET AL.  
(cont'd from preceding column)

OAKMARK FUND AND OAKMARK SELECT FUND  
LETTERS TO SHAREHOLDERS — MARCH 31, 2004

SOMETIMES GREED IS GOOD  
— AT LEAST LONG-TERM GREED.

"He that is greedy of gain troubleth his own house."

— Book of Proverbs

It seems like we just finished the quarter of greed...

It was a big quarter for the word "greed." It was frequently used in courtrooms explaining the behavior of former CEOs who were standing trial. It was used in articles about fund companies that courted market timers.

It was used in Warren Buffett's annual letter referencing excessive CEO compensation. And it was used to explain investors' behavior who are now more interested in buying stocks than they were a year ago when stocks were much cheaper.

You think the bubble is back? Think again.

In his book *Origins of the Crash*, one of my favorite business writers, Roger Lowenstein, also makes frequent use of the word greed. His cataloging of events leading up to the 2000 stock market collapse assigns blame to greedy CEOs, greedy accountants, greedy Wall Street analysts, and greedy investors. Even though the peak occurred just four years ago, Lowenstein's book serves as a great reminder of just how extreme the excesses were: during "the first quarter of 2000, a technology company was going public and doubling every other day — a speculative orgy without precedent in public markets."

The book should be required reading before anyone is allowed to say that the bubble is now back! During the real bubble, CEOs overly incentivized by stock options became exclusively focused on the short term; audits were marketed not just on price but on leniency; analysts hyped stocks to create banking business; and investors bought stocks not because of investment merits, but because prices had risen and they wanted in on the gravy train. Lowenstein says, "The distinction between self-interest and greed ... in the '90s was utterly lost."

Sometimes greed is good — long-term greed anyway.

In the investment criteria we list at the top of this report each quarter, we say we seek to invest with a "management that acts in the interest of outside shareholders." We have further said that we want them incentivized with stock ownership, stock options, and bonuses that pay them for increasing business value. Effectively, we want them to maximize their personal profits by doing what is most profitable for us, the outside shareholders.

One could argue that by using the dictionary definition of greed — the desire for wealth beyond one's needs — we

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OID POTPOURRI  
OAKMARK FUNDS' BILL NYGREN ET AL.  
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are asking management to be greedy. But many times greed and value maximization do overlap. That's why Gordon Gekko's "Greed is good!" speech to the shareholders of Teldar Paper didn't sound entirely self-serving. For tough decisions like downsizing or selling off divisions, as well as for high return investments that result in a growing business, greed may result in the same course of action as value maximization.

Greed and value maximization, however, part ways when short-term goals are pursued that cause long-term damage. As Lowenstein said, in the '90s, "the credo of shareholder value ... became a maxim not for enhancing business values, a process that occurs only over years, but for enhancing day-by-day quotations of shares."

We want managers who'll wash our cars...

We have always been troubled by managements that are more concerned about their stock prices than they are about building business value. Managements often ask our advice on what they can do to get a higher stock price. Our answer has remained the same for years, although it's not necessarily the one they want to hear:

"Run the business to maximize long-term value and invest excess cash in your highest return opportunities. Among the opportunities being evaluated, always include share repurchase. If you do, the stock price will take care of itself." Anything short of that is not behaving like an owner.

A business owner would never sacrifice long-term value in exchange for simply having people believe the business is more valuable today — unless it is being sold! A management focused only on next year's stock price won't make the necessary investments for long-term success.

That's why we look at management's overall incentives. We want managements to make high return investments, even when the payoffs won't be evident for several years. Warren Buffett commented on the short-term focus that can result from an options-only incentive plan, saying "Who ever washes a rental car?" Options can help align a manager's interests with the shareholders, but true ownership creates a better long-term alignment. By focusing on a five-year time frame, we hopefully avoid most of the managers who aren't washing our cars!

WE DON'T TRY TO FORECAST THE MARKET.  
WE JUST BUY CHEAP, GROWING COMPANIES.

Lower stock prices ahead? We're not so sure...

With so much greed in the air, some of our value peers have sold stocks and increased their cash position anticipating better opportunities (i.e., lower prices) ahead. We share some of their concerns because by definition, the higher the market goes, the tougher it is to find stocks that will continue achieving high returns.

But we have never shown an ability to add value through market timing or, for that matter, through use of any macro level forecasts. A *New York Times* headline last month read "Time for Optimism? Pessimism? Pick Your Gauge." The article contained bull and bear arguments

that each sounded compelling. An investor who read only one side could have been easily convinced.

Last quarter, *Barron's* ran a story about the likelihood of a strong rebound in inflation. It was well written and had strong statistical backing. However, later in the same issue, an interview with a highly successful fund manager gave an equally sound argument that deflation was right around the corner.

Usually, a compelling argument can be made for higher or lower stock prices, higher or lower inflation, economic boom or recession.

We don't use a crystal ball. We just buy cheap.

Not only do we lack the ability to select the prophetic ones, but over our five-year time frame, their conclusions generally tend to be less significant than projecting how a specific business is likely to change. That's why we spend our time at the company level — trying to identify companies whose futures are being underpriced. We agree with Lowenstein's comment that "a true analyst is better equipped to appraise the medium-term future in rough terms than to forecast the here and now with precision."

[Editor's note: Like Warren Buffett and Charlie Munger say, they'd rather be roughly right than precisely wrong.]

So we don't try to forecast the market — we simply buy out-of-favor stocks that appear to be selling below growing business values and hold them until the gap has closed. And while it has been hard this year to find new stocks selling below 60% of value, we believe our existing holdings continue to sell at a discount and continue to see growth in their value.

Bulls make out. Bears make out. Pigs get slaughtered....

When my children were younger, they enjoyed a story called "The Magic Fish" by Freya Littledale. In this story, a fisherman catches a talking fish that claims to be a prince and begs for freedom. Upon returning home and telling his wife that he set the fish free, the fisherman is berated for not getting anything in return. The wife demands he ask the fish for a new house. The fish delivers, but the greedy wife keeps asking for more and more until finally the fish takes back everything.

Those who want us to believe that the current stock market is the "Bubble Redux" would say today's investor is behaving like the greedy wife. We're not so sure. Seeing two sides to most every story, we would ask if perhaps those who are waiting for double-digit expected returns while bonds yield only 4% aren't being just as greedy!

OUR BIGGEST GAINER STILL SELLS AT A DISCOUNT.  
AND GAP'S UP, BUT IT REMAINS VERY ATTRACTIVE.

The biggest contributor to our returns last quarter — WaMu.

The Oakmark Select Fund increased in value by 2% in the quarter, slightly exceeding the S&P 500. Performance was positively affected by Washington Mutual's 7% return. As the fund's largest holding, WaMu's performance is frequently the largest contributor to NAV changes.

[Editor's note: Since the end of the quarter, we note that WaMu's price has dropped about \$3.]

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**OID POTPOURRI**  
**OAKMARK FUNDS' BILL NYGREN ET AL.**  
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TOY went up the most, but still sells at a discount.

Our holding that increased the most in the quarter was Toys "R" Us. We first bought Toys "R" Us in early 2000 believing that new management would succeed at improving the profitability of their toy stores. Although the shopping experience today is much better, the profits aren't.

Fortunately, continued growth at Babies "R" Us and growing real estate value underneath the toy stores has allowed the stock to increase despite disappointing progress on our primary thesis. This outcome highlights the value of our investment approach. By investing only when we believe stocks are selling at large discounts to value, we've benefited from a cushion that Ben Graham, the "father of value investing", referred to as a "margin of safety."

While the company's earnings have fallen far short of our projections, the stock has increased in price — and we still believe it is selling at a discount to business value. We are pleased with the steps management is now considering which include a downsizing of the toy division.

And we believe Gap remains attractive...

During the quarter we sold our position in Starwood Hotels. We purchased Starwood a year ago when the Iraq war caused a cutback in travel plans. The stock, which then troughed at \$22, exceeded \$40 last quarter. We still like the business but believe the current quote approximates full business value.

Starwood was replaced in the portfolio with The Gap. We believe Gap is one of the strongest global apparel names. And we are very pleased with the new management, led by CEO Paul Pressler. We think that the stores look better, which is confirmed by higher same-store-sales. Our confidence is growing that Gap's turnaround will be successful. So despite the higher price, we believe the stock is very attractive.

**WE THINK INVESTORS ARE MISSING THE BOAT  
 ON BOTH LIMITED BRANDS AND RAYTHEON.**

Some stocks we sold...

The Oakmark Fund increased in value by 1% in the quarter, slightly trailing the S&P 500. Over the last twelve months, the Fund increased by 33% compared to 35% for the S&P 500. Though we always strive to do better than the market, we rely on an investment approach that focuses on risk. That approach generally keeps us away from the most popular stocks, which means that we tend to add more value when markets are not unusually strong.

We sold three positions this past quarter. We decided our outlook on Safeway had been too optimistic given the high percentage of their sales that come from markets that don't yet have Wal-Mart or other superstore competitors. Though Safeway still looks undervalued, we believe that other companies have less uncertainty and are equally undervalued. Further, sale of Safeway allowed us to increase our capital loss carryforward.

On the positive side, shares of J.C. Penney and Guidant achieved our price targets and were sold.

Investors are viewing the glass as half empty at Limited.

Two new positions were added: Limited Brands and Raytheon. LTD is a specialty retailer with well-known brands including Victoria's Secret, Bath & Body Works, Express, and its namesake, Limited. LTD stock is down from a high of \$28 which was reached four years ago [to \$20 today].

While Victoria's Secret and Bath & Body Works have become highly profitable category-dominant chains, the other brands have struggled. Victoria's Secret and Bath & Body Works now account for two-thirds of LTD's sales and 90% of operating income. Despite this, investors seem focused on the struggling turnaround efforts within the lesser chains.

But half empty would be just fine at today's price.

LTD management has intelligently used the cash generated by these businesses, including a recently completed \$1 billion share repurchase (10% of the outstanding shares). We believe that Victoria's Secret and Bath & Body Works are above-average franchises, that they are well insulated from Wal-Mart competition, and that they should continue growing at above-average rates.

Success in the turnarounds of Limited and Express is possible and would be nice. However, it isn't assumed in our outlook. And selling at 15 times estimated earnings, LTD is being priced as a below-average business.

We think most investors are missing it with Raytheon.

Raytheon is the fourth largest defense contractor in the United States. The stock suffered a brutal decline from its 1999 high of \$75 [versus a current price of about \$32 and a low during the quarter of about \$30. The decline was] due to operating problems following a string of acquisitions, [and the fact that it] then continued to underperform its defense peers — largely due to mishaps in its discontinued construction business.

New management is in charge. And we are confident they are focused on building long-term value. We believe RTN stock suffers from a stale perception of the company's management quality, a lack of understanding of the government's obligations for pension expense reimbursement, and the uncertain timing of a rebound in business jet sales. (Raytheon ranks third in units sold.)

A recent brokerage report missed the boat altogether...

A recent negative brokerage report concluded: "Valuation for RTN appears expensive on all metrics with the stock trading at twenty-five times our 2004 estimate and twenty times our 2005 estimate."

That approach values the break-even business jet division at zero. Adjusting GAAP numbers for pension expense reimbursement and assuming normal business jet demand, Raytheon is trading at eleven times our estimate of 2005 economic earnings. And if our timing proves to be too optimistic and the recovery comes in 2006, then it would be trading at ten times earnings.

We believe Raytheon is a good example of the advantage that can be achieved with the use of a longer time horizon than other investors use.

—OID



CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG  
(cont'd from page 1)

and the NASDAQ and a gain of 8.2% per year for the Russell 2000. Besides encompassing the bursting of the tech bubble and the most recent bear market, Van Den Berg points out that this period also corresponds with the period when Century's Director of Research, Jim Brilliant, assumed a greater role in the firm's investment selection.

We're pleased to bring you the following excerpts from a client presentation given January 24th in Austin, Texas. We always find Arnie's insights and perspectives to be particularly sharp and colorful, and believe you will, too.

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YOU CAN TAKE LESSONS FROM HISTORY  
OR YOU CAN REPEAT THE SAME MISTAKES. \*

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We prefer to learn from history rather than repeat it.

**Scott Van Den Berg:** ...Now I'd like to introduce to you Arnold Van Den Berg — our company president and founder. I always like to introduce Arnold as not only my father, but as a wonderful mentor to myself and our entire staff — and also as my best friend.

So for the next 40 minutes or so he's going to share with all of us what we call the unwinding of a bubble — where he will show us how other manias and bubbles have occurred over history and in various marketplaces so that we can take lessons from history so that we don't have to repeat the same mistakes....

Only in investing does conventional wisdom change so fast.

**Arnold Van Den Berg:** Probably the biggest question we're getting this year is why we're holding so much cash as the market is going up. That's a very fair question. And it needs to be answered in an historical sense.... You truly cannot appreciate the times you are living in unless you put it into a historical perspective — because we are living in very, very unusual times.

There have only been three times in the last 80 years that all of the elements of the stock market, the economy and the debt structure have come together like they have today. The first period was 1922-1929. The second period was the 1949-'66 bull market. And the third period was the period that we witnessed from 1982 to the top of the tech bubble in March of 2000. These were extraordinary times during which the investment thought process changed completely.

It seems to me that this is the only field in the world where conventional wisdom changes so frequently. For example, in mathematics, 100 years ago, two and two equaled four. And 100 years from now, I feel confident that it'll probably *still* be that way.

But that's not how it works in investment thinking. I'm going to demonstrate to you that whatever you believe — whatever the current conventional wisdom is today — it was completely different 20 years ago. And I daresay that it'll be completely different a few years from now. So that's the first thing we want to explain.

Where there are great risks, there are great opportunities.

**A. Van Den Berg:** Then, the second thing we want to show you is how this develops, how it's created, what our strategy is, and how we intend to profit from it — because where there are great risks, there are enormous opportunities if you know how to take advantage of them. And none of us would know how to do that if we hadn't either experienced it personally or looked back in history and seen what happened during those times.

We're going to talk about bear markets. Of course, bear markets are periods during which stocks decline. Bull markets are periods during which stocks appreciate. And while everybody thinks they're short term, they last somewhere between 15 and 20 years once they get going.

There are no mistakes, just lessons.

**A. Van Den Berg:** And then we're going to talk about bubbles. You've got bull markets, you've got bear markets, and you've got bubbles. Bubbles only happen once every 25 or 30 years — because the pain and the suffering and the lessons that are learned are so deeply embedded in those people who experience one.... Therefore, it takes a whole new generation to start a new cycle again.

So we want to learn from this. There's a Hindu saying that there are no mistakes, just lessons. Well, there are a lot of lessons to be learned....

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BUBBLES CAN ONLY ARRIVE  
WHEN ALL THE STARS ALIGN.

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Only when the stars align do you get bubbles....

**A. Van Den Berg:** I want to mention one thing about bull markets. Bull markets always peak out when the whole society is involved in a period of prosperity that is unparalleled. You never get a bubble until the public, the brokerage community, the financial institutions, the pension funds and even the universities are all involved. Working together, they all create this chorus of prosperity.

And it's only in times like this — when you just can't stand to be out of the party — that bubbles develop. Bubbles just completely leave reality. It's just like you're on another planet. And then eventually they fall by their own weight.

So the first thing you need to understand is that bubbles can only come when all the stars align: The economy's got to be good; the outlook has got to be good. New technological changes are going on. As far as the eye can see, there's only prosperity. Only in that kind of an environment are you going to get everybody to just throw caution to the wind and say, "I want to be part of it."

In 1929, it looked like a new era unlike any other....

**A. Van Den Berg:** That was the kind of thing that happened in the '29 bubble. The '29 bubble started in 1922 when both commodity and stock prices collapsed, and interest rates and inflation went down. It was a perfect climate for equities to appreciate in a big way. And that's exactly what they did. (**See CHART 1.**)

While our chart only shows you to 1924, it actually started in 1922 with the Dow Jones Industrial Average at

(continued on next page)



**CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG**  
(cont'd from preceding page)

60. From the Dow's 1922 low of 60, stocks went straight up to 380 — or nearly 6-1/2 times.

Let me read you what the thinking was at that time: President Calvin Coolidge in a speech in November, 1927 — two years before the bubble burst — said "America is entering a 'new era' of prosperity." That's where that term was developed. It was a new era unlike any other era that America had ever experienced.

[Editor's note: President Coolidge was apparently no less optimistic a year later. As Vanguard Founder and Chairman Emeritus John Bogle pointed out in our 1997 *Patient Subscriber's Bonus Edition*, on December 4, 1928, President Coolidge said: "No Congress ever assembled on surveying the state of the union has met with a more pleasing prospect than that which appears at present."]

**A. Van Den Berg:** Yale University's Irving Fisher — one of the most noted economists at the time — said on October 15, 1929 that: "Stocks have reached what looks like a permanently high plateau."

Nine days later, the Dow began a long, steep plunge that stripped the market of 40% of its value in three weeks — and continued with few interruptions until the bottom of 1932 at 41.

Some interesting similarities between 1929 and 1999....

**A. Van Den Berg:** Here's what was happening in '29: The economy was strong. Corporate profits were up 20% over what they were in '28. Real wages had been increasing rapidly. And productivity had soared by 7% annually since '22. The public had reason to be optimistic.

In '99, we were excited about the internet because we knew that it would revolutionize the future. And it will. It just depends on what *price* you want to pay for it.

Well, in '29, look what they had going: They had the telephone, the automobile industry, aviation, and radio. Radio Corporation of America was the darling of that time. And it ended up the same way Cisco did. It was a tremendous company with a bright future. The public was hysterically bullish. And the media... If you read the media during this time, you'd think that America was just never going to have any economic problem in the world.

There's one bad thing about debt — it has to be repaid.

**A. Van Den Berg:** At the same time in 1929, the debt levels had reached 200% of GNP. Now think about that: the economy was roaring — and yet it had twice as much debt. People forgot about these kinds of things. But one thing you know about debt is that it has to be repaid. And so the economy started down on its sickening slide that wiped out all of the gains from that period.

Incidentally, that stock market was on steroids. And

(continued in next column)

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the reason it was on steroids is during that time, you could borrow stocks on 90% margin. In other words, you could put down 10% and borrow 90%. Imagine: you could buy \$100,000 worth of stocks for \$10,000. But there's only one problem — if it goes down 10%, you're wiped out. And that's what happened. People got wiped out.

**DON'T WORRY ABOUT MISSING A BULL MARKET.  
IF YOU JUST FOCUS ON PRICE, YOU'LL BE ALRIGHT.**

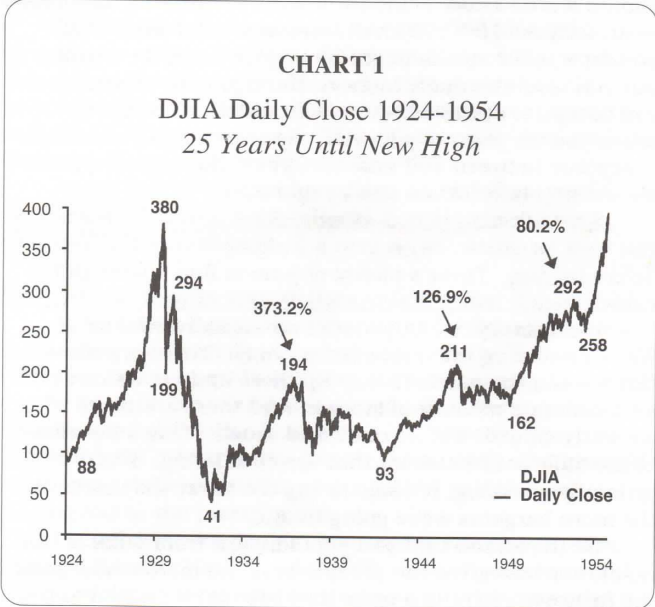
Not only can bubbles kill, but so can bear market rallies....

**A. Van Den Berg:** Then, in the middle of this decline, the markets mounted a sharp rally. Note in your chart that it went from 380 to 199 to 294. So it went down 50% — and then immediately it moved up 50%. And everybody thought that was the beginning of a new bull market. And if you look a little bit down the chart, you see it wasn't. It was probably the biggest rally in a bear market. But people got back in. And as soon as they got back in, the markets went back down....

What can we learn from that? First of all, when you have an era of total participation — an era in which people suspend all logic, become part of the crowd and buy things just because they're going up — you've got a bubble. And there's only one way a bubble goes down — the only way you let air out of a balloon — it either pops, or you just slowly let it out. However, one way or another, the air has to come out of the bubble.

[Editor's note: In a subsequent client review in Houston, he added: "[Here's] the dictionary definition of a bubble: 'Something insubstantial, groundless, or an impractical idea or belief' — in short, an illusion. In other words, stock market bubbles create illusions.

"But Sigmund Freud had about the best definition of an illusion as to how it affects the stock market.... 'Illusions commend themselves to us because they save us the pain and allow us to enjoy pleasure instead. We must therefore accept it without complaint when they sometimes



(continued on next page)



## CENTURY MANAGEMENT'S ARNOLD VAN DEN BERG (cont'd from preceding page)

collide with a bit of reality, against which they are dashed to pieces.' In other words, bull markets create bubbles, and bubbles create illusions, and illusions eventually lead you astray."]

You have plenty of time, after a bubble has burst, to get in.

**A. Van Den Berg:** Now here's the interesting thing about this market. People are always worried about missing the bull market. But once a major bear market has made its bottom, you don't need to worry about missing it. Take a look at that. In 1935, you could've bought the Dow at 100 — two years, three years after the bottom. And if you would've bought it at 100, you could've still gone to 194 and made 100% on your money.

If you didn't buy it during that time, you could have bought it again in 1938 — six years after the bottom — at 100. And five or six years later, you could've sold it for 200. And even if you missed it at that time, 15 years later, you could've bought it at 162. And as the markets moved up, you could've made a good profit then. So you have plenty of time in the stock market, once a bubble has been burst, to buy stocks. There should never be this compulsion to buy things just because they're going up.

Overpaying one time could have set you back 25 years....

**A. Van Den Berg:** For those who bought at the top range, I want you to look at this 380 level, or the 294 level. Look across the years and see how many years it took you to get to breakeven. Let me do the math for you: the answer is 25 years. It took 25 years after a bubble burst to break even. That's the important thing to understand about bubbles.

What protected you from folly and ensured profit was price.

**A. Van Den Berg:** Now, here's the other thing you should learn. Draw a line through the bottom of that chart — around the 150-200 level. And no matter when you bought it, your stocks might have gone down for a while, but you would've made money. But again, by contrast, if you bought it at the 295-300 level and up, it would've taken you 25 years to get even. By contrast, if you bought it anytime between 100 and 150, you'd have made a profit almost no matter when you bought it.

So the lesson is very simple: Once a bubble has burst, you wait for stocks to get into a fundamentally cheap zone before buying. There's plenty of time to find stocks in the value zone.

Incidentally, we buy stocks on an individual basis. We're just using the market as a proxy. There are many times when the market's way up there and yet we can find an inordinate amount of stocks. And there are times when it's fairly valued, but we can't find much. That's because of the different industries that are circulating. But generally speaking, it's safe to say the lower the market is, the more bargains we're going to find.

So the lesson that you should learn from 1929 is that no matter how great the prosperity is, no matter how great the future is, there is a price that you cannot afford to pay — because if you do, it could take you most of the rest of

your life to get even. And by contrast, if you buy in at the right price, it doesn't matter how long it takes — you're going to make money. And this is one of the great lessons that comes out of this '29 era.

By the way, why did it take so long? It took so long because the debt had to be liquidated and paid off. And the companies had to be restored. And the excess capacity that was built up — that had stayed idle for years — had to be used up. So it takes *many* years, when you have an extraordinary bubble, to bring things back.

THE BUBBLE IN THE NIKKEI WAS A CLASSIC.  
JAPAN HASN'T RECOVERED 15 YEARS LATER.

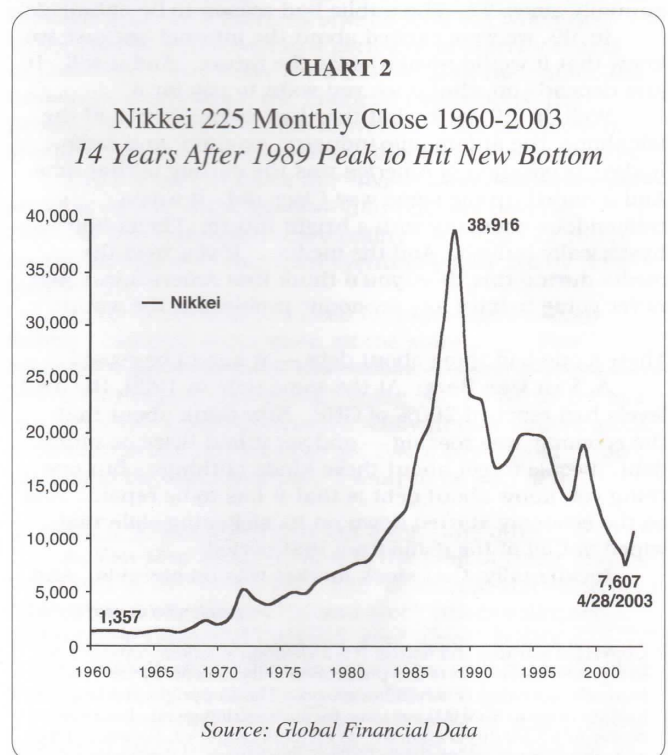
The Nikkei bubble made the '29 Dow look like a piker.

**A. Van Den Berg:** Next, I would like to review the Nikkei stock market in Japan. I would list this as one of the greatest bubbles next to our stock market in '29.

An interesting thing happened to Japan. Of course, Japan lost World War II. Their factories got bombed — and they rebuilt them. They started healing the country. The Japanese people are a very intelligent, industrious people. And they finally built some of the most modern, progressive factories and companies in the world.

As their economy started to move, their stock market started to move, too — and optimism took over. As a result, people started buying stocks and making money. The bull market in the Nikkei started in the '60s — at 1,357. And it just went straight up to 38,916 in 1989 — to nearly 29 times the original amount.

Again, at the top of the bubble in the U.S. in 1929, the Dow only went up about 6 times. The Nikkei went up almost 29 times. (See **CHART 2**.)



(continued on next page)



CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG  
(cont'd from preceding page)

So you can see why the Japanese people were just jubilant, overly optimistic and just hysterically bullish. And they bought stocks like you have never seen people buy stocks — up to their eyeballs.

Not only that, every Japanese company had all of its cash in stocks. People everywhere couldn't get enough Japanese stocks. And the Japanese made so much money that they came over here and bought our golf courses and half of Hawaii. They were just spreading that money around like it wasn't going to stop.

People destroyed by a bubble bursting don't soon forget it.

**A. Van Den Berg:** But all of a sudden, in the midst of this prosperity — at the height of this hysteria — the market started on a sickening slide that only last year made a bottom. Think about it. For those who jumped into the Japanese market at those insane prices, 14 years later, their stocks had still not even hit a bottom. Now that is what you call a *bubble*.

As a result, there is not a Japanese person alive who was involved in this bubble who is ever going to believe in or buy stocks again. Those people are cured *forever*. [Attendees laugh.]

It's just like those people who bought stocks in '29. Some of you have dads and moms and cousins and so on who lived during that time. And as you know, they've never felt the same way about stocks since — and they never will as long as they live.

I've got a client — he's one of my oldest clients — who's been with us since the beginning of the company. And he has had a very good return. Still, he always has that little shakiness in his voice when he talks about the

stock market. No matter how much money we've made him, he's never quite felt secure — because it's a subconscious thing. It's a little voice back there saying: "I've seen this before. I've *lived* this before." No matter what the numbers are, he's going to think about that.

Low interest rates aren't enough....

**A. Van Den Berg:** So Japan has been sliding down for 14 years. Their country has been in a semi-depression — call it a recession, if you will. There's not a lot of economic activity. Interest rates are at 1%. And you'd think that with 1% interest rates, stocks would be skyrocketing, right? You keep on hearing that if interest rates go down, stocks have got to go up.

Well, if Japanese interest rates are 1%, why aren't Japanese stocks going up? The reason why they're not going up is that in order for a high price earnings ratio to help you, you need earnings — and there *aren't* any.

Low interest rates alone won't do it. You need the other part of the equation. And when an economy is down, you don't get much of that. So a low interest rate alone isn't always going to save a market. It certainly hasn't saved the Nikkei.

ANY ASSET BECOMES RESPECTABLE  
IF ITS PRICE GOES HIGH ENOUGH.

Until 1971, U.S. dollars were convertible into gold.

**A. Van Den Berg:** The next bubble I'd like to look at with you is gold. They say there is no fever like gold fever. And if you look at your chart, you can see that's true. (See CHART 3.)

What started the gold bull market in this country? During the '50s and '60s, low inflation and low interest rates created the stock bull market of 1949-1966. And as the economy was expanding and the government was creating more and more money, foreigners got a little concerned because they were holding a lot of dollars.

At that time, dollars could be converted into gold. As a matter of fact, the legal definition of the dollar was: "payable to the bearer on demand 13.71 grains of gold." So you could walk into the Treasury if you were a foreigner and get 13.71 grains — or 1/35th of an ounce — of gold. That was the legal definition of the dollar.

And if they'd kept that promise, your dollars would now be worth \$12 — because gold is selling for around \$420 an ounce, and 1/35th of that would be about \$12.

You can still turn in your dollars today — just not for gold.

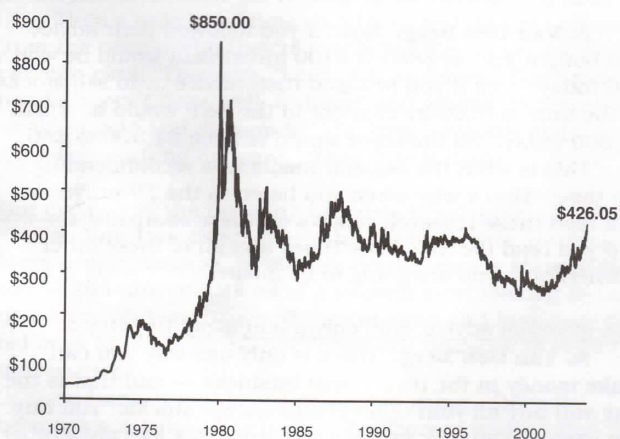
**A. Van Den Berg:** However, when foreigners started demanding gold and they started a run on the dollar, President Nixon knew that if they kept on turning in their money for gold, we would run out of gold. So he disconnected the dollar from gold. As they say, he "slammed the gold window down". As a result, there would be no more dollars exchanged for gold — just dollars trading out in the marketplace.

Therefore, if you look at your dollar bill now, it says "Federal Reserve Note".... Basically, what that means is if you go to the Federal Reserve and you turn in your note,

(continued on next page)

CHART 3

Daily Gold Price  
1970-2003



Source: Global Financial Data,  
Gold Bullion Price — New York (US\$/Ounce)



CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG  
(cont'd from preceding page)

you get *another* note [attendees laugh] — but you don't get any gold.

So long as the price is going up, you'll get a consensus.

**A. Van Den Berg:** Well, the foreigners realized, through their history of monetization, that gold was a little better than the dollar. So they started buying gold. And they had so many dollars around that they drove the price of gold up.

And any investment can be respectable if it goes up high enough. I am convinced it doesn't matter what it is — if it goes up high enough, university professors will write papers explaining why you should buy it. The pension funds will change their laws just in time to be able to get into it at the very top. The public won't *care* what it is as long as its price is going up. And the brokerage houses will shovel out these research reports that'll tell you by buying it, you're doing the right thing. So if its price is going up, you're going to get a consensus.

THE MEDIA IS A VALUABLE INVESTOR RESOURCE  
— BUT ONLY AS A CONTRARY INDICATOR.

Rising price turns barbaric relic into investment of choice.

**A. Van Den Berg:** At the bottom of its bear market, gold was referred to as a barbaric relic. But at the top, it was one of the most universal investments of choice. I'm going to read you some excerpts from an article that was written in 1979. And as I read it, I want you to focus on the date — 1979 — because unless you do, you're going to think it must have been written when the price of gold was at the bottom. But it wasn't. It was written when the price of gold was very near its top.

Here's what's happened: After the stock market was in the doldrums during the late '60s and early '70s and it went nowhere, *Business Week* came out with a startling research report. And when was this timely and scholarly piece of work presented to the world? Right at the top of the gold market and the bottom of the stock market. What was the title? "The Death of Equities". After the stock market had declined 40%, after it had gone nowhere for 13 years and was trading at 8 times earnings, *Business Week* came out with their "Death of Equities" issue. And we're going to talk about what they said about stocks, but let me tell you what they said about gold at that time.

On July 23, 1979, they wrote: "Institutions that manage pension funds began operating under a new and far more liberal interpretation of the labor department law. Pension fund money can now go in not only listed stocks and high-grade bonds, but also into small companies, real estate, commodity futures, gold and diamonds."

After they watched this market go straight up from \$35 to \$850, they decided it was time to get in.

When everybody gets involved in the act, it's too late.

**A. Van Den Berg:** Continuing from that same article, "At least 20 banks now include hard assets in their pension accounts. Just last May, for example, First

Citizens Bank & Trust began accepting diamonds in their self-directed trust accounts because of increased demand from customers."

This is one of the things you learn in this business — when the customers start demanding things, you know it's going to start topping out. This is the only business where the customer could be wrong. [Attendees laugh.]

Continuing from that article, "At least 95% of these customers are trying to escape what inflation is doing to their stocks," stated Vice President Ronald Mulholland. "Given this type of consistent high level of inflation we have been experiencing, the stock market represents speculation and some tangible assets represent the opposite," said Edward McMillan, chief economist for Rainier Bank."

I think about this and think to myself how at the top of the market when we're at 18-20 times earnings or more, people are thinking that it is properly priced, but at the bottom of the market in 1979, when the stocks were selling at 8 times earnings, the economists referred to them as "outright speculation", and gold at \$850 was the investment of choice. I just wonder what this guy would think of today's market at 20 times earnings, but I can only guess.

Continuing from that same article, "Today, one of the strongest proponents of gold investment is Alaska's W.J. Hammond." And here was this guy's wisdom: "He plans to submit a bill to the legislature early next year to lift a law that was passed in the early '60s that prevents the state public teacher's retirement fund from investing in gold. And at least three other states are currently interested in tangible assets for their retirement plans."

I want you to look at these statements from 1979 — and then I want you to look at what gold was selling for at that time. If you do, you'll see how every time when everybody gets involved in the act, it's too late.

If you listen to the media and analysts, you'll be misled.

**A. Van Den Berg:** And the media always gets converted to the prevailing point of view. They are a mirror and an echo of what everybody is thinking. They're going to convince you that you're doing the right thing.

[Editor's note: In our August 11, 2003 *OID* edition, Clipper Fund's Jim Gipson commented on the fact that, "...if there is bad news on the front page of the newspaper as opposed to the back page of the business section, that by itself may attract us to it."]

**A. Van Den Berg:** Now, if you followed their advice and bought gold at \$850, a \$100 investment would be worth \$50 today. And if you followed their advice ... to sell stocks at the time, a \$100 investment in the S&P would be worth \$1,500 today. So the score would've been \$1,500 to \$50.

This is what the popular media was recommending at the time. That's why when you listen to the TV programs and read these research reports on these companies — and you read *the New York Times* and all of these other blatherers — you are going to be misled.

Two pieces of advice: Buy cheap and avoid the crowd.

**A. Van Den Berg:** There is only one way you can make money in the investment business — and that is the way you buy all your *other* things except stocks. You buy 'em *cheap*. You buy 'em at a discount. It's like my mother used to say: "Arnold — you gotta buy it *wholesale*."

(continued on next page)



CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG  
(cont'd from preceding page)

That's the way you buy stocks. You've gotta buy 'em wholesale. Anyway, now you know why it was easy for me to convert to the value approach.

To sum up the words of Gustave Le Bon, who wrote a book on crowd behavior [the 1895 classic, *The Crowd: A Study of the Popular Mind*]: Any individual, when alone, can be a cultivated person. However, put him in a crowd and he immediately becomes a blockhead. The crowd always gets taken in.

[Editor's note: On a more somber note, this would not seem to bode well for democracies in the nuclear age — when oceans, for the first time in history, no longer represent the moat (and forgiving margin of safety for being asleep at the switch) that they always did before. Just one miscalculation like the one the Allies made during the years leading up to World War II, and Pax Americana could be over and mankind could be back in the Dark Ages — perhaps, because of technology, even darker than ever.

In other words, if the price of freedom always is eternal vigilance — and we believe it is — then the price of freedom during the nuclear age is far heightened vigilance. And we would strongly second Van Den Berg's comments and suggest that you not rely on the media to help you reach the right conclusion in matters of geopolitics either.

We apologize for jumping on our soapbox. However, we thought it was just too important to go unsaid.]

PENSION FUNDS ARE THE LAST TO GET SUCKED IN.  
BUT WHEN THEY DO, BOY DOES THE MONEY GUSH IN.

Pension funds don't get sucked into the latest fad.

**A. Van Den Berg:** Let me tell you one thing about pension funds — because they are a wonderful indicator. Pension funds are designed to protect you. So they have the most conservative laws. So whenever a new fad starts, they *never* get involved — because they're prudent men and women. And they're not going to get sucked into a fad. So they always resist the new ideas.

Then a little bit of time goes by — and they get pressure from the people who they're managing the money for at the pension plan. They say, "Look, stocks haven't done well, bonds haven't done well, but gold and diamonds are up — we want gold and diamonds." So they have meetings. However, nothing happens. They vote it down.

But eventually the pressure becomes irresistible....

**A. Van Den Berg:** Then the pressure gets greater. More people come in, brokerage house reports start to pour out — and universities all of a sudden start looking at the new ideas and see how well they've done and how poor the old ones have done. So out comes the research from the universities.

And now it just keeps going and going. Once it becomes a mania, all bets are off. There is no way that the trustee of a pension fund can resist. They have to eventually give in to the pressure from the public, from the liberated trustees, from the brokerage community, from the media and from the university.

And that is why these pension funds always get in at the tail end of *whatever* it is — because they're the last ones to get converted. But once they get converted, *boy* can the money gush in — all of these billions of dollars going into these investments and driving them right up at the top.

The latest big idea? Hedge funds....

**A. Van Den Berg:** Now, are you interested in what the pension funds' latest big idea is — the one they're having meetings on to change the law today? It's **hedge funds**. The latest thing that the pension funds are getting big on is hedge funds. It's an idea that's been around for 50 years, but it's only gotten its new life in the last five years.

Basically what a hedge fund can do is use any conceivable speculative idea known to man. And they can *make* huge amounts of money — and they can *lose* huge amounts of money.

The great thing about a hedge fund is that they don't have to report to the government. They are not regulated. So they can do anything they want. They can invest in anything they want to....

And here's another good feature. They don't even have to tell their clients what they're invested in. So you can just imagine what these things are invested in. They're not regulated and they don't report what they own. And now, because of their track record, these pension funds are moving into them in a big way....

Price determines respectability, not vice versa.

**A. Van Den Berg:** I think you've got the idea from the gold market that you can have a huge run-up in a market that has never been invested in — and eventually you're going to get everybody in.

Any market will gain respectability if it goes up high enough — and any market will *lose* respectability if it goes down enough. That is the *huge* swing in emotion that happens. And that's why conventional wisdom in the investment field changes so much.

And the only way you can get your bearings is to look through history to see what the great investments really have been.

THE INDEX FUND CONCEPT IS A GOOD ONE,  
BUT THERE'S THE LITTLE MATTER OF PRICE.

Conditions were great to start a bull market in 1949....

**A. Van Den Berg:** Now we're going to move on to the next U.S. bull market. This is the 1949-1966 bull market. And in that bull market, the Dow Jones Industrial Average went from 162 to 995 — up more than six times. And then it went sideways for 16 years.

Here is the condition that created the '49 bull market: The country had been in a war. So because everything had gone into the war effort, everybody was flush with cash. And the debt ratio was the lowest it had ever been in the history of this country. People owed less than they ever had. And that is a great way to start a bull market — because all of that cash can just come in and create another big bubble. And that's exactly what it did.

(continued on next page)



**CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG**  
(cont'd from preceding page)

Sometimes index funds are a bad idea — like today.

**A. Van Den Berg:** Seventeen years later, at the top of the bull market in '66 and '68, you just can't believe what was going on. That's when I got into the business — in 1968 — shortly after the market had begun a six-year downward slide punctuated with an occasional rally. And that market hit bottom in 1974. And as you all know, 1974 was the year we started Century Management.

Now what I want you to note is that this market went sideways for 16 years. It peaked out in 1966 at 995 — and it didn't break out above that level until 1982. During that time, if you'd owned an index fund — the *latest* thing that gained such popularity — you wouldn't have made any money for 16 years. (See **CHART 4**.)

We wrote an article back in 1999 in which we said that if you got into an index fund, over the next 10 years, the most we could see you making was a 3% per year return. And so far, it's right on schedule — because if you would've bought that index fund, it would've still been down 27%. And mind you, that's after five years.

Index funds are fine. But there's also the matter of price.

**A. Van Den Berg:** Why did indexing get so popular? It was a good idea that went to an extreme....

[Editor's note: As Charlie Munger recounted at the Wesco annual meeting featured in our December 31, 1999 *OID* edition, that's "a phenomenon Ben Graham talked about over and over again. He said, 'It's not the *bad* ideas that do you in, it's the *good* ideas.'...]

"He meant that if a thing is a bad idea, it's hard to overdo it.... You'll recognize it as a bad idea, so it's not going to cause much investment trouble. But where there is a good idea with a core of essential and important truth, you can't ignore it. After all, it's a good idea with

important truth in it causing big effects. And then it's easy to overdo it. So the good ideas are a wonderful way to suffer terribly if you overdo them."

**A. Van Den Berg:** The idea of an index fund is a wonderful thing: You've got a basket of stocks of the best companies in the U.S. They're low cost. You don't need a money manager. There's only one thing they forgot to tell you. You've gotta buy it *wholesale*. You've gotta buy it at the right *price*. And if you don't buy it at the right price, you can lose money in an index fund just like you can any other way.

And so if you buy an index fund within a value zone, it's a great idea. But if you overpay for it, you're going to lose money just as shareholders have lost millions — no, make that *trillions* — of dollars using these silly ideas. Great idea, kernel of truth, big lie wrapped around it. The big lie is that you can buy it at any price, and you'll do well because you're diversified and own a piece of America.

Doesn't that sound great? It's apple pie/piece of America. But do you want to pay \$25 for an apple pie? You don't like it *that* much, do you? How can you expect to make money by owning an index fund if you buy it when its holdings are selling at two or three times their sales?

So during that period, the market went nowhere....

IF PAST BUBBLES ARE ANY INDICATION,  
AFTERMATH OF THIS ONE WILL BE A DOOZY.

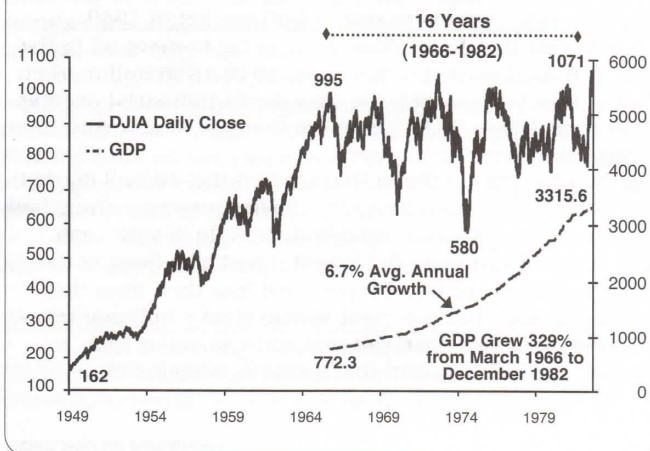
The most recent bull market was a doozy.

**A. Van Den Berg:** Please keep something in mind: The roaring '20s bull market ending in the 1929 bubble went up 6.3 times. The 1949-1966 bull market went up 6.1 times. And here you have the most recent bull market — and it went up 15 times. Does that kind of give you an idea that it might've been overdone a little bit?

The bull market that ended in '29 was not exactly a

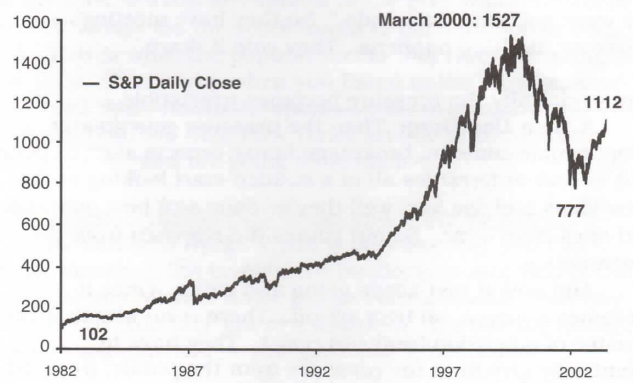
**CHART 4**

DJIA Daily Close  
1949-1966 Bull Market



**CHART 5**

S&P Daily Close  
1982-2000 Bull Market  
Current Bull Market Ending in 2000



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(cont'd from preceding page)

normal one. Neither was the one that began in '49. And for that matter, neither was the most recent one — but it went up more than twice as much. That's extraordinary.... Just take a look at this extraordinary rise. (See CHART 5.)

These aren't just squiggly lines; they're people's life savings.

**A. Van Den Berg:** All of you were reading the papers about the tech bubble. You knew what a great thing this internet was. You knew how these tech stocks were just gonna go and keep going and going and going — that the internet was just starting, that it was only a few percent of GNP. You were just at the birth of a new era.

And then the bubble burst. The sad thing is that there is still \$3 trillion of people's life savings that has been lost in this market. Even after this big rally, there's still been \$3 trillion lost. I want you to think about that. Think about all these people that worked 30 and 40 years to accumulate their life's savings. I've sat across the table from many of them where they've lost half their money. And that is something you never get used to hearing about. It's something you can never stand to hear.

I walk out of those meetings shaking my head and thinking, "These people spent most of their lives — 30-40 years in many cases — accumulating this money. And look what happens — almost in the blink of an eye, poof! — half or more of their life's savings is gone."

That's what bubbles do. They are absolutely extraordinary in terms of the pain that they inflict.

You can learn now or suffer later. The choice is yours.

**A. Van Den Berg:** And that's why it's so important for you to go back to these eras and read what happened

and see it repeated over and over again. It reminds me of a quotation by my favorite author, James Allen: "We either learn by wisdom and knowledge or suffering and woe. And we continue to suffer until we learn."

[Editor's note: As Buffett said in our August 8, 1997 *OID* edition, "Regarding learning from your own mistakes, the best thing to do is to learn from the *other guys'* mistakes.... Our approach is to try and learn vicariously. As Patton used to say, 'It's an honor to die for your country, but make sure the *other guy* gets the honor.'"]

**A. Van Den Berg:** These markets are here for you to learn from. And you can learn from them through wisdom, or you are going to continue to suffer until you do learn. One way or another, you will learn. You may not have all your *money* left if you learn through suffering. However, you will have improved your spiritual balance sheet....

Relative to GNP, U.S. stocks remain near historic highs.

**A. Van Den Berg:** If Saddam Hussein were still around, he would say that this is the mother of all bubbles. This next chart takes the total economy — the GNP [Gross National Product] which is the value of all the goods and services produced by the U.S. economy (about \$11 trillion) — and then divides that figure by the total market cap of all of the stocks that are trading on all U.S. stock exchanges. So it's basically like doing a price-to-sales ratio of the entire nation. (See CHART 6.)

Let me give you an example: A lot of businesses are sold on the basis of their sales. Take a doctor's practice. Let's say a doctor has \$350,000 in revenues. Well, it used to sell for about 80% of sales — whatever the revenues were, it sold for about 80% of that. Doctors' practices have since gone down. And they're now only selling at about 60% of revenues. But that's the idea.

So if a typical company has, say, \$100 million in sales, it might sell at something around \$80 million at its peak price, and maybe \$60 million as an average price.

Market cap to GNP's reflected valuations well in the past.

**A. Van Den Berg:** In '29, people were *very* optimistic about the future — so they were paying 83% of sales. And then you saw what happened afterwards. People *weren't* as optimistic when they *should've* been — and so prices were at 25% of sales. Then the bull market started, confidence returned, respectability for stocks was restored, and everybody was putting money into stocks — so that by December of 1968, the ratio of market cap to GNP of around 79% had returned to its 1929 level.

And then they started on a sickening slide — which I remember very well. They bottomed out at the 32% level. And it was from that level that the 1982-2000 bull market started up. By the way, take a look at 1979 on your chart. Again, that's when that scholarly piece of work on the equity market, "The Death of Equities", came out — with stocks at about 32% of GNP. That's when they were telling you that it was all over for stocks — and that instead you had to buy gold at \$850 an ounce.

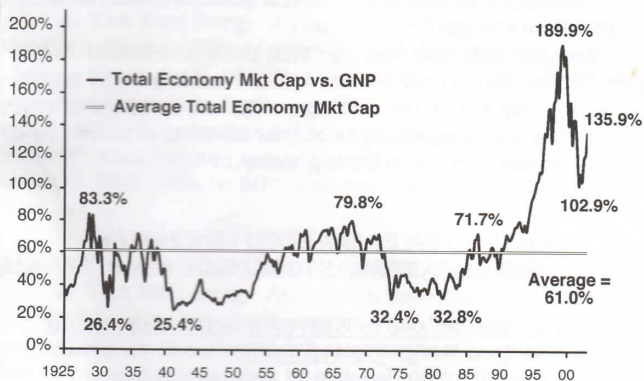
Based on historical market cap to GNP, we're in for it.

**A. Van Den Berg:** Anyway, the market started up. And it got a little heated in 1987 — it got to 71% of sales — and it promptly came back. And then it started rising in

(continued on next page)

**CHART 6**

Market Cap vs. GNP 12/31/24 – 12/31/03  
*Consensus Forecast for 12/31/2003*



Source: Blue Chip Econometric Detail Consensus Forecast, NYSE, NASDAQ, AMEX, BEA



CENTURY MANAGEMENT'S  
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(cont'd from preceding page)

earnest with the arrival of the technology revolution and the internet. And boy, did it do wonders for the stock market. As you can see, the ratio of market cap to GNP rose relentlessly 'til it got all the way up to 190% in 1999.

Again, you can't even *imagine* how big that is unless you compare it to the other bubbles. And that's why I had to show you the other bubbles first. You can't appreciate this chart until you compare it to the other bubbles. And now you can see what we're in for.

In 2002, we could find cheap stocks in a pricey market.

**A. Van Den Berg:** Now we've had a major correction. And the market cap to GNP got all the way down to 100%.... In September of 2002, about nine days before the bottom, we came out with a newsletter and said that was the time to buy stocks — because we were actually buying stocks at 30-40% of sales.

The rest of the market wasn't there. And we couldn't buy all we wanted. But we were buying stocks at 30-40% of sales — and that has *always* been a good time to buy, no matter *what* the regular market's been.

And we could find plenty back in 2000. But not today....

**A. Van Den Berg:** As a matter of fact, ... at the top of the market in 2000, the median P/E of the Value Line was actually between 14 and 15 when the median P/E of the S&P was between 25 and 30. That was the largest discrepancy between the median P/Es of those two indices that we've ever seen. So we were able to buy many, many ideas.

The reason was that there were old economy stocks and new economy stocks. And what *everybody* wanted was the new economy stocks. So they sold these old economy companies all the way down to 30-40% of sales — which is where we bought 'em. And that's why we had such a terrific year in 2000 — there were still cheap stocks.

And today? Well, with U.S. stocks in aggregate at 135% of sales today, we can't find a *thing*. And the reason why is that the rest of the market has finally caught up with the bubble. So big cap stocks have gone down, but the rest of the market is now way up there....

[Editor's note: Indeed, it appears to us that the median P/E of *Value Line* stocks in March 2000 was about 36% below that of the DJIA. Today, it's *above* it.]

THERE ARE TWO WAYS FOR NORMALCY TO RETURN,  
BUT NEITHER IS PARTICULARLY ENCOURAGING.

What do current valuations tell you about the future?

**A. Van Den Berg:** Anyway, here we are today with U.S. stocks in aggregate at something like 135% of sales. And here's what I want you to think about: During the last 50 years, the economy has grown at about 7% per year. And corporate earnings have grown about 7% per year. Isn't that logical to think earnings growth should track pretty closely with sales growth? It may be a bit erratic, but over the long run, the two should be reasonably close.

So I'm going to ask you a question: Starting from an overvalued position, if the market goes up 35%, you know

what that's discounting? Five years of growth. And so that's what this last rally just cost you — five years — because it was already overvalued to begin with. So now it's that much *more* overvalued....

Some combination of two things has to happen....

**A. Van Den Berg:** So what will happen? Basically, here's the answer: Let's take an individual who's about six feet tall. Most men should weigh around 32 pounds per foot. So he should weigh about 190 pounds. Well, let's say this individual weighs around 320 pounds. How are we going to get this individual to a normal weight? The obvious answer is that you can take the weight off. But that's not the *only* way. He could grow four feet [the audience laughs]. In that case, he'd be 10 feet tall, weigh 320 pounds and be just right.

How are we going to do that with the market? Well, it's 130 pounds overweight. So that weight can either come off, or the economy has to grow four feet. The only problem is

PORTFOLIO REPORTS estimates the following were Century Management's largest equity purchases during the 3 months ended 12/31/03:

1. SONOCO PRODUCTS
2. TRANSOCEAN INC
3. NS GROUP INC
4. DIXIE GROUP INC
5. LAYNE CHRISTENSEN

that it only grows 7% a year. And if it's going to grow 35%, it's going to take five years to grow those four feet.

So how do we get back to equilibrium? There are only two ways. Either GNP has to go up — and fortunately it is going up, so that's probably going to give us 7% a year — or the market has to go down. If it doesn't go down and it's 60% overweight, and it's only going to grow 7% a year, then it's going to take 12 years to get where it should be.

Bear markets tend to be long. But there is a way to beat it.

**A. Van Den Berg:** So you either grow into the sales, take the stock price level down or have some combination of both. And that's why, after bubbles break, they take 10, 15 or even 20 years to recoup their losses. In other words, they have been so overpriced that it just takes all these years to work it off.

And the only way you can beat these markets is to buy stock down around 30-60% of sales. And it doesn't matter where the market is. But when stocks are at 135% of GNP, it's hard to find something to buy at 30-60% of sales. And that's the problem we're having today....

PRICE TO SALES IS A GOOD BENCHMARK  
FOR MARKET AND STOCK PRICE ALIKE.

Buffett likes market cap to GNP even better than we do.

**A. Van Den Berg:** Warren Buffett wrote an article in the December 10, 2001 edition of *Fortune* magazine entitled, "Warren Buffett on the Stock Market". He used this very chart. (See CHART 6.) And he said that if he had to use one single measure of corporate equities, that would

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be the one he would use. He said that it has some flaws, but that overall, it's a very good indication.

I personally agree with it. I have another indicator — a chart like this — that I like even better. But I won't disagree with anybody, because basically you're looking at the total gross national product — all the sales of everything in the whole country — and you're dividing it by the value of all the stocks. It's hard to go wrong doing that.

Market cap to GNP bypasses the earnings shenanigans.

**A. Van Den Berg:** And there is one major advantage to this approach — that you're not dealing with earnings. And as we're going to show you later on, earnings can be almost anything economists *want* them to be. [There's a smattering of laughter among clients.] It's not a straight math discipline they use in developing these earnings.

But you can't argue with the gross national product — and you can't argue with what prices stocks are selling for. So this flushes out all of the accounting games that are very prevalent nowadays. Again, it's kind of like looking at a price-to-sales ratio. It's not to be used by itself, but it's a very good indication.

Averages be damned. If a stock's price is right, we buy....

**A. Van Den Berg:** Buffett said that a good spot to start buying stocks is when the ratio falls to 70% or 80%.

[Editor's note: The exact quote is as follows: "If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200% — as it did in 1999 and part of 2000 — you are playing with fire..."]

**A. Van Den Berg:** Now, I've already shown you that the average is 61%. However, I wouldn't again argue with buying stocks at 70-80%. All of the stocks that we buy, generally speaking — not always, but usually — are selling below 50% of sales.

So when we buy a stock, it tends to be 50-60% cheaper than what this chart shows the market trading for today.... [Ed. note: Over 63% cheaper, but who's counting?]

If you bought right, you'd have made money always.

**A. Van Den Berg:** If you start buying stocks when they're selling at 50% of sales — and then average down if they go lower to 30-40% so that you pay an average of 40% — would there have been any time in the history of this chart in which you wouldn't have subsequently made a lot of money? Can you see any place where you would've bought them at 30%, 40% or 50% and not have made money? No. You can't.

Stocks don't stay that cheap — or this expensive.

**A. Van Den Berg:** And that's because when stocks do get that cheap, they don't *stay* cheap. Similarly, when they get this expensive, they don't stay expensive. And that's the important lesson that one should learn from history — they never stay that expensive.

**Benjamin Graham** once said in the short term, the stock market a voting machine; in the long term, it's a

weighing machine. So when the market weighs values, they get back to where they should be. And you can see that they're not there yet.

[Editor's note: We challenged Van Den Berg by suggesting that perhaps today's high profit margins and rich P/E multiples, as well as the way above average ratio of market cap to GDP, are justified, at least in part, because a higher proportion of those earnings come from branded goods companies — many of whom have significant international sales. As a result, we suggested, profit margins and returns on capital *should* be higher. And likewise, the P/Es on those earnings should be higher.

While acknowledging that we may very well be right on those particulars, he quickly provided the *coup de grace* to our argument by providing us with the following chart (See **CHART 7**) and explanation:]

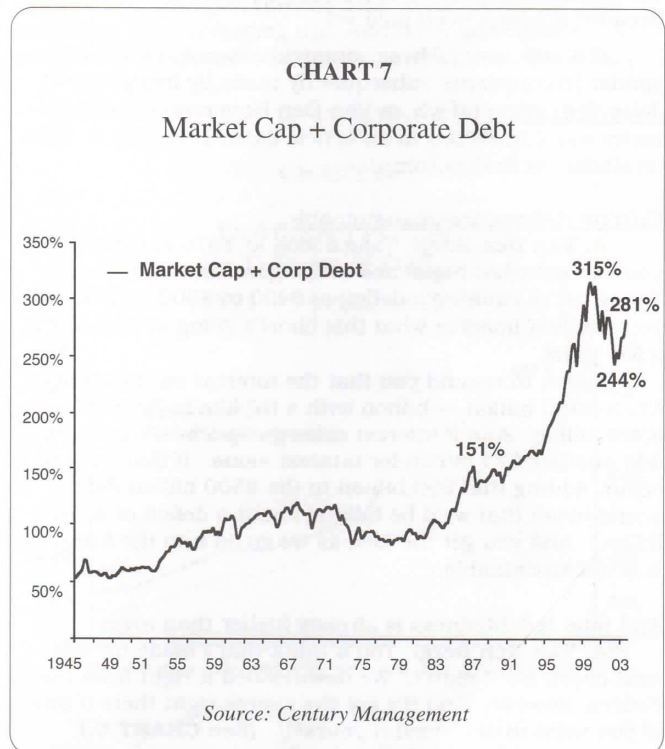
**A. Van Den Berg:** I think our chart that shows market cap to GNP shows just how expensive stocks are today just fine. But when you factor in corporate debt — by looking at the ratio of market cap plus corporate debt to GNP — you see that valuations are even *more* out of sync. And almost nobody is talking about that.

When people lament that this market is selling at a price/earnings multiple of 19 or 20, I don't hear anybody saying it should be lower because of the additional debt.

**OID:** *Because the higher leverage means that the financial risk is greater and, therefore, that the earnings quality is lower.*

**A. Van Den Berg:** Exactly. And it also shows that not only is the consumer tapped out, but that businesses are near record levels of indebtedness, too.

**OID:** *There's no need to get personal.*



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CENTURY MANAGEMENT'S  
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[Editor's note: We now return you to our coverage of this year's Century Management Client Conference.]

BULL MARKETS DON'T BEGIN FROM HIGH DEBT LEVELS  
— AND INDEBTEDNESS TODAY IS HIGHER THAN EVER.

The problem with democracy? Citizens get what they want.

**A. Van Den Berg:** Now I want to give you some ideas on how to judge this presentation — because I know that we're throwing a lot of information at you. And I know that some of you like to research this kind of thing for yourself. And we encourage that. The more people there are in this country who know what's going on, the better chance we've got of getting the right people in office — because when you see the next chart, you're going to know that we've had some people in office that should've never been there.... (See **CHART 8**.)

How did we get here? Let me read you a quote: "I wish it were possible to obtain an article to our constitution ... I mean an article taking from the federal government the power of borrowing."

Who do you think said that? Would you believe it was Thomas Jefferson? How about that for some wisdom? He knew that when you empowered the government to borrow money, the politicians would give you what you want — and this is what they did. They gave you all these wonderful programs. But take a look at the price tag — because it hasn't been paid yet.

[Editor's note: These comments sound remarkably similar to comments subsequently made by living legend John Templeton (of whom Van Den Berg reminds us in many ways) in *Forbes* in an article dated February 4, 2004 (available on [Forbes.com](http://Forbes.com)).]

Current deficits are unsustainable....

**A. Van Den Berg:** Take a look at 1970 and 1980 and you can see what happened to the government debt. Today, we're running a deficit of \$400 to \$500 billion. So you can just imagine what this chart's going to look like in a few years.

I want to remind you that the interest on this debt at 5% is \$350 billion — billion with a "b" like in "babies" — \$350 billion. And if interest rates go up 2%, it's going to add another \$70 billion for interest alone. If that were to occur, adding that \$70 billion to the \$500 billion deficit would mean that we'd be talking about a deficit of \$570 billion. And you get the idea as we go on into the future. It is not sustainable.

And total indebtedness is already higher than ever.

**A. Van Den Berg:** You'll think that I made up this next chart, but I didn't. We downloaded it right from the Federal Reserve. And it's got the source right there if any of you want to download it yourself. (See **CHART 9**.)

When you take a look at this chart, it tells you

everything that's going on in this country. We've had the greatest debt accumulation in the history of this country. And that includes debt of all kind — mortgages, government and consumer. And when I look at the numbers year by year since 1994 — a 10-year period — as a nation, we've added \$10 trillion of debt.

Now to put that in perspective, the U.S. economy took over 200 years to grow to its current \$11 trillion. Just think about that. In the past 10 years, we've added \$10 trillion worth of debt.

Plus, the biggest segment of the economy is tapped out.

**A. Van Den Berg:** The consumer now accounts for 70% of the economy — 70%. It used to be 66%. However, now he's moved up to 70% — because of all of this easy money, borrowing against homes, etc. Most people today use their houses as an ATM machine. If they need money, they borrow it. So the mortgages have grown to be greater than they've ever been.

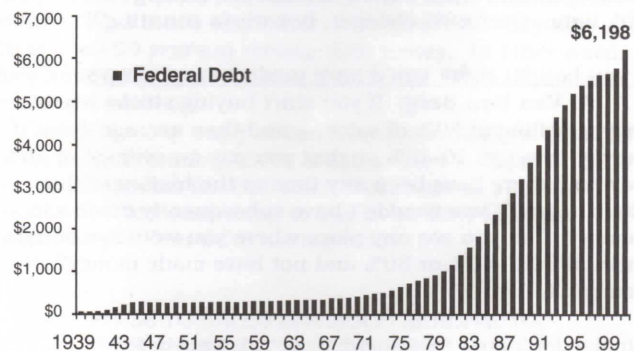
With the tremendous appreciation in house prices, you'd think people would have more equity in their houses. It turns out they have less. That's because they borrowed it all up — and they spent it. And then they borrowed some more.

Now we keep hearing about the economy growing and expanding. And we look at the consumer who's tapped out to his eyeballs. So I'm just wondering, where are they going to get these consumers? Are they going to import 'em from Mars? You just don't have that many people in this country who are that flush in cash.

Compare it to the beginning of the bull market in '49 when the debt to GNP was only one to one. Today, it's three to one. So the consumer is really tapped out. And the interest on his debt is now 18% of what they refer to as "financial responsibility payments" — in other words, 18%

CHART 8

Total US Federal Debt  
1939-2002 US\$ (Billions)



"I wish it were possible to obtain a single amendment to our constitution ... I mean an additional article, taking from the federal government the power of borrowing." — Thomas Jefferson, 1798

Source: St. Louis Federal Reserve, FRED II

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of his disposable income. That's a pretty big burden. And it's pretty hard to imagine that this can go on.

**BESIDES HIGH LEVELS OF INDEBTEDNESS,  
I WORRY ABOUT DERIVATIVES AND MARGIN DEBT.**

Derivatives may transfer risk, but they also create it.

**A. Van Den Berg:** I'm going to show you something. I don't want to dwell on it too much, but it's something that is of great concern to me — and that is derivatives. (See **CHART 10.**)

Because of the low interest rates, everyone has to hedge in the mortgage market. Currencies have to be hedged against each other. And corporations that don't want to take a risk can always find somebody at the other end of a derivative to hedge that risk....

So banks are involved in all of these different schemes to hedge everybody's risk — never realizing that they're creating more risk by doing so.

Now, guess what is the most popular method of investing in the hedge funds? Using derivatives. That's because you can place a bet for less than 10% — sometimes as little as 5%. But let's just take 10%. The notional value — the word they use for the aggregate nominal value of these financial schemes — is \$67 trillion. That's with a "t" like in "terrible". Again, that's \$67 trillion. Only 10 years ago — in 1991 — there was only \$7 trillion of this kind of nonsense going on.

We're going to talk to you a little bit about what happens when these things blow up. But I can tell you that they've added another dimension of risk to the

economy — because in any of these things, if somebody can't deliver on the other end, you've got a loss.

And they're a new source of risk we've never had before.

**A. Van Den Berg:** There are some banks ... that have 25-30% of their assets in this type of thing. So you can just imagine what could happen. I'm not saying it's *going* to happen, but I'm saying that it could happen. And it's an element of risk we've never had in the economy.

Now Greenspan says that it's a good thing because it allows people to *hedge* their risks.... Well, in the good old days, you got paid for taking risks. Now you can pass 'em on to somebody else.

But that doesn't mean that you're totally hedged — because what if the speculator doesn't pay up? What if the loss is so fast and so great that he figures, "To hell with it, I'll lose my money. I'm not going to make up the difference."

Another source of risk — margin debt....

**A. Van Den Berg:** When you go to a brokerage house and buy stocks at 50% margin, the brokerage house is protected because most stocks don't drop 50%. However, in 1987, when the market fell nearly 23% in one day, there were people whose stocks went down so fast that they lost all of their money. And the brokerage firms had to go after 'em and even sue 'em in order to bring in the rest of the money. But if the brokerage house customers didn't *have* the money, they were on the hook.

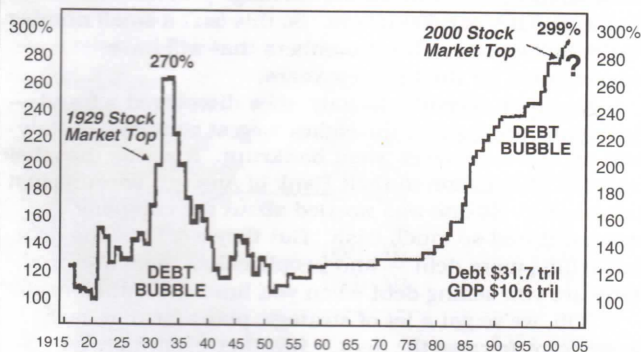
So if we ever get a meltdown, there's going to be a lot of people that are not going to be able to make good on those margin calls. And that's *another* thing to be concerned about.

Leverage is a double-edged sword. It cuts both ways.

**A. Van Den Berg:** What created this bull market, as you can see, was government debt, consumer debt, and everybody else leveraging up. And if it's done over a sufficiently long period of time, you don't even *notice* it.

**CHART 9**

**Total Credit Market Debt  
(All Sectors) as % of U.S. GDP**

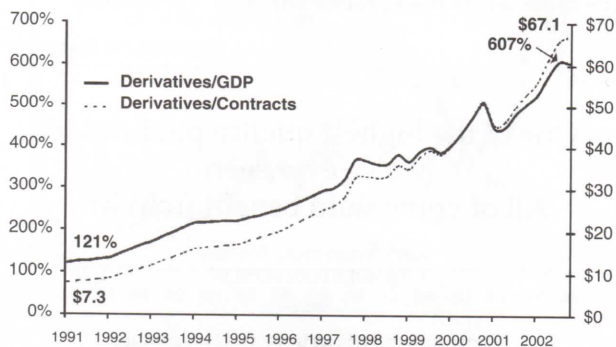


"When we are living on this much borrowed money, we are also living on borrowed time." — Paul Volcker, Federal Reserve Chairman, 1979-1986

Source: St. Louis Federal Reserve, FRED II, BEA

**CHART 10**

**Derivatives vs. GDP  
(in Trillions of Dollars)  
1991 – September 2003**



Source: BEA, U.S. Treasury's OCC

(continued on next page)



CENTURY MANAGEMENT'S  
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(cont'd from preceding page)

But when you see that number from 1994 — when I saw it, I had to go back and check it two or three times, because I could hardly believe that we, as a nation, put on as much debt in 10 years as the gross national product. That is a mind-boggling figure.

I don't even want to *think* about how we are going to pay this all back. I have a feeling that there are going to be a lot of banks with some extra boats and cars and planes and whatever else that are out there. So there's going to be a real opportunity to buy bargains at some point in the future on consumer products.

AS BUFFETT SAYS, ONLY WHEN THE TIDE GOES OUT  
DO YOU FIND OUT WHO'S BEEN SWIMMING NAKED.

It's easy to start down the slippery slope of fraud....

**A. Van Den Berg:** The second thing that causes bubbles to rise is fraud — down and outright fraud. Now you may say to yourself, "Why do bubbles create fraud?" Bubbles create fraud because there is an expectation built in. These companies promise rosy earnings. Some of them actually believe they're going to bring 'em in. And they trot these numbers out — and the stock goes up.

And then, all of a sudden, they're sitting in a board meeting and saying, "Gosh, sales dried up. It must be an aberration. But if we tell the stockholders, the stock is going to tank. So why don't we move some inventories or receivables around — or load up our boxes with rocks and send 'em out and call 'em sales — and book those sales. And then by the next quarter, we'll adjust it."

You know, it sounds like an OK idea if you can get by with it for a quarter.

And there are powerful incentives not to 'fess up.

**A. Van Den Berg:** But at the next quarter's meeting they're sitting there, and they say, "Gosh, the sales dropped even more. So what can we do *now*? Well, maybe we can sell some assets. Maybe we can figure out a way to bring those into the income statement. Or maybe we can fill up some more boxes full of rocks and ship 'em out and

(continued in next column)

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increase our reported sales. Or maybe we can show some inventories." There are a lot of different things you can do if you want to play the game.

Think about what corporations' boards are into. If they come out with the truth, the stock tanks. And if the stock starts to tank, the banks start looking at their bonds. And if the banks get worried about their bonds, they could call their loans. So they're all sitting around and saying, "You know, if we tell them the way it is, they're going to call the loans, and the stockholders are going to sell the stocks, and then everybody's going to lose. So let's just play the game and lie to the people and maybe get by this thing."

And then, of course, the truth catches up — because the sales usually slide down as a function of the economy rolling over.

And nobody cares while stocks are going up.

**A. Van Den Berg:** In this gigantic bubble, very few people cared when these stocks were going up whether the balance sheets were good — whether they made any money. Some of 'em didn't even have sales! But if they're going up, who *cares*? If you're making 50% per year on your money, who needs to get that particular? *Something* must be working OK with the companies. Otherwise, why would their stocks go up? Never mind that they're going up because you're buying them.

Which kind of reminds me of a broker who's talking to his client. He says, "I've got this great little company." And he tells him about it. And the client says, "Well, buy me \$1,000 worth." So he buys him \$1,000 worth. And he says, "You know that little stock I sold you the other day. It's up to \$3,000 already." So the client says, "Oh my God! Buy me some *more!*" So he keeps on moving it up until it's about \$10,000 — at which point the client says, "Boy, this is great. This is a hell of a run. Why don't you go ahead and sell some?" — to which the broker says, "To *whom*?" [Attendees laugh.] That's what happens in these markets.

But the moment of truth eventually arrives.

**A. Van Den Berg:** So these companies came out and stretched. But then there's a moment of truth. Well, take a look at the moment of truth in this chart. (See CHART 11.)

These are companies that have either committed fraud or been accused of committing fraud with total pre-bankruptcy assets of at least \$274 billion.... Do you know what the total corporate earnings projected for next year are? They're \$600 billion. So this isn't a small number. You're talking about huge numbers that will have ramifications for the next few years.

And then recently, in Italy, they discovered a fraud — Parmalat Corporation, the eighth largest company in Italy with 36,000 employees, went bankrupt. It seems that their reported \$5.4 billion in their Bank of America account just didn't exist. No one was worried about the company because it had so much cash. But they were issuing debt and selling more debt — and people called them and said, "Why are you selling debt when you have that much cash?"

"Oh, we've got a lot of strategic plans for that cash. So we want to raise the debt." But they eventually got to the point where they couldn't pay their bills. And then the creditors started investigating them. And Bank of America apprised them that they didn't *have* \$5.4 billion in their bank account.

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(cont'd from preceding page)

You have to wonder what happened to their auditor, or anyone else connected with their financial statements. Well, they found one guy — he just committed suicide. So that's probably a pretty good lead as to who was involved. But they still haven't figured it out.

However, it doesn't matter — because it's bankrupt. These are the kinds of things that happen. In every economy — in every bubble — people have committed fraud. As a matter of fact, in the '29 bubble, the president of the New York Stock Exchange went to jail because of the fraud involved.

Whenever you've got things going up, you've just got people who are going to be doing that kind of thing. Therefore, we have to be on our toes for it.

**ADJUSTING STATED EARNINGS FOR FLUFF,  
P/E MAY BE MUCH HIGHER THAN IN PAST BUBBLES.**

Excluding hot air, the current P/E may be around 24.

**A. Van Den Berg:** Another thing that causes bubbles is overstatement of earnings — not necessarily fraud, but just stretching the truth a little bit, sometimes legally. Now, how do we detect that? Well, you can go to the IRS, download the corporation's profits, and you can see what they report to the government. So *there's* a clue, isn't it? You see what the corporation's reported as profit to the government, and then you see what they've reported to shareholders. And by golly, there's quite a difference today — something in the neighborhood of 25% in aggregate.

**CHART 11**

**Bankruptcy or Fraud**

	Bankruptcy Date	Total Assets Pre- Bankruptcy (US\$ Billion)
1. WorldCom	07/21/02	107.0
2. Enron	12/02/01	63.4
3. Global Crossing	01/28/02	25.5
4. Adelphia Commun	06/01/02	24.4
5. Pacific Gas & Electric	04/06/01	21.5
6. KMART Corp.	01/22/02	17.0
7. Reliance Group	06/12/01	12.6
8. HealthSouth	06/01/01	2.7

Total Pre-Bankruptcy Assets \$274 Billion

Firms listed above have either been proven to have committed fraud or have been accused thereof.

Source: Century Management

Well, have you ever heard of anyone overstating their earnings to the IRS? I don't think so. Therefore, it's a pretty good bet that those are pretty conservative numbers. I don't think there's any bragging in reports to the IRS. But boy — when they dress those numbers up for their shareholders, they're something to behold. And today, the difference between reported numbers and IRS numbers is 25%.

Mind you, it's not all fraud. Some of it is legal. And we're going to show you how that's done. But my point is that when we take the total corporate profits of corporate America and divide them by the total market cap of all publicly-traded companies, we come up with a P/E of 24.6.

The important thing to understand — the only thing you need to understand — about this ratio is that it's much higher relative to corporate profits than it's been historically by a big margin.... (See CHART 12.)

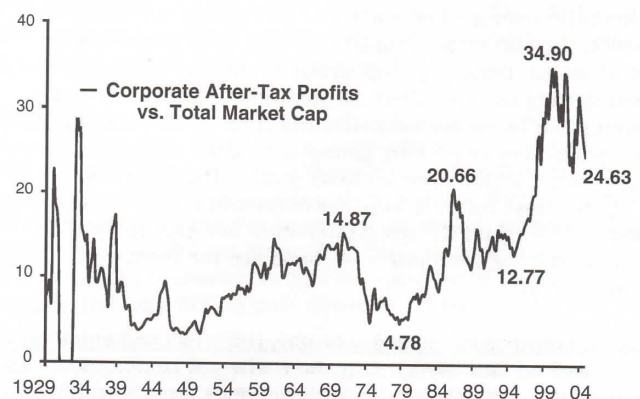
Stated earnings aren't docked properly for stock options.

**A. Van Den Berg:** Analysts project that the companies that comprise the S&P will earn \$60 in 2004. So dividing that by the market cap of those same companies, the S&P is trading for 19 times earnings. Meanwhile, based on the projected earnings those same companies report to the government, they're trading at over 24 times 2004 earnings.

Why such a big difference? Well, let me give you some hints. First of all, corporations do not expense stock options. That means if a company hires a valuable employee and gives him part of the company as part of his compensation, as far as the balance sheet and income statement are concerned, it doesn't cost the company anything. Well, that would be like you giving me 2% or 3% of your home to manage your portfolio and claiming that you still own 100% of your home. Well, you *wouldn't*. I would own 2% or 3% of it for every year that we had that arrangement.

**CHART 12**

**Total Economy P/E**  
*Consensus Forecast through 12/31/04*



Source: Blue Chip Econometric Detail Consensus Forecast, NYSE, NASDAQ, AMEX, BEA

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Did it cost you anything? Well, I think so. And I think that you would say so. And if any of you *don't* think it cost you anything, I'd like to speak with you about implementing that arrangement later today.

So it costs them. But they don't put it down that way. They feel they get it back in terms of productivity. Well, maybe they do. However, it's still a cost. And if they accounted for that cost properly, that would reduce their earnings by 10-15%....

Accounting for pensions properly would hit 'em 10% more.

**A. Van Den Berg:** Number two, these companies have costs associated with pension administration. But the way they account for the pension expense is that they say there's so much money coming due when our people retire, and we're going to make 9% on our money — and bingo, 20 years from now, here's your pension check.

Well, what happens if companies only earn 6% on their pension assets? Or what happens if they don't make *any* money on their investments as has happened in many companies over the last five years? What do you do then?

Well, you had an expectation of 9% — and you only made 6%. So that means 3% is missing. How does the accounting work? Oh, don't worry about it. They don't have to write it off this year. They can just spread it out over the next 20-30 years as a loss.

But if they *make* money on their pension plan — if they estimate that they'll make 9% and wind up making 12% — then they can recognize that as operating income. Now what kind of accounting is *that*? They make money on their pension and put it in as part of corporate profits. And if they lose money, they spread it out over 30 years. You get the idea? If you account for pension expense properly, that would result in their earnings being lower by *another* 10%.

Adjusting for other shenanigans would hit 'em 5-8% more.

**A. Van Den Berg:** And then it would result in reported earnings dropping another 5-8% if you just eliminate your garden variety of stretching the truth — which they do by playing games with their inventories, receivables, moving things around, etc. By God, they're just getting more creative all the time. Frankly, if they would just be as creative running their businesses as they are when they're playing games with their accounting, we'd have some serious productivity gains. But they don't.

So most corporations are overstating their earnings by about 25%. And the overstatements are especially great among the big companies — those are the most overvalued companies.

But accounted for properly or not, the truth will come out.

**A. Van Den Berg:** But the truth will come out eventually. And it may come out sooner than you think. In the year 2005, it looks like they're going to have to start expensing their stock options — and that's a good start. So all those rosy earnings you're hearing from Wall Street might have to be adjusted. And if they are, I believe the market will have to be adjusted, too. Eventually, that will

have to come out. There will be a moment of truth.

And if there *isn't* a moment of truth, it's going to come out anyway — because all those other options they create, when those people turn those options into shares of stock, the earnings pie is going to be divided into more pieces. So these companies are going to make less per share.... When these options come due, and when they're reworked into the capitalization of the company, they're going to reduce the earnings. We call it "fully diluted earnings".

Whenever we look at a company, we factor in the likely impact of the options. We buy it with all the options already figured in.... And that lowers the valuation quite a bit.

BUT EVEN USING STATED EARNINGS,  
WE'RE IN A VERY HIGH MARKET TODAY.

We pay attention to the Value Line median P/E.

**A. Van Den Berg:** I want to turn you over now to something that'll give you an idea of where we are today.... In September of 2002, when the market was coming down very dramatically and people were getting very nervous and prices were collapsing pretty much across the board, we thought we would send out a newsletter to our clients to let 'em know where they were. And to do that, we introduced them to the Value Line median P/E. And if you will recall, I told you I was going to give you my favorite indicator of value. Well, here it is. That's not to say that I don't like the other one that Warren Buffett mentioned. However, I think for us, this is a much better one.

Every week, *Value Line* takes 1,700 stocks and figures out their P/E. But they don't use the *average* P/E like the S&P does, they use the *median*. And what exactly is the median P/E? Well, to calculate the P/E of 500 companies, it's the P/E of the 250th or 251st company — of the one that's right in the middle.... So it eliminates the outliers at both ends that might otherwise distort the value.

Using medians rather than averages reduces distortion.

**A. Van Den Berg:** For example, in 1999 and 2000, we wrote an article pointing out that 10 members of the S&P, because they were so huge and weighed so much in the calculation, accounted for 77% of the performance of the S&P. So these big stocks can really distort an index. But if you take the median, it eliminates that distortion....

Everybody always likes averages. However, averages tend to distort things by a huge amount. If you have your head in your freezer and your feet in your stove, for example, you may have a fairly average temperature averaged out — but I just don't think you're going to be comfortable. [Clients crack up.] So we don't like averages. We like the midpoint. That's the figure we like to use when we're looking at P/Es.

We compare the Value Line median P/E to bond rates.

**A. Van Den Berg:** Now, what I have done over the past 25-30 years is I've compared this median P/E — and you can use the median P/E on the S&P or whatever — and compared it to bond rates. And the logic of it is, if bonds are cheaper than stocks, why buy stocks? We buy bonds. And when stocks are cheaper than bonds, we buy stocks.

So if we've got a bond rate at 7%, we wait until stocks yield 7%. And it's a little bit more involved... But by

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inverting that P/E and dividing it by 100, we get the earnings yield of a stock. So, for example, if there's a P/E of 14, that's the same as a 7% earnings yield on a bond.

But if we can buy a stock at the same yield as a bond, we also get the earnings growth. And in the average stock, that's historically been around 7%. So we have a bargain, right? Wouldn't you rather have something that's a little bumpier but that gives you the same yield right now as a bond, but whose yield also grows at 7%? I mean, a bond may give you 7%, but it doesn't grow. With a stock, you get the yield *and* the growth.

When stocks yield as much as bonds, you get the growth free. Well, when that happens, stocks are an enormous bargain — and that usually happens at the time when most stocks bottom.

With a 14 P/E, there was much upside and little downside.

**A. Van Den Berg:** So when we wrote the newsletter, the median P/E according to *Value Line* was around 16.2. And the 10-year AAA corporate bond was yielding 6.19%. But we used a figure of 6.75% because that's our estimate of the normalized rate.

So anyway, we said stocks are starting to look cheap, but they've still got some risk. In a small down market, they'll decline 8-9%. In a larger market decline, they'll fall 13-14%. But we said the point of maximum pessimism — the time when people are just not being rational about stocks — is when you can buy a stock with the same earnings yield as a bond and get the growth for nothing. And that would be when the median P/E gets down to about 14. Well, lo and behold, it actually got down to 13.84 before the market turned around.

And from the bottom — from a median valuation of around 14 times earnings — we figured the median stock had appreciation potential [to a peak P/E multiple of 20.5] of approximately 46% with very little risk on the downside. So we figured that the risk from that price was negligible.

Today, it's reversed. We're in a very high market.

**A. Van Den Berg:** Well, guess where we are today? The median P/E according to *Value Line* is at 19.5. And the highest peak that we've ever had in a median P/E is 20.7. However, we don't like to wait until we break new records before we sell....

So with a median P/E of 19.5, we have potential

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appreciation of about 6% if it goes to 20.7.... But we have potential downside of 28%.

Now, is that the way it's going to happen? Well, I don't *know*. The market could set a new record peak. However, the average stock is as high as it was in 2000 — if you can believe it. And I don't mean the S&P 500 — because it's still down 27% from its peak. But the *average* stock is that high. So we are in a very high market.

ASSUME WHAT YOU WILL, THE S&P'S OVERPRICED —  
AND WE THINK PROFIT MARGINS ARE UNSUSTAINABLE.

Century's take on the Fed model...

**A. Van Den Berg:** But let's look at the next chart — which I also included it in our September 2002 newsletter. This is what we come up with when we use the so-called Fed model [method of estimating fair market value (FMV)]. Admittedly, it's an oversimplification. However, it gives you the idea. (See CHART 13.)

By the way, when you use this valuation method, the first thing that you've got to believe is the earnings — which we don't. Looking forward to this year's earnings, we use the same \$50 we did in September. If you use \$60, of course, you'd come up with a lot higher result.

The "E" in P/E is well above any sustainable level.

**A. Van Den Berg:** But there is no way the market can earn more than \$50, on a long-term sustained basis — once things get washed out. Mind you, it could do it for a very short period of time — perhaps a year or so. It could even do it for a year-and-a-half — or even two years. However, it's not going to do it over the long run.

And here's why I say that: The S&P has \$700 of sales per share. The average net profit margin that corporations have earned over the last 50 years is anywhere between 4% on the low side to, at *most*, 7% on the high side. There's been a few years — during the high inflation of the '40s and '70s — when, because of inflation, the margins temporarily pushed up to 8% or so, but that certainly wasn't sustainable. Based on what it's been over the last 50-60 years, I expect it to usually be between 4% and 5%, and maybe hit 6% every once in a while.

But if you take the \$60 that Wall Street is projecting, you would have to project 8-1/2% margins. And that's just not sustainable. So if you're using \$60, you may get away with it for a year, but not much more.

Whatever your assumptions, the S&P's overpriced.

**A. Van Den Berg:** Even if we assume profits reach 6% of the S&P's sales of \$700 per share, that would still only give you \$42. And again, they're using \$60. But let's be generous, give 'em the benefit of the doubt, and use \$50. Based on that \$50, as we said in September of 2002, the fair value of the market is 1,100 — and we're already there. In fact, the S&P 500 is now closer to 1,150.

[Editor's note: We understand that many bulls use the Fed Model to suggest that stocks are *undervalued*. Accounting for the difference, besides the reduced earnings assumption described above, is *Van Den Berg's* use of a higher normalized 10-year Treasury rate — about 4-1/2% — to discount those earnings to a present value. (In fact, it's since risen from around 4% to almost exactly that.)]

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CENTURY MANAGEMENT'S  
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**A. Van Den Berg:** So now what? In September, we said the S&P 500 could go to 1,210 — because markets go to 10% over value fairly regularly. That doesn't mean it's a good value. It doesn't mean you'll make money that way over the long run. It just means it could go there.

More importantly, it just means it will go down *more*. Markets even get 15% overvalued — and that would put it at 1,265. So you've got upside of another 10-15% if you're wildly optimistic, if you believe Wall Street, and if you believe all the stuff that you read in the newspaper. And I've already told you how reliable they are. If you believe every one of those things, you can get there. And even if you do get there, so what?

And it could get more overpriced — but not with us in it.

**A. Van Den Berg:** But we can't find any stocks that meet our criteria to buy right now. So what should we do? Do you want us to buy something that's overpriced just because we think it's going to go up? We will *not* do that — I assure you. But we know that most people will — including many money managers. But that's not the idea of the value discipline.

Now people say, "Well, you can't time the market." But I'm not talking about timing the market. I'm just saying if it's not cheap, I'm not gonna *buy*. It doesn't mean that the market won't go up. It'll go up. It'll just go up without us. Meanwhile, eventually, people will come to their senses just like they always do. And when they do, we'll be able to buy stocks at the prices we want to pay...

VALUES AND PRICES CAN MEET IN TWO WAYS —  
THE SLOW WAY, THE FAST WAY OR A MIX OF BOTH.

We can grow into today's value — in about 12 years.

**A. Van Den Berg:** Now, let's talk about how this market could unwind. In the first column of this next chart is the total market value of all U.S. stocks — which today is about \$15.3 trillion. And in the second column is U.S. GNP — which is the total value of all the goods and services produced by everyone in the U.S. For 2003, it's estimated to have been around \$11.3 trillion.

And if you divide that \$11.3 trillion into \$15.3 trillion, you see that you're at 135% of GNP — which, once again, is what I showed you earlier in that big bubble chart.... [Ed. note: See CHART 6 on page 27.] So anyway, that's where we are today.

Now let's assume the market is not going to go down. We're just going to grow four feet taller. Right? Instead of taking weight off, the way we'll get to our normal weight is by growing taller. So we're going to grow the economy. We're going to hold the market cap of stocks constant at \$15 trillion, and assume that the economy is going to grow. (See CHART 14a.)

And as you can see, as the economy grows, the ratio does go down. By 2008, the ratio will have fallen to 98%.

But please take note that by the time you get down to where stocks become real bargains again, it would be 2016.

And that's what's happened in the past....

**A. Van Den Berg:** Well, at this point, you probably think I'm nuts. You're probably thinking, "Are you trying to tell me that if this market doesn't go down, that the economy has to grow 6.7% per year for 10 years?" Well, that's *exactly* what I'm telling you.

That's what's happened in the past. In the '29 bubble it took 25 years. In the '66 bubble, it took 16 years. So far, in this bubble, it's been five years. And it isn't anywhere near its peak. So it's countdown time. You're five years into process. But you've got a long way to go.

Again, that's assuming the market doesn't go down. So if the market stays here, all we need is nice growth for the next 11 or 12 years — and by 2014 or 2015, U.S. stocks will be worth what people are paying for them today.

Stock prices can also meet rising GNP halfway....

**A. Van Den Berg:** But there is another solution. And we show that one on this next table. In this scenario, we've assumed that the total market value of U.S. stocks will drop 10% a year. That would certainly speed things up. If stock prices drop 10% a year and GNP grows by 6.7% per year, then U.S. stocks would be fairly valued by historical standards, by golly, in only *five* years. (See CHART 14b.)

But bear in mind that stock prices would also be down 50% — 10% a year. In fact, by the end of 2008, stocks would be trading slightly below their historical percentage of GNP. So they would be a bargain and perhaps a great opportunity. The only problem is that those bargains would be around five years out and a 50% stock market decline away....

It could happen quickly, but it wouldn't be painless....

**A. Van Den Berg:** For those of you who're in a hurry, this next chart speeds things up even more. In this chart,

CHART 13

The Fed Fair Market Value (FMV) Model

	S&P 500 Price Level (Current @ 830)	Upside Potential (to FMV)	Downside Potential (to 35% below FMV)
15% Above	1265		
10% Above	1210		
<b>FMV</b>	<b>1100</b>	<b>0.00%</b>	<b>-35.00%</b>
-10% Below	990	11.11%	-27.78%
-20% Below	880	25.00%	-18.75%
<b>-25% Below</b>	<b>830</b>	<b>32.05%</b>	<b>-13.86%</b>
-30% Below	770	42.86%	-7.14%
-35% Below	715	53.85%	

Source: Century Management, September 2002 Newsletter

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we assume the market cap of stocks drops 20% a year. When we do that, we can get to the level Warren Buffett thought was a good idea in less than 2 years. But stocks would still be down about 35%. And they wouldn't get down to levels where they've historically been bargains (again, down around 62% of GNP) for just under 3 years — by which time the market would, under this scenario, have declined nearly 50%. (See **CHART 15**.)

In his December, 2001 *Fortune* article, Buffett said that he thought it'd be a good time to start buying stocks when that ratio got down into the 70-80% range. And mind you, he's putting his money where his mouth is. Buffett is sitting on \$24 billion. And he's not even putting it into the bond market. He said, "It's no fun making 1%." He could make another \$1 billion just by going out long in the bond market. And yet he doesn't want to do it because he doesn't think it's worth the risk.

THE MEDIA WILL ALWAYS ECHO THE CROWD.  
WHAT YOU HAVE TO DO IS THE EXACT OPPOSITE.

In Warren Buffett we trust, not some journalist...

**A. Van Den Berg:** It amazes me that most people will quote some guy at a brokerage house, they'll quote some research department, they'll quote some money manager or some guy that wrote an article that never managed money, but most people will never quote Warren Buffett. Now,

**CHART 14a**

Market Cap vs. GNP  
(assuming no change in Market Cap  
and 6.7%/year GNP Growth)

Date	Total U.S. Market Value (w/ no change)	GNP (@ 6.7%/yr growth)	Market Cap + GNP
12/31/2003	\$15,327.67	\$11,277.83	135.91%
12/31/2004	\$15,327.67	\$12,033.45	127.38%
12/31/2005	\$15,327.67	\$12,839.69	119.38%
12/31/2006	\$15,327.67	\$13,699.95	111.88%
12/31/2007	\$15,327.67	\$14,617.85	104.86%
12/31/2008	\$15,327.67	\$15,597.24	98.27%
12/31/2009	\$15,327.67	\$16,642.26	92.10%
12/31/2010	\$15,327.67	\$17,757.29	86.32%
12/31/2011	\$15,327.67	\$18,947.03	80.90%
12/31/2012	\$15,327.67	\$20,216.48	75.82%
12/31/2013	\$15,327.67	\$21,570.98	71.06%
12/31/2014	\$15,327.67	\$23,016.24	66.60%
12/31/2015	\$15,327.67	\$24,558.32	62.41%
12/31/2016	\$15,327.67	\$26,203.73	<b>58.49%</b>

Source: Century Management

here's a guy who's made \$35 billion in the market. And yet most people will just say something like, "That's interesting" and then put more faith in some article in the newspaper....

At the greatest extremes, the noise gets the loudest.

**A. Van Den Berg:** The thing you've got to understand, and I don't care what current publication you're reading, is they are reflecting what the sentiment is. They are merely echoing what everybody's doing. And the only way to take advantage of it is to do the exact *opposite* of what they're doing — because if you follow 'em, you're gonna follow 'em right off the cliff. And at those times when it's most extreme, the noise gets the loudest.

You know, we've noticed in our practice that some of the most widely read clients — the most educated clients, some of the most brilliant people — are the ones who are always calling us at extremes. Do you know why that is? I've thought about this for many years. I've thought, how could this guy catch it that close? I mean, I couldn't do it. If I tried to catch it that close, I'd never get it. Mind you, they're always 100% wrong. However, somehow they never seem to fail to catch the extremes.

And the reason is because they read so widely and they study so much, and they listen to every news channel, that at the extreme, they are *reflecting* that. And that makes them a wonderful bellwether for us to have — because when they call, we know we're near an extreme. They are reflecting what is going on out there.

And when clients actually get mad because we're buying a stock, that's a *winner*. That is a winner.

[Editor's note: What *many* of our contributors — including Walter Schloss, John Neff and Bill Nygren — have told us.]

Our clients are our best contrary indicator — e.g., Sears....

**A. Van Den Berg:** I had a client *fire* me one time when I bought Sears. He was a new client.... And the broker calls me up and says the guy said, "If that money

**CHART 14b**

Market Cap vs. GNP  
(assuming a 10%/year Market Decline  
and 6.7%/year GNP Growth)

Date	GNP (@ 6.7%/yr growth)	Total U.S. Market Value (w/ 10%/year decline)	Market Cap + GNP
12/31/2003	\$11,277.83	\$15,327.67	135.91%
12/31/2004	\$12,033.45	\$13,794.90	114.64%
12/31/2005	\$12,839.69	\$12,415.41	96.70%
12/31/2006	\$13,699.95	\$11,173.87	81.56%
12/31/2007	\$14,617.85	\$10,056.48	68.80%
12/31/2008	\$15,597.24	\$9,050.83	<b>58.03%</b>

Source: Century Management

(continued on next page)



CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG  
(cont'd from preceding page)

manager buys Sears, I don't want him handling my money — because it's about the worst company you could buy. I've been dealing with that company for 20 years. They are total mediocrity..." etc., etc., etc.

Well, what he didn't understand is we *knew* that. Everybody hated Sears. And they drove the price down to 7 times earnings. Now 7 times earnings is a 14% yield — which wouldn't be too bad if it didn't go anywhere. But on top of that, Sears owned many wonderful companies that they were going to spin off and sell that weren't in the price of the stock. So for 7 times earnings, not only were we getting Sears, but we were also getting Coldwell Banker, Dean Witter and Allstate for *nothing*. At the price that Sears was selling, we got all the crown jewels for nothing.

And this guy didn't understand that yes, Sears was a terrible company at the time, but not only was that more than fully reflected in the price, but they had some jewels.

Sometimes you can get hidden assets for free.

**A. Van Den Berg:** It was kind of like we were buying an old house that wasn't worth more than the \$50,000 that we were paying, but that had \$200,000 in the drawer. That doesn't sound like a bad deal to me.

As a matter of fact, I'll give you an example of that. One time at an auction, the U.S. government was auctioning off pilots' emergency kits — the kind that pilots use when they get shot down overseas. And people were just outbidding themselves on these survival kits. The government couldn't figure it out — until finally, somebody realized they'd put three gold coins in each survival kit so that when a pilot would get shot down, he'd have some gold to trade. Well, some people knew that — and they were bidding 'em up.

Meanwhile, some other guy is saying, "Boy, look at that idiot buying that survival kit for \$300 bucks." So you have to understand the value.

CHART 15

Market Cap vs. GNP  
(assuming a 20%/year Market Decline  
and 6.7%/year GNP Growth)

Date	GNP (@ 6.7%/yr growth)	Total U.S. Market Value (w/ 20%/year decline)	Market Cap + GNP
12/31/2003	\$11,277.83	\$15,327.67	135.91%
12/31/2004	\$12,033.45	\$12,262.13	101.90%
12/31/2005	\$12,839.69	\$9,809.71	76.40%
12/31/2006	\$13,699.95	\$7,847.76	<b>57.28%</b>

Source: Century Management

Please don't listen to the talking heads on TV.

**A. Van Den Berg:** When people hate a stock so much that they drive it down to such a cheap level, it's almost a sure sign that it's a bargain. Similarly, when they get mad at you for *not* owning a stock, if you were a short seller, that would be the time to short it. And we don't sell short, but that would be a wonderful lead.

So the thing you have to understand — the most important thing I hope I can convey — is don't read the current publications and don't listen to the talking heads on TV. *Please* — do me a favor.

TEMPLETON AND BUFFETT, ON THE OTHER HAND...  
STUDY SUCCESS AND MAINTAIN YOUR DISCIPLINE.

If you want to listen to someone, listen to successful mgrs.

**A. Van Den Berg:** Go back and read history books on the market. Read about people who've really made money in the market — and listen to them. If you want to listen to somebody, listen to John Templeton. He has a 50-year history of managing money successfully. Listen to Warren Buffett. His 40-year track record is the best in the history of this business. [Ed. note: It's more than 47 years, but who's counting?] If you want to listen to somebody, listen to them.

[Editor's note: Talk about singing our song...]

**A. Van Den Berg:** If you do, you'll understand why we feel this way, because not *one* of them — not anybody with a successful, long-term record of managing money — disagrees with a major premise of our position.

[Editor's note: Other thoughtful observers saying similar things include Bob Rodriguez of FPA Capital, Jeremy Grantham of Grantham, Mayo, Leon Cooperman of Omega Advisors, and Bill Gross of PIMCO.]

**A. Van Den Berg:** And that doesn't mean we're right. But I'd much rather bet on *those* guys than I would on the guys at the brokerage houses with their research reports. And incidentally, those aren't research reports anyway. They're *sales* literature — and you should treat 'em that way.

It's not about brains. What it's about is discipline.

**A. Van Den Berg:** Now, we have our own opinions — which we develop internally. All of our ideas are generated by Jim Brilliant, who heads our research department, and his staff. We don't rely on other people's ideas. We do our own research, we come to our own conclusion, we stand by what we believe 100%, and we will not deviate from it.

The most important thing in this business is discipline. It isn't brains. There are so many smart, educated people out there — I can't begin to tell you the brilliance in this business. But it doesn't seem to add a lot of value — because if you don't follow the discipline, it doesn't work. It's just that simple.

Show me a great athlete and I'll show you someone who's totally focused and disciplined. Show me someone with extraordinary accomplishments in any business at all, any field — music, sports, academia, you name it — and I'll show you someone who is totally committed and dedicated. That's what it takes. The brain factor is not the big part.

(continued on next page)



CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG  
(cont'd from preceding page)

It's the discipline.

[Editor's note: Van Den Berg's comments remind us of one of your editor's all-time favorite quotes (by former President Calvin Coolidge):

"Nothing in the world can take the place of persistence. Talent will not, nothing is more common than unsuccessful men with talent. Genius will not, unrewarded genius is almost a proverb. Education will not, the world is full of educated derelicts. Persistence and determination alone are omnipotent...."]

**A. Van Den Berg:** And the minute you do break it, you don't need to wait too long to find out that you did — because the market speaks a language of its own. And rest assured that it will punish you for breaking a discipline.

WHEN THERE'S NOTHING TO BUY,  
IT'S BEST TO BUY NOTHING.

A disconnect between GNP and stocks from '66-'82...

**A. Van Den Berg:** So now we're going to go to the final market. But first, I want to revisit a previous chart. [Ed. Note: See CHART 4 on page 26.] And I'm going to make a couple of points that are very important for you to understand. Number one, this big bull market that started in 1949 began when the average person had very little debt and nothing but cash. And it went almost straight up until 1966 — at which point it went sideways for 16 years.

But take a look at the chart of what the economy did during that 16-year period. During the whole time that the market was going nowhere, the economy was growing at a very rapid clip — from \$772 billion to \$3.3 trillion — or 329%. That's average annual growth of 6.7%.

That's how it's supposed to work when stocks are too high.

**A. Van Den Berg:** Why did the stock market not go anywhere when the economy grew as quickly as it had at any time in the history of this country? Because the market was *overvalued* — and it needed to grow a few feet. So it took 16 years.

However, in the process of growing those few feet, interest rates and inflation went up — which knocked prices down lower and lower and lower. That was when "The Death of Equities" article was the featured cover story in *Business Week*. In that article, an economist said: "Stocks have been the disappointment. They are the speculation. Gold is the real investment because money market funds" — are you ready for this? — "have outperformed stocks and bonds by a large margin."

Imagine that — for 16 years, money market funds outperformed stocks and bonds. So the article quotes one investment banker who says, "It's not supposed to be that way." But it is supposed to be that way. If people overpay for stocks, even if money market funds only yield 1% or 2% or 3%, they're going to outperform stocks and bonds. It's not that the money market was such a great investment — it's just that stocks were a *bad* investment.

Stocks made *no* money while money market funds

were making 7%, 8%, 10% and 12% a year because of the relatively high level of inflation and interest rates.

At times (like now), money market funds are the best choice.

**A. Van Den Berg:** And today? Today, I'd say that, once again, you're better off being in a money market fund. Even if you're only getting 3/4 of 1% on your money, if the economy recovers, interest rates are going to go back up. Short-term rates will rise to 3-5%. So you're not going to be at 1% forever. But if stocks decline in the meantime, that's not such a bad alternative. And of course, it would beat bonds, too. If you buy a 10-year bond at today's rate, even if interest rates rise to 10%, you're going to be stuck with that lower rate for 10 years.

We are not recommending money market funds as your investment of choice. We're just saying that under certain circumstances, they will outperform stocks. Do you need some proof? Over the past five years, what do you think has done better — money market funds or the S&P?... Well, for the last five calendar years, money market funds have outperformed the S&P. In fact, if you'd been fully invested in the S&P 500, you'd have actually *lost* money.

HIGHER GROWTH WILL MEAN HIGHER PROFITS,  
HIGHER INTEREST RATES AND LOWER STOCK PRICES.

High growth eventually leads to high interest rates.

**A. Van Den Berg:** So given the fact that this went on for 16 years between 1966 and 1982, and given the fact that it's already gone on for the most recent five years, do you think it's possible that it could happen in the future? Think about it. If the economy comes back strong enough to justify the \$60 in earnings people seem to be expecting on the S&P, do you think interest rates might go up?

You can't have it both ways. If the economy grows rapidly, then the Fed's got to raise the interest rates. The demand for money will go up, and interest rates will go up.

And high interest rates will lead to lower P/Es.

**A. Van Den Berg:** And what happens to stock prices in that scenario? They go down. Let's walk through it together: If the five-year bond is yielding 4-1/2%, then according to the Fed model the equivalent P/E should be around 22. But if interest rates rise to 5-1/2%, then the P/E should decline to about 18. So if the P/E goes from 22 to 18, that suggests that stocks should fall 18%....

If you're in a money market fund earning 3/4 of 1% and money market rates rise to, say, 5% while stocks are falling 18%, is that such a bad deal? I don't think so. And best of all, you get the chance to buy stocks 18% cheaper. If you're that gung ho about stocks today, then you should love them that much *more* 18% cheaper.

When people think cash is trash (like now), hold it tight.

**A. Van Den Berg:** The thing you have to understand is the mania. The most hated investment today is cash. Everybody hates cash. Nobody can *stand* to be in cash. By contrast, everybody just *loves* being in stocks. At the bottom of this bull market — back when it began — 50% of mutual fund assets were money market mutual funds. People were in cash because they'd gotten sick and tired of losing money.

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CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG  
(cont'd from preceding page)

By contrast, cash is not an investment choice today — unless nothing else is available.

[Editor's note: Based on annual year end data from the Investment Company Institute, money market assets (taxable and nontaxable combined) expressed as a percentage of total fund assets peaked at 77.1% in 1981, reached their low point of 23.7% in 1999 and climbed to 35.5% in 2002 before falling to 27.7% in 2003. So as Van Den Berg suggests, they're much closer to the low they reached at or near the peak of the bull market than they are the peak they reached at or near the bottom of the bear market in 1982.]

**A. Van Den Berg:** But when nothing else is available, it's the best investment you can make. It's certainly better than *losing* money. So if you don't want to be a victim of today's mania, I recommend that you stop and think about how long it took you to *make* that money. I think that might give you some pause.

We'll make money in this bear market and the next bull....

**A. Van Den Berg:** Also, I want you to remember that you can make money in this kind of market just by waiting for the right opportunity. As I showed you earlier, you're going to get *plenty* of opportunities. Remember that after the market crashed back in 1929, you had the opportunity at least five times — as many as 15 years apart — to participate in the major bull market that followed. So we're not going to miss the next major bull market.

Mind you, we may miss a rally from an overvalued market to an extremely overvalued market. However, that's not a bull market. A bull market is when the country is in a position to keep a sustained recovery going and stock prices are cheap....

THERE'S NO SUBSTITUTE FOR BUYING RIGHT.  
IF YOU DON'T, YOU WON'T MAKE MONEY — PERIOD.

You can overpay for a great company — like Coca-Cola....

**A. Van Den Berg:** Here's what happens when you overpay for the best company in the world. [He shows a *Value Line* chart of Coca-Cola from 1968-'83.] Coca-Cola has been one of the greatest companies — and one of the greatest investments — in the world. Its stock price has been up about 15% per year since 1919, I believe.

However, it went *nowhere* for the entire 10-year period from 1973 to 1983. Why didn't this great company's stock price go up for an entire decade? Well, the answer is very simple. It got overpriced in the '73 bubble. It sold at \$75 when its earnings were only \$1.80. So it was selling for more than 40 times earnings.

The stock got so overpriced that despite the fact that Coca-Cola doubled its earnings between 1973 and 1981, its stock price was still down by half or more. In effect, investors were discounting 10 years of growth. Do you see what happens if you overpay? Do you see how long you can wind up having to sit with your stocks to wait for their value to catch up with the price you've paid?

A great company + great progress ≠ a great investment....

**A. Van Den Berg:** Now let's go on to the next one — IBM. And I can't tell you how IBM was viewed at that time. As dominant as Microsoft is, they still have competitors. IBM was virtually a monopoly. They had the computer business to themselves. And its stock just went up in the Nifty-Fifty era. IBM's stock reached a high of \$91 in 1973. And just like Coke, eight years later it was still trading at about half that price.

And for about 10 years, one person after another said to me, "I don't understand the market. Here we have IBM — and it isn't going *anywhere* despite the fact that IBM's earnings are going straight up!" And they were. They went up from \$2.70 per share in 1973 to \$7.39 in 1982.

But if you pay 34 times earnings for something, you've got a long way to go to discount it.... Despite their outstanding earnings growth [11.8% per year compounded], over nine years you didn't make any money in one of the most dominant companies in the industry.

There is no substitute for paying the right price — none.

**A. Van Den Berg:** There is absolutely no substitute for paying the right price. In the Bible, it says that love covers a multitude of sins. Well, in the investment field, *price* covers a multitude of mistakes. For human beings, there is no substitute for love. For investors, there is no substitute for paying the right price — absolutely none. You've got to buy things at the right price. If you don't, you're not going to make money. It's just that simple.

A VIRTUALLY GUARANTEED WAY TO MAKE MONEY —  
IN BEAR MARKET AND BULL MARKET ALIKE.

When everyone's greedy, be fearful — and vice versa.

**A. Van Den Berg:** And now, we're going to show you how to make money during these times. This is a chart that can impart a wonderful lesson. It's a close-up of the Dow Jones from the peak of the bubble in 1965-66 until 1982 — when the market went sideways for 16 years....

If you look at this chart closely, I think you'll see something truly exciting: (**See CHART 16.**) In 1965, the market dropped to 744 and ran up to 981. That's a 31% move. It then dropped from 981 to 631 and went back up to 948. Well, that was a 50% move. Then it dropped back down to 799 and went to a peak at 1052. So it was up more than 31%.

Now I want to milk this because this is a very important point in human psychology. *Barron's*, the most prestigious magazine of all the analysts, came out with a feature cover story with the Dow Jones Industrial Average right at 1052 in December of '72. Do you know what the title was? "Not a Bear Among Them." Not one analyst they interviewed thought the market was going to go down. Here's an excerpt: "Our panel — the most prestigious panelists — is bullish on business and Wall Street."

So what happened? Three weeks later, the market started down, and dropped 45% — there again, following a bullish consensus. And then, with the consensus bearish, it promptly ran back up to 1013 — for a gain of 74%.

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**CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG**  
(cont'd from preceding page)

A simple way to consistently make money — just buy right.

**A. Van Den Berg:** Here's what I'd like you to do on your chart. Draw lines at 750 and 800 across the page.... And note that if you'd bought stocks anywhere in that range — which, incidentally, just happens to be about 50-60% of sales — you would've had no less than seven opportunities over that 16-year period in which you'd have virtually been *guaranteed* to make money. In fact, you almost couldn't have bought stocks with the Dow at 750 and *not* made big money.

So again, here it went nowhere's for 16 years. And yet you could've made good money every two or three years just by buying into the bargain zone.

Stock prices almost never stay very cheap for very long.

**A. Van Den Berg:** But, you may say, "Wait a minute! There were a couple of times that it dropped below 750." Yes, there were. However, look how short a time it took for the market to turn around when it did. And that's another incredible lesson I'd like to convey to you. When markets do drop below intrinsic value, they behave like a cork. They absolutely *snap* back.

Nobody can stand to have bargains that good for long on the table. So when the stocks drop below their replacement cost, corporations go in there and buy 'em up. If they're planning to build a plant for \$100 million and they're able to buy a stock for \$50 million and get the employees, the plant, the sales, and the whole organization for \$50 million, why would they ever want to build a plant? So when stocks get cheap, entrepreneurs from all over the

world buy 'em up.... Therefore, stocks go right back up.

Oh, for the good old days — like 1974....

**A. Van Den Berg:** So in '69, the market hit a bottom on May 26th, turned around at 10 o'clock, and went straight back up. And while you were down 10-12%, you'd have only been down for three months. In 1974, the market dropped to prices that I just could not believe. I couldn't believe that I could buy stocks at 5 times earnings....

I'd have 30 stocks lined up, and I'd think to myself, "God, it's hard to decide which one to buy. One idea is better than the next one." When I look back now, I realize that I could've bought 'em *all*. I could've been *blindfolded* and made money.

[Editor's note: Van Den Berg's description of his emotions is very similar to how Sequoia Fund's Bill Ruane describes his own experience during that same period. And Ruane says it spoiled him.]

If you buy stocks right, you don't need a bull market.

**A. Van Den Berg:** So you can make money when you buy 'em cheap. And look what happens. As the preceding chart shows, just by buying stocks when the Dow Jones Industrial Average was in that zone of 750-800, you almost couldn't *help* but make good money. Also interesting to me is that you would've made all those returns even before the next bull market started. What else do you need to know?! When you buy stocks that cheap, you don't even *need* a bull market.

And again, you got seven opportunities in 13 years. How much better can it get?! So when you're sitting there in cash, don't worry about it. You're going to be able to buy stocks 20% or 30% or 40% off. And if you can't, just do what we do — just *wait*. The opportunities will come. We *will* have the opportunity.

BUT PREPARE YOURSELF PSYCHOLOGICALLY, TOO — BECAUSE BUYING CHEAP IS HARDER THAN IT SOUNDS.

Buying cheap is easy to say, but hard to do.

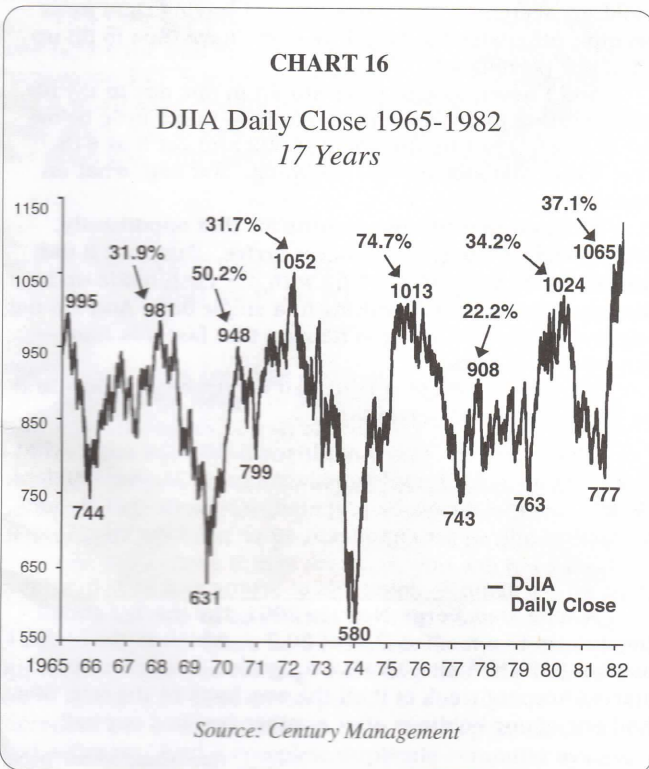
**A. Van Den Berg:** But I can almost guarantee you that when you get the opportunities — when you read the paper and read what's going on — you may not *want* to buy 'em at that time. So please remember what I said and don't give us a call and say, "Hold up on buying for awhile" [attendees laugh] — because that's what we're waiting for.

At the bottom in September of 2002, people were calling up and saying, "You keep buying these stocks, and they just keep going lower." We'd say, "Isn't that *great*?! That enables us to buy *more*. What do you want us to do? Wait until they turn around and go back up to buy more? You've got to buy 'em when they're cheap." Remember that, please. We want to buy 'em wholesale.

That's not difficult to understand, is it? However, it's very, very difficult to practice — even for professionals. As many times as I've been in down markets, I still get that queasy little feeling in my stomach. But it's a *good* kind of feeling. It's the kind of feeling you get when you're an athlete in a competition. You're a little bit nervous and your adrenaline's going, but you just know you're going to do great and make money.

And let me tell you — there's no greater feeling in the

(continued on next page)





CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG  
(cont'd from preceding page)

world than the feeling you get when you're buying bargains at the bottom of a particular stock or at the bottom of a bear market. And there's nothing that's safer to do either.

If everything looks ugly and you're nervous, it's time to buy.

**A. Van Den Berg:** Let me tell you what was going on in '74 when we started Century Management: inflation was up around 12%. Oil prices had just quadrupled. We were in the middle of the worst recession we'd seen since 1929. President Nixon was in the process of getting impeached. We had price controls. There were riots in something like 100 cities. So it was just about the worst imaginable time to be reading the newspaper.

But it was a wonderful time to be buying stocks. And that's what you've got to remember. If you feel good about buying stocks, you may not be getting bargains. On the other hand, if you've got sweaty palms, you've got bargains. And that's the time to buy....

HOWEVER, WAITING FOR BARGAINS PAYS OFF.  
BUT BE PREPARED TO ACT QUICKLY.

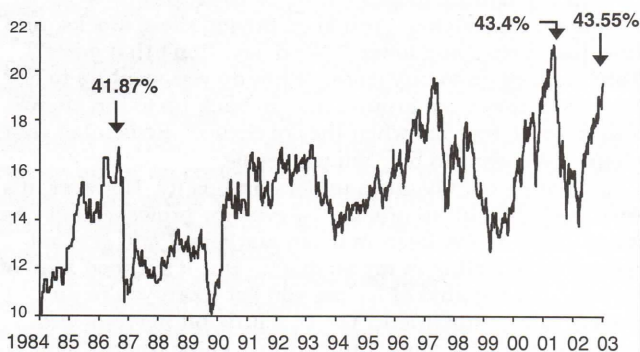
As long as we can buy stocks cheap, we will.

**A. Van Den Berg:** And now we're going to turn to the final chart. This is the median P/E of the Value Line.... The arrows show when we reached the peak levels of cash in our accounts. (See CHART 17.)

I hope you'll notice something about our cash position — we don't just go to cash because we're nervous about the market. In fact, I'll buy *any* stock, *any* time, *anywhere* — I don't care *where* the market is trading — as long as it's a bargain. For example, in the year 2000, with the market at nearly 190% of GNP, we were still buying stocks. And

CHART 17

CM Cash Positions vs. Value Line Median P/E



Source: Century Management

that's because we were able to buy stocks at low multiples. And as long as we can do that, we *will* do it.

So we're not timing the market. We don't *care* about the market. We only care about individual stocks — period.

Again, if there's nothing to buy, buy nothing.

**A. Van Den Berg:** Now the median P/E in 1987 got up to 17 or 18 when interest rates were 10%. And that was totally out of whack. And the same thing happened with the stocks that we owned. So we kept selling stocks and selling stocks. And we couldn't find anything to buy. And that was the first time since 1974 that we just kept selling and not buying. And I was getting all this pressure from people saying, "What are we doing with so much cash? Look at the way the market is going?"

And I was starting to question myself. I thought, "God, what if this market keeps going up?" And then I thought about it — I got by myself — and it finally hit me: What if it does? If I can't buy something at the right price, I shouldn't be buying it. That's what Benjamin Graham taught 50 years ago. And it worked so well for him — so I've got to stick with the discipline. But it was the first test of the philosophy. And we got up to a high of 41.8% cash.

Wait for the opportunity and be prepared to take advantage.

**A. Van Den Berg:** Then one day, when I walked into the office, the market was down nearly 23%. And my buy list went from ... 13 stocks to 266 in less than four hours. All of a sudden, we had 266 buys. So sometimes it happens very quickly.

And when I looked at that screen, I just couldn't believe that those stocks were dropping the way they were.... And everybody was saying, "Why don't you wait until tomorrow? The market's down 400 points. Maybe it'll go lower."

But I couldn't stop looking at that list. And something like 30 or 40 minutes before the market closed, I told my secretary, "We've got to start buying right away — because otherwise I'm afraid we won't have time to fill up all of our portfolios."

And I never bought more stocks in one day in my life. I was putting in orders very carefully — just a little below the market. I put in one order at \$22 and got it at \$18. That's how fast stocks were dropping. But *boy*, what an opportunity.

So I had to wait nine months for that opportunity. And it seemed like it would never arrive. But once it did, the stocks we were able to buy with our cash made up for the opportunity cost of waiting in a single day. And I'm not suggesting that it's going to happen that fast *this* time — but you never know.

So anyway, the idea is to wait for the opportunity and be prepared to take advantage.

[Editor's note: This sounds much like the advice that living legend John Templeton always gave his shareholders. He told them to always be prepared — both financially and psychologically — for significant stock price declines.]

Here we are again — doing lots of selling and little buying.

**A. Van Den Berg:** Now, in 2001, the market got all the way up to a median P/E of 20.7 — which is the highest median P/E the Value Line's ever gotten to since they started keeping track of it all the way back in the late '60s. And one of our holdings after another reached our sell

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CENTURY MANAGEMENT'S  
ARNOLD VAN DEN BERG  
(cont'd from preceding page)

points. So we were selling and selling in 2001; and we ended up in cash. And then the market went down and we invested that cash in September/October.

Well, here we are in the same position today. It's the third time in our career that we just can't find stocks to buy. And we *are* selling — and we're just going to have to sit with it until the opportunities come — because we've learned from experience that if you can't find stocks to buy at the right price, then it's not worth it to buy 'em at all.

[Editor's note: Very shortly before we went to press, Van Den Berg informed us that he estimated that the average cash level in accounts which had been with him for a year or more had risen to about 55%.]

We're happy to wait for bargains. We know it'll pay again.

**A. Van Den Berg:** But one thing I can tell you — the market always does what it's supposed to do, only never *when* it's supposed to do it. So we may be out of sync for a while. But what difference does that make? If for some reason the market were to stay at this permanent plateau that Irving Fisher talked about in '29, then the worst that would happen is that we wouldn't be in the market.

On the other hand, God forbid, if it corrects to where it should, unless it can grow four feet in the next year, we're going to have the problems I talked about.

But we'll buy any stock any time it gets into that zone — and then we will sell it when it gets overvalued. And even if we have to wait for a year, a year-and-a-half or even two years, given how quickly you can make returns back in any one movement, you can see that if you don't make any money for a year or two, it's not the end of the world.

Our 20% per year performance from 1975 to 1982 was *before* the bull market even started. And you could have made 14.9% in an index fund during the bear market. But if you'd have bought in at the top in '66, you wouldn't have made *any* money for 16 years. And it's going to be the same way with this market — as I've just shown you.

WE EXPECT INCREDIBLE OPPORTUNITIES  
— AND WE PLAN TO BE PREPARED.

The opportunities could be *enormous*. And we'll be ready.

**A. Van Den Berg:** In summary, I'd like to leave you with a few thoughts. First, all bubbles end the same way — with stocks going through many years of unwinding until all excesses have been wrung out. Excess debt has to be liquidated. Fraudulent practices and companies have to be exposed. Speculative practices have to be eliminated. However, once those things are done, you will have some great opportunities.

We want you to know that we have done everything in our company to prepare us for the next few years and the opportunities we see coming. And they could be *enormous*. We've added a lot of talented people to our staff. We've increased our research staff to have more specialization. And we've installed a complete duplicate computer system

off site so that it will never be interrupted. We have completely revamped the way we're going to be communicating with you so we can keep you up to date on all of the developments that we see coming. We want you to know that you have our thinking at all times.

We expect rare and incredible opportunities....

**A. Van Den Berg:** So where does that leave us today? Well, the market has corrected a lot of the tech bubble. Some of the fraud has been uncovered. Speculative fever has been eliminated, but it's coming back. And I want to say one thing about speculative fever. Sometimes it helps us get out of a position at a little better price than we would normally get. So it's not *all* bad.

And out of this cleansing will come a bright future with incredible opportunities. The only way I can explain it to you is by calling them "mouth-watering opportunities." You only get an opportunity to buy at that type of level once or twice in most lifetimes. And if you *really* live to a ripe old age, you might get three — but most people only get two. And when you *do* get those opportunities, as I said earlier, you can buy stocks blindfolded.

This is the best place to live and the best place to invest.

**A. Van Den Berg:** With all the problems that we have in this country — and we do have some to work out — there is no better place on earth. When I study the economy, when I study the markets, when I study the accomplishments of the American people, there's nothing in history that even comes close. We have the greatest nation the world has ever seen....

And out of this latest bubble will come a cleansing period ... which will lead to the next era of prosperity — because despite the bubbles, each bubble's bottom, when it came, yielded another period of prosperity that was greater than the last. As great as things were in 1929, they were a lot better in 1949, in 1966, and in 2000.

So I am a long-term bull on America. I can't conceive of any country — no matter how much China, for example, is industrializing — even coming close, because there is a lot more to living in a country than just making money.

But it is the capitalist system and the stock market that creates the kind of prosperity that we have. And we're all looking forward to it as a staff to guide your portfolios and to prepare for the opportunities that we foresee.

—OID

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CLIPPER FUND'S  
JAMES GIPSON & MICHAEL SANDLER  
(cont'd from page 1)

For example, during the 3, 5 and 10 year periods ended April 15th, Clipper Fund's performance put it in the top 6%, 3% and 1%, respectively, of funds in its category according to Morningstar. It ranked in the top 1% of funds in its category for 15 years, too, as of its most recent full writeup in *Morningstar Mutual Funds* (on December 6th).

Renowned in the mutual fund industry for some of the most thoughtful, well written letters to shareholders to be found anywhere, Gipson and Sandler's comments at their annual meetings are no less meaty and thoughtful. We're very pleased to bring you excerpts from their latest — held March 26th in Beverly Hills.

THE MARKET IS LESS OVERVALUED THAN IT WAS —  
NEVERTHELESS, IT'S HARDER TO FIND BARGAINS.

Thank you for having been patient with us...

**James Gipson:** ...I see a number of familiar faces that have been here year after year. And for those of you who were here four or five years ago, I'd like to thank you now for your patience at that point. Irrational exuberance had taken over the market at that time. And therefore, because we weren't buying Yahoo at 1,000 times earnings, we looked like intellectual fossils.

The irrational exuberance went on for a *remarkably* long period. And it certainly tried our patience — I'm sure it tried yours. However, during that period, we remained rational and disciplined investors. We *didn't* buy Yahoo at 1,000 times earnings.

As a result, there was a sizable outflow of shareholders from Clipper Fund from people who were dissatisfied with that stuck-in-the-mud kind of philosophy. However, it did pay off in subsequent years.

[Editor's note: And how. According to *Morningstar*, from the market peak in 2000 to the trough in 2003, Clipper Fund managed a gain of 13.25% per year. That's versus a loss of 13.71% per year for the S&P 500.]

**Gipson:** So again, I'd like to thank those of you who were patient with us during that time....

In the tech bubble, valuation was very uneven. Not today.

**Gipson:** From a gross standpoint, the stock market was more overvalued then than it is today. The S&P 500 had a higher P/E, a lower dividend yield and a higher ratio of total stock market capitalization to gross domestic product, for example. However, the overvaluation was highly concentrated in a small sliver of stocks — technology and dot.com stocks. And in the "all other" category where we invested, we could find a number of cheap stocks at that point in time.

Today, the stock market is once again priced at generous levels. But unlike four years ago, where the overvaluation was highly concentrated, today that overvaluation has spread out to *most* stocks. It is uncommonly difficult today to find cheap stocks.

Because our sales exceed our buys, our cash level is rising.

**Gipson:** And as a consequence, we have been building cash in your portfolio. Four years ago, we were adding names to the portfolio. And two years ago, we were also adding names. As a result, as of a year-and-a-half ago, the cash position in Clipper was down to under 10%. So we were basically fully invested.

As you know, we are a bottom-up, stock-by-stock value manager. And on a stock-by-stock basis, recently, we have found more stocks to sell than to buy. As a consequence, our cash position is rising.

THE FED HAS MADE IT PAINFUL TO HOLD CASH,  
BUT IT'S A MISTAKE TO OWN OVERVALUED STOCKS.

It's one of those rare times when almost nothing is cheap.

**Gipson:** Normally, when the price of one asset class is high, there is a valley of cheapness in some *other* class. However, this is one of those *very* rare times in which *most* long-term assets are generously priced. Priced to yield 3.7%, the 10-year Treasury makes *no* one salivate. And junk bond spreads have collapsed in the last year — which has been good for junk bond performance during the last year. But going forward, the result is that investors are presented with a very unappealing trade-off of risk versus reward.

Capitalization rates in real estate are well down. As a consequence, it's less than clear that that's a cheap asset. And gold is up. In fact, virtually all long-term assets that you can think of are priced fairly to generously.

The Fed's made it very painful to hold cash....

**Gipson:** One of the major reasons why is that the Federal Reserve, with its Fed funds' rate of 1%, has made it extremely difficult, even painful, to hold short-term funds. For example, at this rate, your money market fund will double in 140 years. [Attendees laugh.] As a result, the compulsion is to think, "Well, therefore I have to buy something else."

Unfortunately, the menu of "something elses" looks very generously priced almost no matter *what* it is. And keep in mind that those low levels of short rates aren't going to be there forever. Even Mr. Greenspan came out last month and said that the Fed funds' rate is going to go up at some point, but he just wasn't going to tell us when. At this point, I suspect he doesn't know himself when he's going to make that decision.

It's a long-term mistake to own assets that are overpriced.

**Gipson:** However, what we have done in this period is that we've gone from a roughly fully-invested position to a roughly two-thirds-invested position. We've done it on a stock-by-stock basis — because we recognize that it is a long-term mistake to own assets that are overpriced. So we've sold stocks on an individual, stock-by-stock basis....

It has been a wonderful time to own long-term assets.

**Gipson:** The returns on equities since the bottom in 1983 have been unusually good. You can see that perhaps more simply with bonds. The yield on the long Treasury bond in the early '80s at one point hit 15-1/4% — which is the highest interest rates we've seen during the entire two-and-a-quarter century history of the country. By

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CLIPPER FUND'S  
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 (cont'd from preceding page)

comparison, it's something closer to 4% now.

So if you'd done nothing other than stay long term in either bonds or stocks during that period, you'd have done very well. It *has* been — *past tense* — a wonderful time to be invested in long-term assets.

But that was then and this is now....

**Gipson:** But this is *not* a good time to be invested in long-term assets now. I'd certainly hope at the time of our next annual meeting, I'm talking about all the cheap stocks or bonds or whatever that we've found to invest in between now and then. But from this point of departure, we have a selection of long-term assets all of which are fairly-to-generously priced.

And for that reason we've pulled back and increased the most contrarian and uncomfortable asset possible — which is short-term cash. We are not shy about using it when the opportunities are present. However, as an investment manager, all that we can do is *recognize* attractive opportunities when the market offers them to us — we can't *create* them. And right now the market isn't creating very many....

THE SEC SHOULD BE PAYING US A VISIT SOON.  
 HOWEVER, WE DON'T SEE 'EM VERY OFTEN.

Mutual fund scandals have been a non-issue for Clipper.

**Gipson:** Fortunately, none of the practices that have been uncovered in the recent mutual fund scandals have any effect on us in terms of our operations, although they certainly add a lot of work in terms of the regulations and paperwork required to be an investment advisor. However, if you go through a list of the currently controversial practices... We've never done late trading. We don't have any 12b-1 fees.

Market timing is an issue that's worth a separate note — because it is not contrary to law. But it's something that we have tried to avoid for 20 years because it's not a great business practice. We started Clipper Fund with a back-end 2% redemption fee to keep out market timers. Again, this was 20 years ago — not in the last six months as a consequence of the recent scandals. But we found that the time period was too long, and we later scrapped that. But we have continued to work with our transfer agent to identify and keep out market timers during this period. So this is not a new practice as a consequence of the latest scandals. This is a continuation of something that we've done since the inception of the firm.

Again, we didn't do it because the practice was contrary to law, but because we are long-term investors.

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And the kind of shareholders that we want in Clipper are long-term shareholders as well. There is a class of investors who jump in and out of no-load mutual funds. And in doing so, they may generate more transaction fees than you'd really like. That's the kind of shareholder we try to keep out....

So the current scandal has not touched us — because basically we've kept a long way from the line of illegal behavior. So as that line's moved, that hasn't affected us.

We haven't seen the SEC lately, but we'll see 'em soon.

**Gipson:** However, that doesn't mean that we haven't done anything differently. In conjunction with our auditors and legal counsel, we have reviewed the policies and procedures we have in place. And we continue to bolster them in order to try to make sure that when the SEC comes to examine us again that we will be in as good a shape then as we were when they last examined us. Normally, the SEC comes to see you once every two years if they're concerned about you, and every four to five years if they're not. We're halfway into the *sixth* year. And we expect them next month, Mike?

**Michael Kromm [Compliance Officer]:** April. They'll be here. [He laughs.]

**Gipson:** That's the prediction Mike has been making for the last couple of years. The SEC does not tell you the timing of their examination. They simply come walking through the door. So if Mike continues to make that prediction *long* enough, he's going to be right. I do suspect that whether it's April or May, we probably won't get through the spring without another SEC exam. However, the reward for us doing a good job is that they probably won't come back for *another* four or five years. Anyway, we're well prepared for their next visit.

Don't expect Clipper to be at the center of future scandals.

**Gipson:** However, I recognize that the current rash of scandals has created a reasonable amount of concern on the part of investors as to whether you can trust your investment manager. We've certainly done everything that we can to merit that trust.... So if there are any scandals in the future, I feel safe in saying that they won't be at Clipper Fund....

WE HAVEN'T FOUND A NEW IDEA IN MONTHS.  
 BUT WE'VE FOUND SEVERAL WORTH SELLING.

By going out a few months, we get a little higher yield.

**Shareholder:** What percentage of your portfolio consists of cash right now?

**Gipson:** About 32%. However, let me define cash a little more carefully. Cash to us includes not just cash, but also short-term federal agency paper that might go out a few months. But it's non-equity — and it's not long term.

The reason why we go out a few months is that there's a very steep yield curve — so we're paid to go out a little on it. And also it gets you out of the playground of money market mutual funds, which are by law required to stay extremely short. So we can pick up a little yield without

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any detriment in safety.

But basically, the non-equity portion of our portfolio is a little over 30%.

Today, unlike 2000, we're not finding any new ideas.

**Shareholder:** So I take it from your comments that you're not adding anything new to the portfolio right now?

**Gipson:** It's been nearly a year since we've had a new idea. And that's not because we've suddenly become lazy or gone off to play golf — although I have tried to take that sport up. But at this point four years ago — keep in mind that it was back in March of 2000 that the equity markets hit their all-time highs — we were actually finding a number of cheap stocks in the "all other" category. And at this point two years ago, we were also finding a number of new opportunities.

But the answer to your question is no — in the last few months, we haven't found a single new name worth adding. And we've found several worth lightening up on.

However these things go in cycles. And my hope is that at some annual meeting — hopefully the next one — we'll be talking about all the cheap assets out there. But there sure aren't many today.

We want to be tax efficient — within reason....

**Shareholder:** Given that you've been selling, are there any implications regarding capital gains distributions in this tax year?

**Gipson:** Some of the things we have sold were formerly cheap — Tyco being one that we discussed in the last annual meeting or two. We bought that cheap, it became cheaper, and we bought more. It was only a little over a year ago that it was selling in the \$10-12 area. We have reduced our holdings now that it's up to \$28-29. Fortunately, its value has gone up a bit, too.

I suppose that is a concrete example that there will be some capital gains. But we do our best to put those into the long-term category.... We do try to manage the tax aspects of the portfolio reasonably. However, we're not going to let the tax tail wag the investment dog. The important thing is not to have excessively valued assets in the portfolio.

PLAYS ON A LOWER DOLLAR? SURE.  
 CURRENCY SPECULATION? NO THANK YOU.

We have some currency plays, but we're not experts.

**Shareholder:** You mentioned most long-term assets being overvalued.... Some other deep value investors... Warren Buffett has gone into currencies of other countries. And Bill Gross of PIMCO is looking at commodities. Do you look at some of these other asset classes? And do you look to make any kind of a play in some of them — if not directly, than indirectly?

**Gipson:** [He sighs.] Well, in an indirect fashion, some of the companies we have — including Tyco, by the way, since I mentioned that a moment ago — do have sizable foreign operations. So as the U.S. dollar weakens,

the earnings that they accrue in foreign countries will be translated back into a larger number of dollars. Therefore, in an indirect kind of fashion, there are a number of stocks in the portfolio that would qualify there.

However, we are not currency experts. I remember a Ph.D. economist from the World Bank who had done his doctoral thesis on predicting currency movements, telling me at one point that after years of trying to do it, he concluded that neither he nor anyone else could do that particularly well.

[Editor's note: Living legend John Templeton has said much the same thing.]

**Gipson:** I don't think Warren has positioned himself as a currency expert, but rather that he's recognized that we have an extreme and unusual case here. And therefore, he's made what amounts to a reasonable bet. However, it's not a bet that we're making in the context of the fund.

It's not that we're not willing to buy other things....

**Gipson:** In terms of looking at alternate assets, I think we do have an unusual willingness to look at things that are different. Even though we are an equity fund, in the late '80s, we bought major positions in bonds on a few occasions when bonds were cheaper than stocks. Going into the Crash of '87, for example, we had 40% of the portfolio in zero coupon Treasury bonds which went up when stocks went down. But that was when zero coupon Treasuries were yielding you 10%.

They're yielding less than half that today. And that is the anomaly — at least it has been in my business career. Generally, when one long-term asset class is expensive... It's usually been a little bit like Colorado — where you get a few peaks of excessive price here, but you also get a few valleys of cheapness there. But today, valuation levels are as flat as the Midwest — like the terrain in Ohio or Nebraska — and all of them at a high level.

But we try to always stay within our circle of competence.

**Gipson:** There very well may be some potential in currency markets from this point forward. However, there's another guiding principle at work here, too — which is that we always try to maintain a realistic assessment of our circle of competence and not go too far outside it. And commodities, or something like that, would be well outside of our area of expertise.

And you're much more likely to get into trouble than generate good profits if you're buying something you don't understand well and have a comparative advantage with.

ALTHOUGH THERE IS THE OCCASIONAL EXCEPTION,  
 WE PREFER TO BE DANGEROUS IN ONE LANGUAGE.

Foreign stocks tend to be outside our circle of competence.

**Shareholder:** In Japan last year, I think the Nikkei dropped below 8,000. There were a lot of stocks there that were trading under their cash value, let alone their book value. Now the Nikkei has gone up.... Are you seeing any opportunities there that you would invest in?

**Gipson:** There may be opportunities. But most of them are outside our circle of competence and, therefore, beyond our ability to take advantage of. I think that this is

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very important, although it's similar to a partial answer that I gave earlier: There may well be a cheap stock in China or Japan or Germany, but there's also only a limited amount of resources we have to work with. And in general, we try to stick to our circle of competence.

Sometimes we think we do understand a foreign stock.

**Gipson:** Once in a while, we do buy foreign stocks. So we have no theological bent against them. However, in the case of something like Tokio Fire & Marine [now Millea], for example, 10,000 — or perhaps even 100,000 — Japanese are always going to know it better than an investment manager here will.

And generally, we've not been willing to buy a foreign stock unless we think we have at least some reasonable understanding. We bought De Beers Consolidated Mines, for example, several years ago. But we had a reasonable understanding of that operation — in part because Michael was South African born.

We prefer to be dangerous in only one language.

**Gipson:** But going outside your circle of competence is usually a good way to get yourself in trouble. I travel a good deal for recreational purposes. However, I'm dangerous only in one country. And we do try our best to focus our investments in areas where we think we have a reasonable probability of getting a very good understanding of the business and we have a comparative advantage in evaluating it.

EL PASO'S VALUE IS SOMEWHAT LOWER,  
BUT THE DISCOUNT REMAINS PRETTY BIG.

The value of El Paso's reserves has declined some.

**Shareholder:** How does the reserve write-down of a company like El Paso change your valuation?

**Gipson:** *Down*, as a matter of fact. However, that's a good question, even though the answer is obvious. In any portfolio, you're going to have some short-term mistakes — elements of good news and bad news.

There are some elements of *good news* in El Paso. However, in response to your question, they did write down the value of some of their gas reserves. In some cases, they shifted the classification of their reserves. So it looks like by *additional, tighter drilling*, they will be able to get the same amount of gas out as before in *some fields*.

But in total, they have taken another look — just as Shell has recently — at their reserves. Incidentally, estimating reserves is an art and not a science. But the best estimate available right now is less than it was before. And that has lowered our value on El Paso.

But most of El Paso's value isn't in its reserves.

**Gipson:** And to take that one step further, the valuation process for us is a dynamic one. As new pieces of information become available, we will change our value

accordingly. El Paso's value has gone down. But meanwhile, Tyco's value has gone up. Our goal at any one point in time is to take the best available information and calculate the best reasonable value of what a rational private buyer would pay for the business.

One additional thing about El Paso that is fortunate is that most of the value is not in the oil and gas reserves, but in the largest pipeline network in the country. And that business has been basically unaffected by some of the other controversies there.

Value's roughly the same — discount's still pretty big.

**Gipson:** So while our value has come down a bit with regard to the value of the company's oil and gas reserves, there is an offsetting aspect here in that gas prices are way up. So while the quantity of gas that is down there appears to be less, the price attached to it appears to have gone up.

But again, the major segment of value in that company is not in the oil and gas reserves. It's in the largest pipeline network in the country. And that value has remained roughly constant during the period in which we've owned the stock. By the way, we note that pipeline transactions tend to take place somewhere in the range of 8 to 9 times cash flow.

**Michael Sandler:** The bottom line is that El Paso still sells at a pretty big discount to our lowered intrinsic value....

[Editor's note: Indeed, *Portfolio Reports* estimates that El Paso was Pacific Financial Research's ninth largest purchase during the quarter ended December 31st.

Another contributor who is a large holder of El Paso (with 10.8% of the shares outstanding) is Brandes Investment Partners, who reportedly purchased 8.5+ million shares during the two months ended February 29th.]

I THINK THAT TENET IS STILL A CHEAP STOCK.  
I JUST WISH WE'D WAITED LONGER TO BUY IT.

In the hospital business, when it rains, it pours.

**Shareholder:** What's your current assessment of Tenet? In the past, you've spoken favorably of it as having strong management. Has your assessment changed?

**Gipson:** Well, the management has been changed. But let me put it in perspective: In the last year, we bought two hospital management companies: (1) HCA — which is up by about a third from our cost, and (2) Tenet — which is down by about a third. When we bought Tenet, we were aware of the Medicare outlier payment problem. That is, we didn't buy it on good news, we bought it on *bad news*.

And the news, frankly, has become somewhat worse since we bought it. What is clear now in terms of facts that was not clear then was that the company was being very aggressive in pricing not just with Medicare outliers, but with regard to managed care facilities as well.

The hospital business is one where when you get in trouble, the trouble seems to multiply like rabbits — which has been the case here. And Tenet and El Paso are probably the two current significant problems we've had in the portfolio.

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Tenet is a cheap stock. I just wish we'd waited to buy it.

**Gipson:** We think Tenet is cheap at current prices. They do have a new management in there. We have met with them on several occasions. They do have a number of good, profitable hospitals — so it's not a matter of their total business falling apart. However, it's fair to say that, while we bought it cheaply, there were some elements of bad news — particularly their excessive pricing of managed care — that came out only *after* we bought it. They're selling off a number of their problem hospitals and shrinking back to a core which, based on the present facts, looks like it could be very profitable for them.

But as I said, it's in the context of HCA that was bought at the same time. It went up by a third, while Tenet's down by a third. We would hope to keep our mistakes to a very small number, but they will not be zero.

On the other hand, at present prices there's enough classic fear, uncertainty and doubt — the FUD factor — that I think Tenet, at roughly \$10, is a cheap stock. I just wish we'd waited a year or so before buying it.

Hopefully, Tenet will be HCA revisited.

**Sandler:** Also, by comparison, we purchased HCA several years ago. And we bought it again around June of last year. But when we bought it several years ago they went through the same crisis that Tenet has gone through. And HCA also has spun off a big chunk of their hospitals. They were able to spin 'em off rather than having to sell 'em. But HCA has emerged a much stronger company after paring off its weaker hospitals.

We think that a similar thing can happen with Tenet. But the disappointing thing was that we gave more value to the hospitals that they've slated for sale than the company has stated they can get for those hospitals. It's sort of like El Paso's reserve write-down — where there was less there than we originally thought.

So we did lower our valuation of Tenet a little bit. However, as Jim said, it's still cheap.

Thank you for asking us about El Paso and Tenet...

**Gipson:** Yeah. And again, this is a good case of where when the facts change, we try to change our value. We hope to see the facts change in a favorable direction — and sometimes they do. However, the questions here just happen to have focused on the two companies in the portfolio — El Paso and Tenet — where the facts have changed in a negative direction in the last year.

But that's fair enough. It's a reasonable concern. And I hope we responded to it.

FEAR, UNCERTAINTY AND DOUBT ARE NO PROBLEM  
AS LONG AS THE BUSINESS AND PRICE ARE RIGHT.

If we understand the business, we don't mind controversy.

**Shareholder:** ...One thing that's really fascinated me about what you do is your willingness to wade into fraud, accounting problems, regulatory problems and lawsuits — things that scare me. What would you say are some of the

things you've learned that might not be understood by the general investment public? And does that give you a competitive advantage in your own industry relative to what other fund firms are willing to do?

**Gipson:** Well, we are willing to buy into controversial situations where we have a reasonable understanding of the business. And that's very important — because there *are* some controversial, or troubled, businesses where you really *can't* understand them. For example, I don't think *anyone* can predict the future of a biotech company five or 10 years down the road.

For example, we understand and like Tyco's businesses.

**Gipson:** But there are some businesses — Tyco is probably a good example of what you're thinking of — where we recognized that there were some problems that involved the misbehavior of the people at the top. On the other hand, Tyco has some very good businesses with very good market positions. You're sitting under a Tyco sprinkler, for example.

**Shareholder:** Should we be nervous? [Sandler and audience laugh.]

PORTFOLIO REPORTS estimates the following were Clipper Fund's largest equity purchases during the 3 months ended 3/31/04:

1. CVS CORP
2. FEDERAL HOME LOAN MTGE
3. FEDERAL NATL MTG ASSOC
4. PITNEY BOWES INC
5. WYETH

**Gipson:** No. In fact, over the last 150 years, those sprinklers have a *remarkably* good record for going off when there's heat in the room. Hopefully, there won't be too much heat as a consequence of my comments.

However, my point is that their security service business, their fire protection business and a variety of others were understandable, good, market leading, cash-generating businesses you could understand that were quite apart from any misbehavior of a small number of people at the top of the company.

Remedy for fear, uncertainty and doubt is understanding.

**Gipson:** But what happened during that period was that there was a lot of fear, uncertainty and doubt — and that drove Tyco's share price below our estimate of its intrinsic value. So we bought some. And then it went further below our valuation — and we bought some more.

But again, what we tried to do was update our value as time went on. And there were periods where we reduced our Tyco value a little bit based on new information, although lately we've been raising it.

However, certainly our willingness to buy into controversial situations — or situations that are unpopular or situations that are simply being ignored — is a fundamental element that's required to be a value investor. But we also want a reasonable understanding of the business we're buying into.

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(cont'd from preceding page)

And don't forget margin of safety....

**Gipson:** We also want a satisfactory margin of safety in case we're wrong — which occasionally we are. We've just mentioned two companies where, at least in the *short* term, we *have* been wrong.

So in terms of things to learn, a lot of it is particular to the analysis of an individual company. However, if there's one generic observation to go away with, it's that if you're buying into a troubled or difficult situation, you want to get it cheaply enough that you have a good margin of safety in case you need it — because sometimes you *will*. And if you don't need it, then that margin of safety will give you a good deal of profit to look forward to.

A short-run controversy may mean a bargain long-term.

**Sandler:** And then there's time horizon. A lot of the Street's focus is only six months — or maybe 12 months — down the road. When news flow peaks on a company, as it did with Tycos and as it has more recently with Tenet and El Paso, people panic. You naturally feel uncomfortable.

Our discipline is to look out five years or 10 years. And if we're confident that the franchise will be stronger further down the road, then we're more than comfortable to step into these controversial positions.

[Editor's note: The great importance of having a longer time horizon is, of course, one that's been emphasized by many *OID* contributors over the years — including Warren Buffett, Charlie Munger, John Templeton, Charles Brandes and, recently, Nicholas Sleep, to name just a few.]

**Sandler:** But as Jim emphasized, we can only develop that comfort level when we know the business and think we can understand it....

WAL-MART WILL BE A PROBLEM FOR THE GROCERS.  
BUT IT'S NOT LIKE IT'LL PUT 'EM OUT OF BUSINESS.

Why we sold our stakes in Toys "R" Us and McDonald's....

**Shareholder:** ...I noticed that you've participated in the past in Toys "R" Us and McDonald's, but not last year.

**Sandler:** As regards Toys "R" Us and McDonald's, we were disappointed. We owned Toys "R" Us many years ago. We were disappointed. It was one of those holdings that didn't work out very well. We sold it and moved on because our estimate of its intrinsic value had declined.

On the other hand, we did hold on to our McDonald's. We thought it was worth in the mid \$20s. And we sold that late last year when it reached that level.

**Gipson:** That's a concrete example of what I said earlier — about us finding more stocks to sell than to buy in the last year.

Kroger/Safeway haven't yet recovered from the recent strike.

**Shareholder:** Can you talk about Kroger and Safeway, particularly vis-a-vis competition from Wal-Mart?

**Gipson:** We have positions in Kroger and Safeway — two generally well-managed supermarkets, although they've gone through a strike in the last six months, which has disrupted things. And it'll take a few months for them to get back to normalcy. Kroger in particular has been a major cash generator and purchaser of shares — which is something we generally like to see.

Wal-Mart's hurting Toys "R" Us today....

**Gipson:** Wal-Mart is both a fuzzy and future danger for the supermarkets. It's a clear and present danger for Toys "R" Us — because Wal-Mart has passed Toys "R" Us in retail toy volume. And the main reason why it's managed to do so is that its prices are much cheaper. And also, since most toys are bought in the fourth quarter of the year, Wal-Mart uses that shelf space for something else during the first three quarters and then opens up that shelf space for toys during the fourth quarter — which makes it an extremely effective competitor to Toys "R" Us.

[Editor's note: Of course, the investment case for Toys "R" Us — as articulated by Oakmark's Bill Nygren in *OID* features over the last few years — has been that the challenges facing their U.S. toy stores have been more than discounted in their share price. And some bulls suggest that those challenges — and the recent credit downgrades — only increase the likelihood that the company's underlying asset value (which Century Management's Jim Brilliant recently guesstimated to be in the low \$20s) will be realized sooner rather than later.]

Wal-Mart won't drive Kroger and Safeway out of business.

**Gipson:** Over the long term, Wal-Mart should be a very effective competitor for *some* of the supermarkets. Here in California, for example, they just opened a box in Palm Springs — their first in the area — just two weeks ago. And over the very long term, Wal-Mart will be a relevant competitor for some portion of the supermarket business.

But it's not going to take it all away. I don't think Wal-Mart is going to open a new big box a block from here. There is a market segment and a geographic segment that Wal-Mart goes after — and they do that exceptionally well.

Keep in mind that Wal-Mart was an 8% holding in our portfolio at one point. Shortly after they announced the bad news that after 99 straight up quarters they weren't going to make it 100, we were able to establish a major position.

And we certainly respect them a lot. However, they aren't going to drive Kroger and Safeway out of business. The great majority of people aren't going to drive a long way to buy their groceries.

[Editor's note: Another concern some observers, including yours truly, have is the impact of competition from Whole Foods and the rest of the very rapidly growing organic/healthy segment.]

Kroger/Safeway will have to learn to live with Wal-Mart.

**Gipson:** But at the margin in some geographic areas and at some price points, Wal-Mart will be a more effective competitor at some point in the future. And generally Kroger and Safeway will have to learn to live with them in markets where they do have some market overlap with Wal-Mart.

But again, Wal-Mart isn't going to take all of the grocery business in the country — although I'm not

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suggesting that it isn't a relevant concern in the medium-to-longer term.

And the supermarkets have more immediate problems....

**Gipson:** However, the problems that the supermarkets have suffered through in the recent past have really had little or nothing to do with Wal-Mart. What they've had to do with is the aforementioned strike — and competition among the supermarkets themselves.

People are afraid of Wal-Mart — and in the long term, that's a relevant concern. But that has nothing to do with the problems they've experienced recently.

OUR BUSINESS HAS GOTTEN MORE BUREAUCRATIC.  
 BUT DON'T CONFUSE PAPERWORK WITH PROTECTION.

Increased regulation's made business more bureaucratic.

**Shareholder:** In the current regulatory environment, corporations have to make a lot more disclosures...

**Gipson:** So do *we*. [He chuckles.]

**Shareholder:** And they have to spend a lot of money doing it. Do you think that has represented a net positive for corporate America, and for the investment process? What is your viewpoint on this increased regulation?

**Gipson:** You're right that there's a whole lot more in the way of paperwork and regulatory requirements. I'll use Tenet as an example.... Tenet has compliance people in their hospitals now — at least in all of their major ones. And the compliance people don't perform operations and they don't change bedpans. So in terms of the overall efficiency of the hospital system, do they add any value? No. Nevertheless, it has become a required element of doing business.

We'll be hiring a full-time compliance person soon, too.... So increased regulation has increased our paperwork — and required us to become a bit more bureaucratic.

In a contest between rules & crooks, I'd bet on the crooks.

**Gipson:** The other part of your question, I think, was

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whether that really adds any value to you as investors. And frankly, in most cases, I don't really believe it does. You have a lot more formal rules. However, in any contest between formal rules and clever crooks, I would bet on the clever crooks.

What we've seen — and actually, we're going to address this topic in our next quarterly letter — is that it's basically the decent and honest companies who will do all of the paperwork. A whole lot of companies are going to have to do it. And there will always be a small minority — and it really is a small minority of people out there — who are clever crooks who'll find a way around whatever rules are put in place.

So don't confuse more paperwork with better protection.

**Sandler:** Actually, there are other little things that should come out eventually — hopefully in '05 — like expensing stock options, which will have more of an impact on the bottom line than additional compliance.

**Gipson:** But to manage a public company of any kind has become a much more paperwork-intensive process. Unfortunately, that is not quite the same thing as saying that all of this paperwork protects you, the investor.

Excessive compensation will be less of a problem....

**Shareholder:** In recent years, executive greed seems to have become more prominent. Do you stay away from companies which have evidenced the fact that their executive compensation is just totally out of kilter — companies like Disney, for example?

**Gipson:** Yeah. We have not owned Disney. And that is certainly *one* of the decisions that goes into it — whether or not the top management unduly enriched themselves relative to shareholders. And getting that balance right between rewarding owners of capital and providers of high-grade labor, if you will, is a difficult thing to do. In the *extreme* cases, we have passed on situations where compensation was [over the top]. On the other hand, there are situations where a small number of bright, capable people *can* add significant value. So it does have to be evaluated on a case-by-case basis.

I think one of the things that you can look forward to is that society's general negative reaction to excessive executive compensation combined with what is likely to be the expensing of options — which is the prime method by which that process is taking place — should make it less of a problem in the future, not by abolishing it, but by reducing it....

WE EXPECT STRENGTHENED GSO REGULATION,  
 BUT IMPLICIT GOVERNMENT GUARANTEE TO REMAIN.

This time will probably be different for Freddie and Fannie.

**Shareholder:** It seems like every time that we're having a meeting, there are rumblings in Washington about Freddie Mac and Fannie Mae.

**Gipson:** Oh yes. Actually, I was drafting the quarterly letter — and that will be the first topic.

**Shareholder:** Is this time different?

**Gipson:** Well, it is different in that I think there will

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be a strengthened regulatory environment. As it looks right now, maybe next year, a regulator will replace OFHEO — the current federal regulator — operating outside of the Treasury Department.

The Treasury at one point decided that it wanted to regulate Freddie and Fannie. Then it had buyer's remorse and decided that it didn't really want to — because that would imply that there was an implicit Treasury guarantee. And there is still a good deal of uncertainty as to just where the regulatory function is going to go. But there probably will be a strengthened regulatory environment.

The companies themselves want that, too — because that will remove a fair amount of the clouds from them.

But their implicit government guarantee will remain.

**Gipson:** One of the other concerns you occasionally see is that Freddie and Fannie will become privatized in some way. I'm not sure what that means exactly — because they are privately owned right now. However, presumably that means that they'll somehow be cut off from government help if they get in trouble.

I listened to Greenspan's congressional testimony. And in that testimony, he basically said that that wasn't going to happen — that it *couldn't* happen — because, as with Long-Term Capital Management (which nobody thought had any federal support until Greenspan gave it to 'em six years ago) if any large financial institution gets into some kind of trouble, the federal government will act to prevent that risk from spreading to the rest of the system. So Greenspan himself said in congressional testimony that there is no way to really cut the connection between the government and the government-sponsored enterprises Fannie Mae and Freddie Mac.

On the other hand, it *will* be different this time if there will be — over, say, the next year or two — a somewhat strengthened regulatory function.

A SIMPLE CONCEPT: THEY EARN A "BIG FAT GAP" —  
 BUT WITH COMPLEX UNKNOWNABLE ACCOUNTING.

The "big fat gap" is what makes 'em such good businesses.

**Shareholder:** What did you think about the article in the *Financial Times* about their derivatives?

**Gipson:** It's difficult to look just at their derivatives — which they use to hedge the value of their mortgages — without looking at the mortgages as well. But as Fannie promptly came out and said, the *Financial Times* article was focusing on only one element of the valuation, rather than on the whole picture.

From a conceptual standpoint, Fannie Mae and Freddie Mac are very simple businesses. However, from a practical standpoint, once you get into the companies' accounting, it does get very complicated. But the essence of it is that they are able to earn a spread — a "big fat gap" was Greenspan's inelegant phrase, but an accurate one. They earn a big fat gap between the cost of their funds and return that they earn on their assets. And that's what makes them such good businesses.

Their use of derivatives makes sense....

**Gipson:** They both use derivatives — Freddie moreso than Fannie — (and very properly so, I might add) in order to protect themselves against swings in interest rates. However, it is difficult in any given period to perform a good valuation of all of their assets and liabilities. But in this case, the use of derivatives is a very reasonable and appropriate thing to do.

Actually, as Fannie Mae's Franklin Raines pointed out in his congressional testimony, the reason they do it is to protect against interest rate swings. Your typical bank that owns mortgages does *not* do it, but it *should* — because it is a rational way to reduce the risk associated with holding a mortgage with an uncertain duration so interest rates don't hurt you.

Are Fannie/Freddie vulnerable to higher rates? Maybe not.

**Gipson:** That's the reason why they own derivatives. If interest rates go up, then the value of their mortgages they own go down. Any fixed-income asset will go down. However, the value of their derivatives will go up.

**Shareholder:** So they offset.

**Gipson:** They offset. The whole reason for their use of derivatives is not for speculation, but rather to address precisely the issue that you raise — which is that if interest rates go up and you're a financial institution, you're likely to have some assets that go down in value.

So if Fannie Mae and Freddie Mac have managed their balance sheet correctly, their derivatives will go up in value — and they'll have effectively hedged their portfolios.

Fannie and Freddie could outgrow counterparty capacity.

**Shareholder:** You don't have any problem with the quality of the derivatives Fannie Mae and Freddie Mac use? I believe Buffett sold about \$1-1/2 billion of Freddie Mac at one point. And I think he regrets it today. But his point at that time, I think, was that he was concerned about the complexity or the quality of their derivatives.

**Gipson:** It's a good question, and one which outsiders really can't answer completely. The quality of their derivatives really breaks down into several parts: First, there's the issue of counterparty quality. In other words, who stands behind the derivatives — a no-name firm or someone like Morgan Bank or Citibank?

If there's one reasonable concern about derivatives long term (and it's one that gets very little mention), it's the risk that Fannie and Freddie may actually grow to the point where they simply don't have enough counterparties — good quality counterparties — available out there from whom they can buy derivatives.

But in truth, an outsider can never be 100% sure....

**Gipson:** The second element of derivative risk — which I suspect is the focus of your question — is whether or not an outsider can really understand how well they've managed that book of business? And the answer is that *no* outsider can.

However, after looking into it in a variety of ways, what we *can* say certainly is that their general purpose for using derivatives is absolutely right. The long-term effect of using them has been effective. And Fannie and Freddie have, by the reputation of the business, a number of bright

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people and good systems in place in terms of the utilization of the derivatives.

However, as an outsider, can you ever be 100% sure that they have managed it right? They're much like an insurance company. An insurance company may have 10,000 policies in force. So as an outsider, can you ever be sure that they're all accurately recorded in terms of the present value of their potential losses? You really can't.

What you can do, however, is look for indications that they *have* done a good job. And in the case of Fannie and Freddie, I think they have in terms of the utilization of the derivatives. That's something very different from how they account for them — which is where Freddie is having problems right now.

And we have a secret weapon — a canary in the coal mine.

**Gipson:** One of the people who I talk to every two or three months is the head of a private mortgage insurer — who is sort of our canary in the coal mine. He deals with Fannie and Freddie on a regular basis — he insures some of their higher loan-to-value loans. And if they ever have any problems, he will see those problems first.

And he isn't a Wall Street analyst, but someone who's in the business. And he has a great deal of respect for the caliber of the people that Fannie and Freddie have hired. In terms of detailed knowledge of the mortgage market, they are two or three times better than the next best private institutions like Morgan and Citibank.

So in a variety of ways, we *think* that they're doing a good job on the derivatives. However, can we really look inside there? No. And that's why there always should be a risk premium for Fannie and Freddie and others. But based on how they've *used* them as opposed to how they've *accounted* for them, to date we don't have any concerns.

ARE FANNIE AND FREDDIE BULLETPROOF? NOPE?  
 BUT WE WORRY ABOUT LOTS OF THINGS MORE.

If they have problems, you'll have bigger ones, too.

**Shareholder:** I believe a pretty respectable number of value investors — including one gentleman I met with yesterday — think that the derivative exposure Fannie and Freddie have is unanalyzable. And some of them have expressed concerns about their counterparty risk — and about the fact that apparently a large percentage of counterparties go through J.P. Morgan, and whether or not J.P. Morgan has its house in order. Apparently, its derivative exposure is over \$1 trillion — and its equity is minuscule by comparison. How comfortable are you with your ability to analyze that?

**Gipson:** Well, I answered part of that question before: Can you ever be completely comfortable — particularly in a financial institution that has a complicated balance sheet? No. Can you be *reasonably* comfortable? I think you can — at least I think you can on several issues.

First, on counterparties, Freddie and Fannie really have limited themselves to a small number of the biggest and best banks in the country. So if Citibank is unable to

honor its derivative commitments to Fannie and Freddie, then I think we'd have much larger problems in the economic system than just Fannie and Freddie per se.

And there are things that we'd worry about a lot more...

**Gipson:** But there are a variety of businesses... Again, you can compare it to something like an insurance company where you are relying on the capacity and integrity of the management to maintain reserves at adequate levels. There does have to be an element of trust.

But there is an additional benefit with Fannie and Freddie — in contrast with the current very good earnings reported by a number of brokerage firms. A great game to play if you're a hedge fund or a brokerage firm has been to go long the four-year and short the two-year Treasury — to basically play the yield curve. And as long as the Fed has kept the Fed funds' rate low, that has basically been a way for those entities to mint money on a highly levered basis.

Most of you probably remember 1994, when they were playing that game and suddenly interest rates went up and they lost their shirt. That was a risky thing to do because they were making a one-way bet.

Well, Fannie and Freddie *aren't* making one-way bets. They're using their derivatives for one purpose and one purpose only — and that's to dampen the interest rate risk in their mortgage portfolios. So in contrast to other people who are using derivatives very aggressively, they're using them in a highly focused way to accomplish one objective — and a commendable objective at that.

A question bears/skeptics might have trouble answering...

**Gipson:** But there will always be a residual concern as to how competently they've measured and managed their risk. And that's a reasonable question. I think that they have bright people who've done a good job in that area to date. And they realize that they're under a microscope right now. So I imagine they're probably trying extra hard to get it just right.

But you can turn the question around to someone who is concerned about it and ask, "Why exactly are you concerned about it?" I've just given you some reasons why my comfort level is what it is — including the fact that we've talked to people who they're dealing with who think that they have a lot of bright people doing a very good job. So I think that it might be interesting if you turn the question around and say, "I understand your concern. But why exactly do you think the folks at Fannie and Freddie are doing a *bad* job?"

If you phrase the question that way, I suspect that the folks raising those questions may have some difficulty answering you.

FREDDIE & FANNIE ARE TWO WONDERFUL BUSINESSES  
 — AND TWO OF THE CHEAPEST THINGS THAT WE OWN.

Do we like Fannie and Freddie at 10X earnings? You bet.

**Gipson:** So we recognize that there is an element of controversy. However, in the current environment there aren't very many cheap stocks. And Fannie and Freddie are two of the cheapest things that we own. And to be able to buy two such highly profitable, growing businesses at only 10 times earnings, I think we feel a bit like Brer Rabbit

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— we don't mind a bit being thrown into that briar patch.

They've done a really great job managing asset quality, too.

**Sandler:** One of the things we do expect under the new FASB pronouncements like FAS 123 is a little more volatility in earnings with both Fannie and Freddie. And as shareholders of Clipper, you should expect it. But over the long term, we think both companies will generate good returns for us.

**Gipson:** The real concern at this point is whether there's going to be some major change in how they conduct their business and the profitability of it. And it appears that the answer is no. However, there certainly will be some changes in the regulatory framework.

The real thing you worry about with Fannie and Freddie — and really any leveraged financial institution — is the quality of the assets. And the reason why I say that is because if you are levered, what will destroy your equity is exactly that — asset quality problems. Well, Fannie and Freddie have done a really great job of managing that area. Actually, their loan losses are, if anything, too low.

But they have done a very good job of managing their asset quality in the past. As long as they do half as good a job in the future, they'll both be very good investments.

Wonderful, well managed and two of the cheapest....

**Gipson:** So Fannie Mae and Freddie Mac are both very well managed, as Greenspan — who is actually a critic — has gone out of his way to say. And they're both selling at something around 10 times earnings. They're two of the cheapest large stocks around. And they're so efficiently managed — not to mention the fact that they have that implicit government guarantee that no one can really measure or get rid of. They're truly wonderful businesses.... We just wish that we could find more like them.

EVEN USING CONSERVATIVE ESTIMATES,  
 KRAFT AND ALTRIA REMAIN UNDERVALUED.

Legal cloud over Altria seems to be lifting.

**Shareholder:** Can you talk about your outlook and value estimate for Altria?

**Gipson:** Actually, the CEO of Altria was in our offices two days ago. So we're reasonably current on that one. I've done most of the talking so far. Michael was present, too. So Michael, let me give you a chance to talk.

**Sandler:** ...Altria was a tougher company to own a year ago than it is today. The legal cloud seems to be lifting. Over the last 12 months, the share price has done really well. Twelve months ago, it was in the \$30s. Today, it's in the \$50s. So we've been pretty happy with it.

We still think the company is undervalued. It's likely that the company is going to split itself apart once the three major lawsuits read against it have been overturned or resolved. One is the Engle class action suit in Florida.

It's been completely rejected by the appeals court. It's on appeal to the supreme court. And everyone's waiting to see if the Florida Supreme Court even considers it.

Second, there's the Justice Department lawsuit, which is likely to be heard later this year and perhaps decided early next year. And finally, there's a Florida class action lawsuit related to Lights cigarettes.

If those lawsuits wind up getting resolved, and no other large class action suit pops up, then it's likely that Kraft Foods will be spun off. And perhaps some time down the road, the international and the domestic tobacco businesses will be split off.

[Editor's note: Last year, Sandler and Gipson explained why they believed the lawsuits against Altria lacked merit and would be resolved in the company's favor. And their thinking just happened to match up very closely with that of Semper Vic's Tom Russo. (Of course, the cases and the company were discussed in significant detail in our August 11, 2003 edition.)]

It remains an incredible cash machine....

**Sandler:** Altria management is very focused on enhancing shareholder value. When CEO Louis Camilleri was in our office a couple of days ago, he kept on emphasizing that.

Altria's underlying businesses are still doing okay. Kraft is the weakest member of the group right now. But we think management's taking pretty good action to get their various product lines moving ahead again.

Altria's domestic tobacco business is starting to grow again. The deep discount cigarettes are no longer making inroads. And the international tobacco business will always have a few problem spots around the world. However, in general, its revenues and earnings should continue to grow in sort of the mid-to-high-single-digit range.

So net net, it's not going to be a super high growth company. But we think it's an incredible cash machine. We don't expect it to ever sell at a premium to the market. But we're very comfortable holding it in the mid \$50s.

We did lower your holdings a little bit a few months ago when the share price rose into the \$50s. But again, it's not because we have a concern with management or a concern with the direction of the company. It's just the way we manage risk in the portfolio. When a share sells at a huge discount to intrinsic value, we'll add to the position. And when a discount shrinks, we pare it back — just like we did with Tyco earlier this year.

[Editor's note: Russo said he'd lighten up as it rose, too. But to cause him, Gipson and Sandler the maximum possible embarrassment, let us add that they (and other contributors) reported buying Altria during the first quarter of 2002 when it fell below \$46 for only part of one day. (Russo unabashedly admits buying some then in the \$50s.)]

Even absent rapid growth, Kraft and Altria are undervalued.

**Sandler:** And maybe it's a metaphor, especially the Kraft business, for most consumer products companies today with exposure to the First World — in other words, the U.S., Latin America and, of course, Canada — that have a problem growing the top line. We're not deluding ourselves into believing that the top-line growth is going to suddenly skyrocket into the high single digits again. We're

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expecting most consumer products companies to have very low single-digits top-line growth.

And a lot of the margin expansion's already occurred. So it's going to be very difficult to grow these businesses longer term.

However, even using conservative estimates, we still think that both Kraft and Altria are undervalued.

**Gipson:** You haven't seen it in the newspaper in the last few months — and that by itself is good news....

WE TEND TO INVEST IN HIGH ROE BUSINESSES  
 — LIKE ALTRIA GROUP, FANNIE AND FREDDIE.

Rich or poor, it's good to have a high return on equity.

**Shareholder:** You've written a number of times on return on equity — both in the particulars of companies you own, and as a whole for corporate America. Could you give us an historical perspective on that — where you think that might go in the future?

**Gipson:** Well, it's gone *up* in the last year.... In an ideal situation, as is the case with Altria and Fannie Mae, to pick two, we invest in companies that generate high returns on equity — and do something shareholder-oriented with the money that they earn. Altria's dividend yield is currently up around 5%. And they'll probably resume share buybacks by next year, too.

And it's nice to have reinvestment opportunities, too.

**Gipson:** In the case of Fannie and Freddie, they both earn returns on equity around 20% — which is very good. And most of the time, they have the opportunity to achieve additional organic growth by buying more mortgages — although this is not one of those times, by the way. When the spreads are narrow, they reduce their mortgage purchases. So there's a cyclical aspect to it.

But it's much better to have a company that does have a good return on equity and generates cash. And that's one of the things we look for in most of the companies that we invest in.

WE CAN'T LIVE ON CREDIT CARDS FOREVER.  
 EVENTUALLY THE BILL WILL HAVE TO BE PAID.

Recent swing in national budget has not been good news.

**Shareholder:** There's a huge amount of concern about our federal budget and trade deficits. These numbers are... Well, I can't count that high.... Are you concerned about the potential impact on equity markets of a continuation of our current national economic policy?

**Gipson:** The very short answer would be yes. On the federal budget deficit, it's remarkable that that has gone in Bush's tenure from a surplus as far as the eye can see (although I think you'd need eyeglasses based on that assessment) to a very large deficit in a very short period of

time. And there are a variety of reasons for this, which we won't go into. But that has not been good news.

[Editor's note: Keynes, of course, would disagree. The budgetary antidote for recessions according to Keynes, as we understand it, was the stimulus of significant deficit spending. Surpluses, in his view, would only exacerbate the problem by dampening economic activity.]

Even the U.S. can't live on credit cards forever.

**Gipson:** As regards the trade deficit, even though the percentages of GDP are roughly the same — 3-1/2% to 5% — that is qualitatively different. Basically, we're living on credit cards that the rest of the world is giving us. At some point in time...

You can live on credit cards for awhile. As the world's largest reserve currency, most countries' central banks have reserves that are denominated in dollars. And that introduces an element into the equation that is qualitatively different. I think it means that you can live on credit cards much longer than you could if you were Argentina or Brazil. But the basic problem remains that at some point, if you consume too much...

Absent higher savings, there'll be little gold in golden years.

**Gipson:** Put another way, we're saving too little. And that's not *precisely* the same thing. However, it's reasonably close. We have a very low national savings rate — partially as a result of that excessive consumption.

From the standpoint of people saving for their retirement, the people in this room are not typical. I think our national savings rate is only 3-1/2% to 4%. The good news for the baby boomers as they retire is that actuarially they're going to live a long time. The bad news is that they're not going to have a lot of gold to go into their golden years.

But don't ask me how it ends — because I don't know.

**Gipson:** There are a number of consequences. The one you may be thinking of is that traditionally, when a country has a large current account deficit, there is often also a collapse of its currency. And we've certainly seen a weakening of the dollar in the last few years. Will it weaken further from here, or will China and Japan want to go on holding dollars to keep their own currencies weak?

I think that we have a condition somewhat similar to the one that we faced in the early 1930s when every nation was basically trying to keep its currency weak in order to promote its competitive advantage in trade.

But predicting how it will end, and when, this time, no one can do. However, it probably won't end well.

I DO SEE PARALLELS BETWEEN TODAY AND 1972.  
 BUT ULTIMATELY, IT'S ABOUT FINDING BARGAINS.

I see some parallels between today and 1972....

**Shareholder:** In your third quarter report, you kind of compared this period with the early '70s — to the time when Nixon was going for reelection.

But there's the twin deficits. That's about \$1 trillion worth of problems right there. The consumer is loaded up with debt. Many people think interest rates are artificially low because of the Japanese and Chinese buying our securities. And the Fed funds' rate is down at 1% — back

(continued on next page)



CLIPPER FUND'S  
 JAMES GIPSON & MICHAEL SANDLER  
 (cont'd from preceding page)

at its 1958 level.

So for all of those reasons, there's a good likelihood that interest rates at some point will go up. And I understand higher interest rates are not good for stocks.

So there are so many factors out there right now that concern me. Is there anything that concerns you?

**Gipson:** Well, all of the above. But just for the benefit of the other people in the room, let me make one amplification on Nixon in '72 and its parallel to today. Richard Nixon attributed his very narrow loss to Kennedy in the 1960 election to the recession that hit that year — the third recession of the Eisenhower administration — and that had not ended by the time the election took place.

So learning from experience, Nixon decided that he was going to do things differently in '72 when he came up for reelection. Even though he had a very weak opponent, he made sure that the economy looked as good as possible. He stimulated the money supply, pursued deficit spending, etc. And the economy was booming by November when the election took place. But it peaked a couple of months later — and then the S&P proceeded to decline by 45%.

I'm not predicting that's going to happen again, but that, I think, is the thought process you mentioned. We have a parallel today in that within a very short period of time, we've swung to a large budget deficit in order to stimulate the economy. And we certainly also have a stimulative monetary policy.

Will it end like the situation did with Nixon? That we can't say. But what we *can* say is that the prices of securities really are very generous across asset categories.

Ultimately, what it's about is finding bargains.

**Gipson:** To answer your question in particular, there really are lots of things to be concerned about — and that is *always* true. And if there aren't things to be concerned about, then you should be concerned about *that*.

But there are definitely things on the positive side of the ledger, too. For example, corporate profits are doing *very* well.... So in terms of overall pluses and minuses, there are some things to be happy about and some things to be concerned about. And that will always be true....

What should drive your portfolio, however, we believe, is really the analysis of particular stocks — and the search for individual stocks that are cheap. That's what it really comes down to on *our* side — to finding a few good, cheap stocks to buy. And lately, we're just not *getting* 'em — we just haven't been able to find very many.

**Sandler:** And again, the reason we want cheap stocks is to have a margin of safety so that if interest rates do back up, we at least have a little protection — not guaranteed, but at least there will be a little protection.

ARE MARKETS GETTING MORE EFFICIENT?  
 NOT IF THE RECENT PAST IS ANY GUIDE.

Are markets getting a lot more efficient? I don't think so.

**Shareholder:** I have a question regarding the overarching strategy of your investment philosophy.

You've said that there's a dearth of value investments right now in almost all categories and that this has been going on now for quite some time.

**Gipson:** No. If you go back only a-year-and-a-half or two years ago, I wouldn't have said that.

**Shareholder:** I understand. But a-year-and-a-half or two years is a long time to be spending with my money in my pocket. My question is this: Do you feel that we may be witnessing a slight but noticeable increase in efficiency in the market? And if that's the case, have you perhaps thought that we need to adjust our criteria when we look for deep value — in effect, that perhaps the discounts just aren't going to be as deep as they once were?

**Gipson:** That's a good question. Let me reply in two parts: As far as the efficiency of the market is concerned... I've got a 12-year-old son. I'll never be able to explain to him how a market can be as inefficient as it was in 2000 — when it had the highest P/E ratio, the lowest dividend yield and the highest ratio of stock market capitalization to gross domestic product in history. So when people look back at the efficiency or inefficiency of financial markets, we'll have seen — not just during our lifetime, but during the last few years — arguably the least efficient market in American history. So, obviously, that would not represent strong evidence that financial markets are becoming dramatically more efficient.

I suspect that greed and fear have not been banished.

**Gipson:** However, the general concern that you raise is one of those lingering questions that you can't really answer. It's certainly possible that financial markets have reached a level of sophistication and efficiency where really good values are no longer going to be present — where we won't be able to buy at a 30% discount from our estimate of intrinsic value. And maybe we'll have to just adjust to that climate. But we haven't done that yet.

I recognize that that's a theoretical possibility. And yet when people talk about the efficiency of markets, I can't help but think about what it looked like only four years ago and suspect that the emotional elements of greed and fear have not been banished from the market.

[Editor's note: Indeed, as Seth Klarman points out (on page 4), it's remarkable how *little* investors seem to have learned from the bear market.]

**Gipson:** ...I think it's remarkable within the context of so many bright investment analysts — many of them using computer-based valuation models — how totally *nuts* markets can be....

—OID

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

Munger is the first.<sup>1</sup> (Given that Buffett is very close with Microsoft's Bill Gates and the fact that Buffett's I.Q. is, of course, way off the charts (probably quite literally), both observations become even more remarkable.

Buffett credits Munger with opening his eyes to the virtues of investing in superior businesses. He even says he slowly came around to his point of view on *many* points — that thanks to Charlie, he's "evolved".<sup>2</sup> And he suggests that if he hadn't, "Boy ... would I ever be a lot poorer."<sup>3</sup>

More than a few of our most astute contributors and subscribers say very similar things — that they find Munger's insights particularly valuable and that they make a point of going back and reading and re-reading them again and again. We couldn't agree more. His insights about human nature, flaws in our "wiring", business, investing and more have been excruciatingly penetrating. And as long-time subscribers know, Munger has been right again and again about the major issues of the day — including the S&L scandals, debacles in derivatives, misleading accounting and self-serving, out-of-control executive compensation — *before* they hit the front pages.

For those reasons and more, we're very pleased to bring you these additional excerpts from Munger's remarks at last year's Wesco Financial annual meeting which space considerations precluded us from including last edition. As always, we heartily second Buffett's comments about the enormous value of his counsel and highly recommend a careful reading and re-reading of anything and everything that Munger has to say.

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JUST AS WE SCREWED UP BY NOT BUYING WAL-MART,  
WALTON SCREWED UP BY NOT BUYING COSTCO.

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Our sins of omission have cost us a lot.

**Shareholder:** Charlie, there's been one question already about your sins of omission. And you answered that in a very interesting manner by mentioning the banking and finance sector. The other sin of omission you talked about at the Berkshire meeting was Wal-Mart.

**Charlie Munger:** Yeah, that was an \$8 billion sin.

**Shareholder:** ...That's obviously very significant. But I'd be particularly interested in hearing anything that you want to say to expand upon that including the context of your perspective as a director of Costco.

**Munger:** Well, what happened with Wal-Mart is that we started to buy it — and, of course, the price went up. And we're naturally so cheap that we stopped buying. And of course, stopping has cost us \$8 billion so far.

<sup>1</sup> Roger Lowenstein, *Buffett: Making of an American Capitalist* (New York: Random House, 1995), p. 162.

<sup>2</sup> L.J. Davis, "Buffett Takes Stock," *New York Times Magazine*, April 1, 1990, p. 61.

<sup>3</sup> Carol J. Loomis, "The Inside Story of Warren Buffett," *Fortune*, April 11, 1988, p. 26.

If we were only 5% smarter, we'd be a lot richer.

**Munger:** Now it's true that it isn't \$8 billion we *lost*. It's \$8 billion that we would've made that we didn't.... I haven't got 100 of these things to tell you about. But our sins of omission have cost us a *lot* in terms of [missed] opportunity. And I wish I could tell you that we were going to stop doing this. But based on our past record, I don't think we are.

The things we're almost smart enough to do and don't quite do, I think, will always be with us. On the other hand, we do find some things to actually do which, on average, have worked pretty well. But if we only could've been 5% smarter, our shareholders would have been a lot better off.

Two perfectly amazing stories — Wal-Mart and Costco.

**Munger:** Regarding Costco and Wal-Mart, what's interesting there is that those are two of the most admirable retailing operations in the history of the *world*. Wal-Mart probably has the best retailing record in the whole history of the world. And it was created by a guy who was over 40 when he started it — and he hasn't been dead all that long. So it's a perfectly amazing story.

And the Costco story is a similarly remarkable story. But Costco would be worth a lot more money if there weren't any Wal-Mart — whereas when Wal-Mart rose, there wasn't any other Wal-Mart.

Sam Walton made the same mistake Warren and I did....

**Munger:** What's really interesting is that Sam Walton, being as smart as he was, talked to Sol Price several times about buying what is now Costco. And those two titans, who admired one another, never got together. We screwed up by not buying Wal-Mart stock, big time — and I think *they* screwed up years ago [laughing] by not paying whatever Sol Price wanted.

MCLANE'S A SUPER EFFICIENT DISTRIBUTOR —  
A VERY DECENT BUSINESS LIKELY TO GET BETTER.

We don't expect fantastic growth forever from McLane.

**Shareholder:** I don't understand your purchase of McLane.... It's a low margin business. Yes, Wal-Mart owned it. And being a captive, they couldn't maximize the business' customer base. Is it a cash flow game? What's your major rationale behind that purchase?

**Munger:** Obviously, we like the manager a great deal. And obviously, we trust Wal-Mart to stay with us as a major customer. And obviously, we thought it was a very decent value for us at the price we're going to pay.

What more can I say? It isn't some business that's automatically going to grow at fantastic rates forever. After all, one of the main products it distributes is tobacco.

But we didn't *pay* for a business that was guaranteed to grow at remarkable rates forever. We think it's a very decent business — and one that's likely to get better. We think it was worth what we've agreed to pay for it. And we *like* buying decent businesses at fair prices.

Think of McLane like FedEx or UPS....

**Munger:** It's a very efficient... You should think of a business like McLane not as a normal merchandising business, but as a *logistics* business — like Federal Express

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

or UPS. It's a *super-slick, super-efficient* system of accomplishing an important physical distribution function. And just as UPS has found a niche in capitalism by being super-efficient, so has McLane.

I think Wal-Mart sold it because they're the best in the world by a broad margin at their basic retailing — and I think they like concentrating on what they're best in the world at. Well, I would, too.

BERKSHIRE/WAL-MART RELATIONSHIP IS STRONG.  
BUT DON'T GET CARRIED AWAY ABOUT IT....

We trust Wal-Mart and Wal-Mart trusts us.

**Shareholder:** ...Berkshire's recent purchase of McLane in which Wal-Mart exclusively approached Berkshire and the fact that 85% of the production of Garan is sold by Wal-Mart has led us to appreciate the strong Berkshire/Wal-Mart relationship. Going down the list of Berkshire businesses, one is struck by how many similar products Wal-Mart sells.

For example: paint. But I don't believe Benjamin Moore is now a vendor to Wal-Mart. There's footwear, apparel, jewelry, kitchenware — also, there are over 800 McDonald's in Wal-Mart's. Could Dairy Queen participate there as well? The possibilities of GEICO desks and See's kiosks in Wal-Mart's and Sam's...

Is it realistic to expect accelerated volumes of Berkshire products flowing through the Wal-Mart system given the mutual trust of the Berkshire and Wal-Mart organizations? Or does Wal-Mart bargain too hard on price to be a major Berkshire sales engine?

**Munger:** Obviously, based on the transaction and the past history and the Garan transaction, we trust Wal-Mart and Wal-Mart trusts us. We greatly admire Wal-Mart. How can you not admire what's been accomplished there? It's a total meritocracy that's passionate about delivering value to the ultimate customer. How in the world could you have a good value system and not admire Wal-Mart?

But don't expect a vast flood of our goods into Wal-Mart.

**Munger:** I wouldn't get carried away by the Garan and McLane transactions, though. Wal-Mart will buy, with one of the best buying systems on earth — in fact, it may be the best buying system on earth — what's good for them to buy. And they're not going to be buying anything from us [chuckling] because they like us.

We wouldn't want it any other way. We only want to sell what we *deserve* to sell. So I wouldn't expect some vast flood of our products into Wal-Mart....

CLAYTON WILL BE EVEN STRONGER WITH BERKSHIRE  
— AND WE THINK IT'S PLENTY STRONG ALREADY.

Manuf'd housing industry suffering from a vast oversupply.

**Shareholder:** I've been a Clayton Homes shareholder

for a number of years. So I'm very intimately involved and knowledgeable about the company. And you have actually bought an absolute *jewel* of a company, as you well know — although it would've been nice if you'd paid a *little* bit [he's interrupted by audience laughing] more for it.

But having said that, given that you're paying cash for the company, my concern is that the company is able to continue the culture that it has had for so many years. Having the family involved in the business is a real asset. Have you made any provisions to not let them off the hook, so to speak — and not just give them a big payday?

**Munger:** We wouldn't have bought Clayton Homes if the family members you like weren't there and weren't planning to remain. With reference to the price, of course, the entire industry worked itself into a disastrous collapse with vast oversupply of used units and huge ... losses.

Clayton is the jewel of its industry.

**Munger:** And you're right — Clayton is the jewel of the field. However, even Clayton has felt the strains of the general calamity and the general oversupply of used homes, etc. But we think Berkshire will help make Clayton stronger. And like you, we think it's plenty strong already.... But, of course, we're buying it at a time of great stress in the field. What can I say? It strikes us as OK for Berkshire. And we think it's also OK for the Claytons.

We're delighted to buy it. But a lot of other people would be terribly worried by it. That's the kind of thing Berkshire is willing to do all the time that a lot of companies aren't. Most companies just can't *stand* the idea of buying something with the taint of failure and disgrace surrounding it. There's nothing wrong with Clayton. There's been a lot of disgrace and failure in the industry surrounding them. And most people just don't want to buy into that kind of a situation. We're willing to do things like that — all the time.

And our AAA credit rating — it won't hurt Clayton. [Audience laughs.]

We've had no trouble keeping managers historically.

**Munger:** Everything you like about their culture — does it seem all that inconsistent with Berkshire's culture?

**Shareholder:** Well, I'm just concerned that the Claytons will continue to have a stake in the business.

**Munger:** We've bought business after business after business from founders like the Claytons because we admired the people and what they'd done with their lives. And in almost every case, we've expected the founders to stay on and run it. And we have had a perfectly marvelous record of having our expectations not disappointed.

I've always thought manuf'd housing had a bright future.

**Munger:** Also, in the case of Clayton, it's father and son. And the son's young — at least compared to us. So it *totally* fits the Berkshire pattern. And we *love* the place.

I've *always* thought that manufactured housing ought to have an even bigger place in the country than it does now — and that it might even morph into some different kind of a system than we have now. The way we build homes now in America — not so much the tracts here in California with piecemeal labor, but the way that houses are built in a lot of places — is *very* inefficient.

(continued on next page)



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

There's some logic to higher housing prices....

**Shareholder:** What are your thoughts regarding the housing industry and housing values in the U.S.?

**Munger:** ...We've had a boom in housing prices that is almost without precedent in the history of the country. And it's kept going on even after we had a lot of horrible reverses in a lot of different places.

Partly, the increased housing prices make sense with interest rates so much lower. And partly, we're getting a boom where everybody buys housing because everybody who *previously* bought it did so well.

But since I have a proven lack of competency there....

**Munger:** But in some places, we got housing so high that when big reverses came — as in Silicon Valley — housing prices went down markedly. In particular, *high-priced* houses went down a lot in price.

I don't know a lot about the housing price market. And I wouldn't have predicted that an ordinary, little house in Palo Alto would *ever* have become worth \$3-1/2 million. That took a combination of a good school system, plus that perfectly amazing Silicon Valley boom, plus the university. Again, I wouldn't have predicted it. And having failed to predict correctly in the past, I don't know why I should — [cracking up] based on my clear lack of competency — make a lot of future predictions here.

I do think that ordinarily the best time to buy housing you need for your family is when you *need* it — and not to try and time the market.

OUR RATIONALE FOR PURSUING BURLINGTON  
WASN'T A SUDDEN LOVE AFFAIR WITH TEXTILES....

Burlington was a peculiar, add on, one-of-a-kind thing.

**Shareholder:** In the mid-'80s, you and Warren exited the textile business. And I believe that Warren in the 1985 Berkshire report spoke of the very bad economics of textiles and criticized Burlington in particular. Can you share some insights as to the thinking behind your recent interest in Burlington?

**Munger:** Yeah, that's very easy. Burlington has a segment that relates to Shaw — Shaw does flooring and carpets, of course — that would fit in very nicely with Shaw. What *wouldn't* fit in nicely with Shaw, we were willing to buy at the price that we offered after allocating what we were willing to pay for the business that *would* fit in with Shaw.

And that was a peculiar, add-on, one-of-a-kind thing. We haven't suddenly decided that the textile business is the place to be.

Reasonable men may differ — and we did....

**Munger:** The judge in that case... thought it was perfectly fair for us, in effect, to give the world a put for many hundreds of millions of dollars with no obligation on the *other* side to deliver. And of course, in the world in which *we* live, puts are worth a lot of money. The judge thought the amount we should receive for the put we gave

was less than what we thought was the minimum.

He was a perfectly reasonable judge, but we're perfectly reasonable, too. And the end result was that we walked.

A broad category facing very tough competition indeed....

**Munger:** But our pursuit of Burlington doesn't mean we suddenly decided that the troubles in textiles are over. Generally speaking, if you're in *any* business of a manufacturing nature in which after considering all transportation costs, China can do well, I think you're in the crosshairs of a very tough opponent.

Now why didn't we know this better before we bought so heavily into the shoe business? Well, as the old German said, "You're too soon old and too late smart."

CORT WAS CLOBBERED BY DOT.COM DECLINE.  
THAT'S FINE. IT LETS US BUY *OTHER* CORTS.

The timing of our Cort purchase was terrible.

**Shareholder:** My question is about Wesco's Cort subsidiary. We're in an interesting economic time that's impacting all of our operating companies.... But I'd suggest that perhaps Cort is suffering something other than a temporary decline because of the demise of what I would call the "dot.com boom" and all the since-gone office space that came along with it. I'd like your comments on that....

**Munger:** Well, of course, Cort's been *clobbered* by the big dot.com decline. The whole temporary office business in the country had a huge boom. The law firms expanded. The accounting firms expanded. The venture capital places expanded. And then, they all went into reverse with the great bust. Used furniture prices went down. There was less business from people that wanted temporary offices, etc. There's no question about the fact that we caught, in that business, a big recession.

So was our timing great in buying Cort? No, it was terrible.

But do we think it's hopeless? Just watch our wallet.

**Munger:** A similar recession today has caught NetJets — making used jet airplane prices go down like crazy.... There have been big contractions. And NetJets is losing some money. As I sit here, Cort is losing a little money. But do I think NetJets is going to fail over the long term? No. Do I think that Cort is going to permanently fail? No. I just think that there are these vicissitudes in life — and that sometimes they last for a pretty long time.

If we ever think it's hopeless, believe me, we would be capable of facing it. We don't have *any* idea it's that way with Cort. On the contrary, we've been buying *other* furniture rental firms — and we're buying them at declining prices. So some people vote with their feet. Well, we're voting with our wallet.

ASBESTOS LITIGATION IS NO MODEL FOR SOCIETY.  
WAY LESS THAN HALF HAS GONE TO THE INJURED.

Asbestos hasn't been the legal system's finest moment....

**Shareholder:** I have a question about USG. Its enterprise value is about \$4 billion. They're sitting on about \$800 million in cash. Armstrong recently settled

(continued on next page)



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

their asbestos litigation for about \$3.1 billion when historically they paid twice as much in claims as USG did. So it would take about \$4 or \$5 billion in asbestos judgements to wipe out the common shareholder of USG.

There is currently legislation that's steamrolling — that's gaining momentum. It has bipartisan support. Do you feel that the Berkshire investment in USG will pay off?

**Munger:** Well, obviously, that — so far, at least — has not been one of our happiest investment ventures. Practically everybody in America has underestimated the amount that can be lost to asbestos liabilities. And one of the reasons why it's cost so much is because the way the legal system is manipulated, an *awful* lot of money goes to people who aren't hurt by asbestos. A lot of the money goes to the inefficiencies of the system.

If you took all the asbestos liabilities that have been paid in the U.S., *way* more than half has gone to lawyers and experts and people that weren't hurt. That's a pretty inefficient way of handling a social problem, in my judgement.

They did it a lot better when they had black lung in coal miners. They put some kind of a tax per ton of coal — and they paid everybody with black lung. And so all the money did not go to lawyers and experts and people that weren't sick. It was a *much* better system.

I don't think USG will go to zero...

**Munger:** How USG will play out is a very interesting question. And it isn't just USG. There are four or five other companies that are much the same. In *my* judgement, the common stock of USG will not go to zero. But how well it'll work out on the plus side between zero and infinity, I'll leave for you to figure out.

THE SCORES? JUST ONE OF WARREN'S QUIRKS....  
I THINK A NEGATIVE INTEREST RATE TURNS HIM ON.

The SCOREs gave Warren something to do...

**Shareholder:** Could you comment on why Berkshire issued SCOREs — and how the cost of this instrument reflected the intrinsic value of Berkshire's stock at the time of issuance?

**Munger:** Yeah. Warren has a big motor. And there isn't enough going on at Berkshire — with its miserable, little, tiny pile of assets and it's insufficient number of large businesses. Occasionally, he likes to keep active, and some security seems to him a little mispriced in the world. And if the world wants a slightly mispriced security of Berkshire in a way that won't really *hurt* anybody, I suppose he's willing to issue it. I wouldn't bother, myself. Just call that one of Warren's quirks.

(continued in next column)

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But he did this way back, too. Remember the LYONS? You probably don't. But way back, he did a similar thing. We only have to put up with it about once every 20 years.

I think borrowing money at a negative rate turns Warren on.

**Munger:** It doesn't have much significance given Berkshire's size. It was just that Warren felt that it was, on balance, slightly advantageous to Berkshire to issue that security at that time — and it *could* be done.

I think the mere idea of borrowing money at a negative interest rate turned him on. [Shareholders laugh.] You know — not many people are able to do that.

[Editor's note: If so, Buffett's in the right business. Of course, one of the incredible things about Berkshire is that some of its insurance subsidiaries (for example, GEICO and Gen Re) have *historically* borrowed money at negative interest rates. As our late friend and long-time Berkshire scholar Tony Russ pointed out to us and others, that's one of Berkshire's most under-appreciated virtues.]

**Munger:** Just call that an intelligent quirk — and you will have found out why it happened....

CONSUMER FINANCE HAS BEEN A GOLD MINE.  
BUT EXTREMES OF PROSPERITY MAY BE BEHIND US.

The money made in banking has been simply awesome.

**Shareholder:** Your 1990 letter to shareholders of Wesco outlined your thinking on the savings & loan, banking, and money funds industry. Could you give us your current thinking on how the industry is placed and your view on the rise of some of those growth companies within the industry such as Washington Mutual?

**Munger:** The banking industry has been a perfect *gold* mine. As I said a couple of different times at different Berkshire meetings, Warren and I *blew* it on that one. We probably should have invested a lot more money in banks. It became a lot more profitable than we figured. Even though we did well in it, we probably should have been heavier in it. The amount of money made in banking has been simply *awesome*.

And it's been easy money — so far...

**Munger:** Now a lot of people who have made the money are only — what should I say — moderately skillful. I had an old client when I was young who remarked about the remarkable success of one of his fraternity brothers who'd impressed him as a perfect ass in college. He said, sadly, "He was like a duck sitting on a pond — and they raised the level of the pond."

So banking has been... The amount of money that is buried in the profit figures of brokerage houses and banks now for borrowing short and lending a little bit longer is just astronomical. It's been so *easy* at a time when interest rates just kept going down, down, down, down. Mechanically, it's so easy to borrow short and lend long, if you're a broker or a banker, that people have tended to do more and more of it. And the more they did, the better it worked.

Can that go on forever? Well, as some wise-ass economist once said, if a thing can't go on forever, it will eventually stop. So my guess is that the absolute *extremes* of prosperity for banks may be behind us.

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

It's like selling heroin to addicts. But it may not continue.

**Munger:** Also, consumer credit has been a perfect gold mine for people who knew how to do it correctly. It's like selling heroin to addicts. It's intrinsically a profitable activity. And there are a lot of fiscalholics in the world who are decent enough that they'll probably pay their bills even though they were stupid enough to run them up in the first place. And some of the people who have understood that and shrewdly taken advantage of it have made a great deal of money.

And various *disguised* ways of being a bank — like big brokerage houses with a lot of margin accounts — have been *marvelous* businesses. But I would personally predict that it won't continue to get better and better the way that it has — and it might even get a lot worse....

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EVERY GREAT COMPANY (AND COUNTRY) WILL FAIL.  
BUT WE'RE WAY MORE RESISTANT TO USUAL CAUSES.

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Yes, Warren's getting older; but he's still getting better, too.

**Shareholder:** One challenge for Berkshire over the very long term, it seems to me, is that most — maybe all — business models break down at some extreme of scale or complexity. It seems possible that Berkshire will some day have acquired so many operating units — 150 or more, if it keeps going at this pace — as to be very difficult to manage effectively. And the talented founders, obviously, will gradually need successors, as will Berkshire itself. And the successors may be far less able than those in place now.

For those of us who hope to continue to own Berkshire stock for another 20 to 30 years, how should we best assess the magnitude of this risk? Or will the insurance business simply dominate to such a degree by that time that the decline in the excellence of some operating units is not such a big threat?

And last, if Berkshire *does* push the boundaries of complexity, how can we assess whether management simply prefers to continue playing a game it enjoys rather than return capital to stockholders via dividends or stock repurchases?

(continued in next column)

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**Munger:** I said to my fellow directors of Berkshire quite recently when we were discussing Warren Buffett in his absence: "I know it's hard to believe, but Warren is actually still getting better. He is actually *learning* with each passing year."

And obviously, this is not going to go on forever. However, at the moment, I'd say Warren is still improving — which is *very* remarkable because most 72-year-old men are *not* improving. But he is.

Even w/o Warren, Berkshire would have a lot going for it.

**Munger:** The Berkshire hand — if Warren were to die tomorrow — is a pretty easy hand to play creditably. We couldn't invest the new money as well as Warren does it. But it wouldn't go to hell in a handbasket either. The thing is *drowning* in money. All the places that are owned are spewing out vast amounts of money. If the stock went way down [Munger's voice cracks with laughter] the company could buy it. There's just no *reason* to worry about it going to hell in a handbasket.

And there's actually a pretty good chance that it would continue on *quite* creditably in practically every place you could imagine. The people that are running MidAmerican Energy have a *formidable* amount of ability. And I'll be horrified if that isn't a much bigger and a much stronger place — whether Warren lives or dies.

As for the insurance business, well, Ajit is young. And I can't imagine Ajit not continuing to be one of the jewels of the insurance business in the whole world as far ahead as you can see. So I don't think it's a big problem.

That said, every great civilization and company will fail.

**Munger:** However, if your basic problem is that eventually all of these things will crest, then I say that you're right. I always say the rate of the loss of dominance of great civilizations is 100%. *Every* great civilization that was dominant in due course passes the baton.

Similarly, the great companies of yore are not necessarily the great companies of 100 years hence. I love looking back over long periods and looking at what was up, and looking at what's up now. Who'd have predicted 50 years ago that Kodak and Sears, Roebuck — and you could name other great... The names you could go through.

Who'd have guessed that General Motors would have a market cap that is now so small a percentage of the market cap of all companies? So sure — vicissitudes come to all these places.

However, we are resistant to the usual causes....

**Munger:** However, I think Berkshire is structured so that it's unlikely to fall back the way General Motors did. General Motors basically transferred the enterprise value to the employees instead of the shareholders. That is not the Berkshire culture. We want the employees to be rewarded, to be esteemed, to have a good time in life and to get rich. But we're not in the business of transferring the enterprise value deliberately from the stockholders to the employees.

In a big, unionized company, you try and get one more year without a calamity by giving the union everything — and then feel like you've got to give everybody else more because they're your employees and they're *not* in the union. Well, if you do that for 40 years running, pretty soon you've given away so much that the shareholders have

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

been virtually destroyed. That is not the Berkshire culture.

So I think we're *way* more resistant than most places to the kind of collapse you see elsewhere. But eventually will everything that's now great fail? I suppose it will.

WILL WE HAVE INTERGENERATIONAL CONFLICT?  
IT DEPENDS. WILL WE HAVE 2% PER CAPITA GROWTH?

Intergenerational conflict is not inevitable....

**Shareholder:** At the Berkshire annual meeting, Warren stated and you concurred that Social Security is an intergenerational program. There are projections showing that as we live longer, there will be fewer and fewer people paying into social security and more people collecting it. Do you think this will lead to intergenerational warfare?

Also, you and Warren suggested that in essence, no Social Security assets should be put in the stock market. From my understanding of the plans being proposed, only people under the age of 50 would be able to have a portion of their Social Security money going into the stock market — and it would be a very small portion, perhaps as little as 2% of their total contribution.... Why do you and Warren believe that it's great for us here to be able to own shares in wealth-creating businesses and yet deprive the poor from doing the same thing with a very small portion of their Social Security money?

And concerning the tax rate on dividends, it's not only the very rich who own stocks. More and more people who own stocks and receive dividends are *not* rich. What would be wrong with a dividend tax break if we — given your concern about the rich not paying their fair share, or the appearance thereof — institute a wealth tax of 1% or 2% of assets over \$500 million or \$1 billion, or some other arbitrary number?

**Munger:** Well, that's a very interesting series of questions. Are we headed for intergenerational conflict because of the fact that we're getting so many more old people relative to young people? And of course, we're also inventing different ways of spending money on keeping them going, more or less, as they get old.

The answer to that is quite simple: If the growth rate of the country per capita goes to zero, then of *course* we'll have intergenerational tensions. If the country continues to grow in real terms at about 2% per annum per capita, then we *won't* have serious problems. So the great thing that should be preserved as a matter of public policy is a 2% per annum real growth rate per capita. As long as we do that, I don't think we've got any significant problems with Social Security....

I'm afraid that a wealth tax would *really* gum things up.

**Munger:** As to your question about a wealth tax... Well, the wealth tax has existed. Immediately after World War II, Germany — in desperate shape — passed a onetime wealth tax to try and bring Germany back. And people cheerfully paid it given that people were having difficulty eating and staying warm and so forth. And it *was* a onetime tax.

In this country, I'd be afraid that once non-wealthy people discovered the joys of a wealth tax, it might keep going and going and going. And I think that might *really* gum things up to a fare thee well.

Keep death taxes, but have an entrepreneurial exclusion....

**Munger:** I *like* the idea of our retaining gift taxes and death taxes. But as for the guy who builds up a good business that's worth \$5 million and wants to leave it to his children, my idea of a fair inheritance tax would be zero. But for the people who really are *up* there, I think the current taxes are entirely fair. So that's my attitude on the wealth tax....

HIGH EQUITY RETURNS? THEY'RE NO CERTAINTY.  
HOWEVER, THE GOV'T SCREWING THINGS UP IS.

High returns from stocks are not guaranteed by God.

**Munger:** And as for putting money into stocks in Social Security, that idea arose because common stocks did so well for a long time that people wanted to show off how smart they were by saying, "Gee, you can give bigger benefits to these people in Social Security at a lower cost by just sticking the money — at least some portion of it — into stocks." There were various schemes. And a lot of the people who made those arguments took it as Gospel straight from God that common stocks would continue to yield very high returns over long periods of time.

Well, I don't *have* any such Gospel directly from God that guarantees me in a way that gives me confidence that common stocks are going to yield 8% or 10% per annum in real terms over time.

The last thing I want is government-controlled companies.

**Munger:** And I *do* have a big faith that when the government gets involved with something, it's likely to screw it up big time. So my desire to have the government all involved with the stock market in relation to its promises vis-a-vis Social Security is pretty close to zero. Therefore, I'm *against* all these things my Republican party loves in terms of putting Social Security funds into common stocks.

I wouldn't want the trustees appointed by the government *voting* all the common stocks in America. If you made the program big enough, the Social Security system would own a lot of the common stocks of America. There are a great variety of reasons why I'm willing to leave well-enough alone.

Stocks can get *too* high priced....

**Munger:** Then too, I always say that common stocks are valued in two ways: (1) based on rational estimates of future use value in distributing money; and (2), as things that will probably go up in market price because of the behavior of other people who want to buy them. In other words, they're valued partly like bonds and partly like Rembrandts. And once you get the government acting to create an automatic Rembrandt value by buying heavily every year, God *knows* what could happen to the coherent, intelligent management of the country.

The idea that there can be sure, wonderful money at high compound rates for everybody available *easily* by just

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

shunting a little Social Security money into common stocks or the like doesn't appeal to me at all.... I'm afraid of it. And I'm afraid of the politics.

If something sounds too good to be true, it probably is.

**Munger:** Plus, I don't believe the numbers that people have projected. And by the way, all the projections that most people argued for three years ago now look silly. Maybe in the long run their projections will prove to be right. But I don't think that's guaranteed at all....

For example, what would've happened if the government of Japan, say 20 years ago, had shoveled most of their equivalent of Social Security money into Japanese stocks and they'd gone up for a while — so everybody got to spending more, and the politicians had voted bigger monthly payouts and so forth — and then the common stocks all went down by 80%. Well, I think Japan would have a bigger mess on its hands than it does *now*.

So basically, I'm afraid of it. The more anything sounds like easy, free money, the less I tend to believe it. And I wonder why so many economics professors, generally an anti-tooth-fairy crowd, believe in this particular tooth fairy.

CARNEGIE BIOGRAPHY TAKES YOU BACK 100 YEARS  
— AND MAKES YOU THINK ABOUT CHANGES TO COME.

A book Munger recommends you read slowly....

**Shareholder:** Do you have any books that you might recommend for the coming year?

**Munger:** The one book I didn't mention because nobody asked me at the Berkshire meeting was again from a Berkshire shareholder. He sent me a copy of *A Matter of Degrees* by a physicist named Gino Segre. And that's a perfectly *marvelous* book.

It is not a book you can just read at 90 miles an hour and understand every word — at least *I* can't. But if you'll parse it out slowly, it is a perfectly marvelous book. It has a lot of interesting things in it. So I recommend it to you.

You'll get a lot of hours per dollar if you use it right.

Carnegie's life makes for a very interesting story.

**Shareholder:** Would you please recommend several of your favorite biographies?

**Munger:** Well, I recently read the Carnegie biography that was done by the guy at Grinnell 10 or 12 years ago. And I forget the author's name, but it's the definitive Carnegie biography. I found that a *very* interesting story.

[Editor's note: The book Munger's referring to is *Andrew Carnegie* by Joseph Frazier Wall published in 1989 by University of Pittsburgh Press.]

**Munger:** And maybe many of you have never read a biography of Carnegie. But he started in *absolute* poverty. His total education was about 4-1/2 years of grade school — and that in a schoolhouse where there was, in effect, one teacher for a student body of maybe 170 or 180.

From that beginning came Carnegie Steel and all of the Carnegie charities — and all of the Carnegie eccentricities. It's a *very* interesting story.

What a difference a hundred years makes....

**Munger:** And it's helpful to somebody with an investment perspective — because as the man said, "The past is a very strange country. People behave quite differently there." And that was a different *world*. The way labor was treated in the 1800s was really something. You brought people in and you made 'em do dangerous things. There was no pension and no workman's compensation and no liability. If a fellow workman injured them or if they started to fail in any way, you could just let 'em go. And if there were a general reduction in prices causing pressure on the employer, you'd just tell 'em they were all going to take a 40% pay cut. So it was a perfectly amazing period by our modern standards.

As you read through a biography like that one, it brings you back. And it makes you think about how different the world 100 years from now is going to be from the world we look at now.

It was a different world....

**Munger:** One of the interesting things, of course, as you read a biography like that, which describes the world 100 years ago, is just how much the growth of GNP per capita mattered. Between 1900 and 2000, GNP per capita probably grew by a factor of seven. Well, that's a *lot* in a single century. In fact, it may be without precedent in the previous history of Man.

What the next 100 years is going to hold for mankind, we don't know. But, a book like this will make you *think* about it. So I certainly recommend the Carnegie biography.

I also read a certain amount of science biography. That wouldn't be everybody's taste. But I think practically *everybody* will like *Carnegie*.... It was a very different kind of a world. Carnegie probably got married at 51, or whatever he was, as a *virgin*. It was a different world....

WHEN OLDER, FRANKLIN WAS MORE SELF-INDULGENT.  
BUT ON BALANCE, HE WAS A MARVELOUS STEWARD.

Asked about some well-known biographies....

**Shareholder:** As an inveterate reader of biographies and a devotee of Benjamin Franklin, I assume you've read David McCullough's biography of John Adams.

**Munger:** Yes.

**Shareholder:** John Adams is quoted as saying that Benjamin Franklin, when he was part of the American delegation to Paris, was lazy, that he often did not awake until 10 o'clock in the morning, that he did not practice what he preached, and that he didn't make an accounting of the public money he was spending. I wondered what your thoughts were, Mr. Munger, on this. And also, I wondered if you have read at all any of Robert Caro's work on Lyndon Johnson.

**Munger:** ...Yes, I've read the biographies of Johnson. I think Caro's is a masterful piece of biography.... And of course, I've read the Adams biography and the various biographies of Franklin.

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

Franklin was a marvelous steward of public responsibility.

**Munger:** Sure, Franklin was quite *old* by the time that he was ambassador to France. And sure, Franklin, after he was world famous, very rich, had gout and was reasonably near the great beyond, was more self-indulgent than he was when he was a young tradesman making his way in life.

But I'd argue that he was by *far* the most effective at getting the French to part with vast sums of money — and that whatever was wrong with him from John Adams' point of view helped him with the French. [Audience cracks up and applauds.]

However, on balance, I think Benjamin Franklin was a marvelous steward of public responsibility his life long. And I'm willing to take the fellow as he averaged out. And *certainly* I'm in favor of old people allowing themselves to have a little enjoyment. [Shareholders laugh again.]

THE BEST WAY TO GET SUCCESS? DESERVE IT.  
IT'S JUST SO SIMPLE — OH, SO SIMPLE.

If you want to get rich fast, you're talking to the wrong guy.

**Shareholder:** This fall, I will be entering UCLA. And in large part, inspired by the work and life of both you and Mr. Buffett, I am weighing careers in law or finance. Given your prominence in both fields, I can't think of anyone better to beg for advice. Could you say a few words — any words — of advice about the future of these two professions?

**Munger:** Yeah. Well, of course, we get these questions a lot from the enterprising young. And it's a very intelligent question. You look at an old guy who's rich and you say, "How can I become like you except faster?" [Audience cracks up.] And my answer would be that I did it slowly — inch by inch and insight by insight — by grinding away, patiently accumulating, taking losses when they occurred, etc., and that if you're looking to do it with vast rapidity, you're talking to the wrong man.

Slugging it out day after day — well, that's my way.

**Munger:** I *know* it works my way. And you've got to do something during the years anyway. You don't want to just play tiddlywinks. So I say welcome to the pool if you want to come in and spend each day trying to become a little wiser than you were when you got up in the morning and keep reaching for responsibility and reaching for the ability to discharge your duties faithfully and well. That way, step by step, you get ahead.

But you don't necessarily get ahead in nice, neat, little increments. The getting ahead comes in *spurts*. But you're *preparing* for those spurts by discipline, day by day, over long periods.

And one of the things you have to learn is not to go *crazy* when you're in the midst or on the top of a big spurt — because a lot of people do. You may not need Zsa Zsa Gabor or a Lamborghini or a whole lot of other things that you may think you'd like to have now.

But slugging it out an inch at a time, day after day, that's *my* way.

The way to get success is to deserve success. It's so simple.

**Munger:** In the end, if they live long enough, I think a fair percentage of people get something roughly near what they deserve. If I'm right on that, the way to *get* success is to *deserve* success. It's just so simple — just so simple.

It's like getting a good spouse. I mean, what's the best way to get a good spouse — a *very* important thing which I lucked into? The best single way to do it is to *deserve* a good spouse — because a good spouse, by definition, is not nuts....

IF YOU WANT TO AVOID SORROW,  
YOU HAVE TO KNOW WHAT CAUSES IT.

Buddha encapsulated it best....

**Shareholder:** It seems to me that a lot of what you talk about is more about philosophy than pure finance. Today you've mentioned "reality cubed". You say that *working harder at being rational is a key reason for your and Mr. Buffett's success*. Can you give us some of your basic philosophical tenets on life?...

**Munger:** Well, we've tried to do that throughout everything that we've ever written or said. However, we can't condense extremely: "Please discharge effective human wisdom over a whole, large array — and do it in one sentence." We're not *up* to it.

Other people have tried. If you want it short, why probably the guy who did it best was Buddha. And Buddha said, "I only teach one thing. I teach the cause of human sorrow — and how to avoid *some* of it." Now that isn't exactly what he said — it isn't word for word. However, that's the gist of it.

Well, that is very much *my* approach to wisdom. In other words, *if you go around figuring out what doesn't work and then avoid it* — and you also learn, when you get the sorrow that you can't avoid, *how to handle it* (which is what Buddha was trying to teach), well, that's pretty good encapsulated wisdom.

In order to avoid sorrow, you must know what causes it.

**Shareholder:** But you do focus on rationality.

**Munger:** Well, I think *Buddha* was focusing on rationality. I think that's a very rational approach to the human condition.

**Shareholder:** That life indeed is difficult — or even miserable.

**Munger:** No. [He laughs.] That if you want to *avoid* sorrow [chuckling] you've got to know the *cause* of sorrow. In other words, knowledge is very helpful and there are certain ways of understanding life that improve outcomes....

Well, I guess that does it for one more year.

—OID

As always, the preceding has been reviewed and lightly edited by Charlie Munger (and *OID*) and reprinted with his permission.



## JAMES GIPSON, MICHAEL SANDLER, ET AL., CLIPPER FUND

"First, do no harm" is the injunction given to young doctors. The same idea applied to investment advisors might be: First, do nothing dumb. Both doctors and investors feel the strong impulse toward action. That impulse to do something does not mean, however, that there's an opportunity to do something smart and productive. Opportunity, or the lack of it, is the problem. The stock market has risen to generously priced levels....

"Napoleon observed that 'ability has nothing to do with opportunity'. The current lack of cheap opportunities is a challenge to even the most able investor. In contrast to ... two years ago when we found a number of cheap stocks to buy, recently we've found more to sell. The consequence is a shrinking number of stocks in your portfolio and rising ... cash.

"Cash seems like a four-letter word, particularly given the low level of short-term interest rates which creates an almost desperate compulsion to buy long-term assets.... Rather than buy long-term assets at today's prices, we're choosing to build cash for potentially better opportunities tomorrow.... [I]t is better to do nothing than to do something dumb."

First Quarter Letter to Shareholders — April 2, 2004

## CHUCK ROYCE, ROYCE FUNDS

"...The word 'bargain' is not in our current [vocabulary]. We are finding *okay* absolute returns.... Expected returns from our investments aren't where they used to be. They're down substantially from where they were a couple of years ago.

"Virtually across the board you had a wonderful market.... So there's almost nothing that is a true bargain area. We're spending a lot of time on energy — and have some feeling that the energy area is going to be relatively attractive. The weighting in the indexes in energy over the last 20 years is down substantially. That's not a reason to buy something — but it sort of tells you where it is relative to everything else. So that's an area where we're doing a bit more shopping....

"Gold remains a bet inside the Low-Priced Stock Fund. Whitney [George] feels very strongly about that.... Cash is on the full side. We have many portfolios ... in the 15% cash range. That is sort of our internal maximum cash position...."

Conference Call for Financial Advisors — March 30, 2004

## CHARLES DE VAULX, FIRST EAGLE FUNDS

"We're at 21-22% [cash] in both the Global and the Overseas Fund. Gold-related securities — [as] we define them — are roughly 5-6% in both the Global and Overseas Fund. Likewise, in the U.S. Value Fund, which is a much smaller fund, the cash level is as high as 24%, which basically means that we're just not able to find much in the U.S. market currently.

"...In the last 25 years, [we've] never have had so little in U.S. stocks. Excluding a few gold mining stocks, like Newmont Mining and Freeport, McMoran, which are not really U.S. stocks so to speak — basically we have less than 20% in U.S. stocks, which is an all time high. And again, that's a reflection of the fact that the U.S. market is extremely pricey.

"Whereas four or five years ago during the bubble, [we had] a two-tiered market — large-cap growth stocks, technology and media stocks were very high, but a lot of old economy stocks, especially the small stocks, were rather cheap — today that valuation gap has disappeared; and so everything, small, big, growth, value — everything out there — is quite pricey."

Annual Meeting — March 31, 2004

Dear Subscriber,

Notwithstanding the comments of the contributors in this edition, we believe that every one of them would put the big picture aside and buy the stocks of any companies they would like to own if they felt the prices were right. Similarly, we don't think they would sell such stocks if they owned them already. Like Sequoia's Bob Goldfarb, Oakmark's Bill Nygren and Fairholme Fund's Bruce Berkowitz, we believe that more than a few stocks — including some of those we've featured in the recent past — remain at prices which are above slam dunk bargain levels, but well below intrinsic value.

So, like them, no matter how much we may succeed in frightening ourselves with big picture considerations, we're inclined to think that unless one owns equities via margin, warrants or options — rarely a good idea any time, but an especially bad idea today (do as I say, not as I do) — prices, not fears, should drive one's buy/sell decisions.

On that score, we're pleased to note that we believe this edition includes at least two or three ideas which may remain bargain priced even today. And, we're pleased to tell you, four or five of our contributors have volunteered to provide us with a few ideas that sound equally intriguing (sadly we think emphasis should be put on the word "few") for possible inclusion in upcoming editions of *OID*.

Still, whatever we or anyone else might think or say, as always, don't fire 'til you see the whites of their eyes.

Until next edition,

  
Your Editor

P.S. Thank you for your patience and your support.

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