

# Outstanding Investor Digest

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

## Investors featured in this Edition:

BERKSHIRE HATHAWAY'S WARREN BUFFETT...16, 20, 21, 30, 42, 64

DAVIS ADVISORS' CHRIS DAVIS...2, 48, 50, 64

HERITAGE VALUE EQ FD'S DAVID DREMAN...4, 64

MARKEL GAYNER ASSET'S TOM GAYNER...4, 10, 11, 64

LONGLEAF PARTNERS' MASON HAWKINS ET AL. ...20, 63, 64

WESCO FINANCIAL'S CHARLIE MUNGER...2, 6, 17, 21, 30, 41, 64

OAKMARK FUNDS' BILL NYGREN...26, 53, 64

## Other Investors in this Edition:

FAIRHOLME CAPITAL'S BRUCE BERKOWITZ...24, 25

FISHER INVESTMENTS' PHILIP FISHER...30, 31

GRAHAM/NEWMAN'S BEN GRAHAM...30, 34, 37, 63

SOURCE CAPITAL'S GEORGE MICHAELIS...15

LEGG MASON VALUE'S BILL MILLER...8, 28, 53

GARDNER, RUSSO'S TOM RUSSO...9, 31, 55

TEMPLETON FUNDS' JOHN TEMPLETON...32, 40

THIRD AVENUE VALUE FDS' MARTY WHITMAN...28

MUTUAL SERIES FUNDS' DAVID WINTERS...38, 50, 59

(and more.)

## Companies & Investments in this Edition:

AIG...8, 19  
ALTRIA...64  
ANHEUSER-BUSCH...55  
AON...4, 8, 23

BANK OF AMERICA...64  
BERKSHIRE HATHAWAY...10, 18  
CHIRON...54  
CHUBB...6

CITIGROUP...37, 53, 56, 60  
COCA-COLA ENT...54  
COMCAST...26, 55  
COUNTRYWIDE...60  
DISNEY...26, 29, 52, 55, 63  
FANNIE MAE...54, 57, 60  
FREDDIE MAC...35, 57  
GAP...58

GENERAL MOTORS...27  
GOOGLE...32  
H&R BLOCK...61  
HEINEKEN HLDG...55  
HILB, ROGAL...23, 27  
HOLLINGER...29  
IBM...44

JANUS CAPITAL...61  
JPMORGAN CHASE...37, 54, 61  
KMART...62  
LEVEL 3...24  
LEUCADIA NAT'L...24  
LIBERTY MEDIA...26, 55, 62  
LIMITED BRANDS...53

MARSH & MCLENNAN...4, 11, 23  
MERCK...54  
MCI...24, 25  
MICROSOFT...28, 29  
NIPPONKOA...28  
PETROCHINA...31, 32  
PFIZER...28  
PROGRESSIVE...6, 38  
ROYAL DUTCH...44, 47  
SCHERING-PLOUGH...28, 54  
TOYS "R" US...56, 62  
TYCO...3

VIACOM...54, 62  
VIVENDI...29  
WAL-MART...28, 38, 52, 53, 55  
WASHINGTON MUTUAL...54, 56, 64  
WELLS FARGO...37  
WILLIS GROUP...23, 27

(and more.)

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INSURANCE UPDATE: DAVIS ADVISORS' CHRIS DAVIS & MARKEL GAYNER ASSET MGMT'S TOM GAYNER  
"IT'S NOT ABOUT THE REALITY, BUT THE PERCEPTION — AND IN THIS CASE, WE THINK THE TWO DIFFER GREATLY."

Having shaken up (and shaken down) both Wall Street and the mutual fund industry, much feared and respected New York Attorney General Eliot Spitzer has, as you know, now turned his attention to the insurance industry. Thus, we thought it only appropriate that we do the same. And who better to speak with about the probable implications — and possibly an opportunity or two — than Davis Advisors' Chris Davis and Markel Gayner's Tom Gayner.

(continued on page 2)

LONGLEAF PARTNERS' MASON HAWKINS ET AL.  
"MISPRICING AND VOLATILITY ARE OUR STOCK IN TRADE BUT TODAY, WE'RE SEEING PRECIOUS LITTLE OF EITHER."

Longleaf Partners' advisor, Southeastern Asset Mgmt, has run circles around the S&P 500 for the 24 years ended December 31, 2003 — having earned a compound return of 18.1% per year before fees versus 13.6% per year for the S&P 500. Incidentally, they've run circles around the index for the 3, 5, 10, 15 and 20-year periods, as well — by 14.9%, 12.9%, 5.4%, 3.8% and 3.4% per year, respectively.

(continued on page 20)

BERKSHIRE HATHAWAY'S WARREN BUFFETT & WESCO FINANCIAL'S CHARLIE MUNGER  
"ASSET ALLOCATION IS PURE NONSENSE. THE BEST WAY TO MINIMIZE RISK IS TO THINK."

The numbers almost defy comprehension: A measly \$10,000 investment in Buffett Partnership, Ltd. at its inception in 1956, reinvested in shares of Berkshire at the partnership's termination in 1969, believe it or not, would today be worth more than \$350 million. And mind you, that's actually *after all taxes, fees and expenses*. Incredibly, before fees and expenses (but after taxes) that \$10,000 would've grown to something closer to \$600 million.

(continued on page 30)

OAKMARK FUNDS' BILL NYGREN  
"SOME MANAGERS PREFER TO WAIT IT OUT IN CASH. WE BELIEVE WE'VE FOUND A BETTER PLACE...."

From its inception on November 1, 1996 through December 31, 2004, shareholders of Bill Nygren's Oakmark Select Fund earned a compound annual return well over double that of the S&P 500 — 20.6% versus 8.5%. And its performance for the five years ended December 31st — when it earned 14.5% per year while the S&P was down 2.3% per year — put it in the top 1% of funds in its category.

(continued on page 53)



DAVIS ADVISORS'  
CHRIS DAVIS  
(cont'd from page 1)

If money management talent can be encoded in DNA, Chris Davis should certainly have it. Davis' grandfather, Shelby Cullom Davis, started his investment career in 1947 at age 38 with a portfolio of insurance stocks and turned a \$100,000 investment into \$800 million by 1994. That's a 47-year compound annual return of more than 21%! (All figures were provided by Davis Advisors.)

Davis informs us that not only was no money added to the initial investment, significant sums were taken out for his living expenses and charitable contributions. However, Davis did want us to emphasize that his grandfather did utilize varying amounts of leverage throughout most or all of the 47-year period. (But for that, it would have been an impressive record...)

For more about how his grandfather did it, Chris refers us to a book — *The Davis Dynasty: Fifty Years of Successful Investing on Wall Street* by John Rothchild, published by John Wiley in 2001.

Chris' father, Shelby Davis, continued the tradition. He founded the fund now known as the Davis New York Venture Fund in 1969. And during his nearly 28 years as manager (through his final calendar year), the fund's compound annual return of 14.4% handily beat the 11.6% return of the S&P 500 during that same period.

Perhaps equally impressive, during his entire tenure, the fund's rolling 10-year average return exceeded that of the S&P 500 during every single 10-year period. So much for the efficient market theory... (Preceding data provided by Davis Advisors — and excludes the sales load.)

Chris Davis became co-manager of the fund in October 1995. (Shelby retired as manager of the fund in October 1997, and Ken Feinberg became co-manager in May 1998). Thus, beginning with Chris' first calendar year as co-manager, we estimate that shareholders have earned a compound annual return of 11.8% versus 9.6% for the S&P 500 (for the 9 years ending 12/31/04).

And they've maintained the fund's reputation for consistency, too — by outperforming the S&P 500, as well as the average fund in their category, for the trailing 3-year and 5-year periods, and during seven of those nine years. (Data provided by Morningstar.)

Grandfather Shelby Cullom Davis' fondness for insurance stocks is well known. His son, Shelby, reportedly had an ongoing fondness for the equities of financial firms during his highly successful tenure as manager of the fund he founded. And like grandfather and father, like son. As recently as July 31st, Davis New York Venture Fund reported having over 17-1/2% of its assets in insurance stocks.

So for all of those reasons and more, we thought that we'd give Chris Davis a call and ask him to help us sort out recent developments in the insurance industry. The excerpts which follow came from a series of conversations with Davis which took place between December 3rd and December 19th. We learned a thing or two in the process — and hope you will, too.

SPITZER HAS A GREAT FORMULA  
FOR MAKING TRANSGRESSORS PAY UP.

**OID: Long time, no speak. How are you?**

**Chris Davis:** These are busy times. And you?

**OID: Never a dull moment.**

**Davis:** Ain't it the truth. Isn't that a curse?

**OID: May you live in interesting times.**

**Davis:** Yeah, that's it. And as my grandmother says, that's only a curse until you consider the alternative. When I say, "Oh, I'm so busy," she says, "Don't complain about being busy. The alternative is a lot worse."

**OID: Unless you're in investment publishing...**

**Davis:** That's true. It's good to hear from you. What's up?

**OID: Several things. First of all, when I called, I should have said it was Eliot Spitzer calling.**

**Davis:** That would've been fine. We have a couple of those electric paddles that can restart my heart nearby.

**OID: That's actually one of the reasons I was calling. At Wesco's meeting this year, Charlie Munger talked about the untoward practice of brokerage firms receiving referral fees from money managers in return for sending clients to them.**

**Davis:** That's right.

**OID: And as I recall, at that meeting, some months before Spitzer descended on the insurance industry, you specifically asked Munger if he thought that the brokerage commissions paid by insurance companies to insurance brokers for the referral of business was similarly questionable.**

**Davis:** That's right. I did ask about that — about the practice of paying contingent commissions. And it is a similar structure in some ways and different in some ways: Paying a mutual fund load to a broker, that commission, is the way that the vast majority of mutual funds — certainly all load mutual funds — have been sold since the industry began. In fact, a 6% commission used to be the norm. However, unlike a contingent commission in insurance, the customer is paying it. It's not the mutual fund company paying it.

But despite some differences, there are similarities, too. Presumably, we're off the record here — right?

**OID: Given our circulation, I would say so.**

**Davis:** Let me answer you this way: The world is a better place for Eliot Spitzer's work.

**OID: Certainly better for attorneys. As another of our contributors pointed out to us, Spitzer seems to never fail to leave the pump primed for his fellow attorneys to follow up and collect huge payoffs.**

**Davis:** People may disapprove of his tactics and question his motives, but there were a lot of practices going

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DAVIS ADVISORS'  
CHRIS DAVIS  
(cont'd from preceding page)

on in financial services that nobody would be proud to tell their children about.

**OID: Absolutely.**

**Davis:** But one of the things that I've found striking about Eliot Spitzer and one of the tactics that he seems to have employed is to associate in the minds of the public two different practices when he's taking on an industry. And the first practice he targets is something that's relatively easy to understand, not widespread, and clearly both unethical and illegal. Then, the second practice is something *very* widespread, *difficult* to understand, and distasteful and possibly unethical, but not clearly illegal.

So in the mutual fund industry, you had late trading and market timing. Well, late trading was not widespread, but it was clearly unethical, illegal and easy to understand. As Spitzer put it, late trading was like betting on a race after the horses have already crossed the line.

**OID: I think I'm with you.**

**Davis:** Market timing was much more ambiguous. It's hard to understand. It's complex. You can argue about whether or not people were hurt by market timing. Was it widespread? Apparently it was, although we didn't allow it at *our* place. Was it illegal? In most cases, it wasn't really illegal — at least not clearly illegal.

By comparison, late trading was easier to understand. So even though it was not widespread, by linking it to market timing, Spitzer's allegations carried much more weight than they would have otherwise — and, therefore, helped bring about change in the broader practice.

**OID: Gotcha.**

**Davis:** Moving to the insurance brokerage business, you have contingent commissions and bid rigging. Well, bid rigging is clearly illegal and easy to understand. However, it seems to have been very narrowly practiced — not widespread. But now, bid rigging has been associated in people's minds with the payment of contingent commissions — which was a vast, widespread practice that wasn't understood as well and perhaps wasn't disclosed as well as it should have been.

So what Spitzer did was link a practice which is clearly illegal and should be prohibited with one that arguably should just be better disclosed — although you can argue that people shouldn't be doing it in the first place. For whatever it's worth, obviously, if it were up to us, we wouldn't allow *any* of this stuff.

**OID: I know you wouldn't.**

**Davis:** In the messiness of the real world, those are

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two different practices. However, by finding the narrow illegal practice, Spitzer comes up with the lever to change the industry and remove the distasteful, unethical practice, even though it may be perfectly legal. And that has been a very brilliant tactic.

[Editor's note: Threatening executives personally in order to motivate them to make concessions on behalf of their companies doesn't exactly look dumb either.]

IT'S NOT ABOUT WHAT THE TRANSGRESSORS DID,  
BUT ABOUT WHAT THE PUBLIC THINKS THEY DID....

**OID: And it didn't hurt to have the full faith and cooperation of the press.**

**Davis:** That's right — because they sort of muddy it all together. I think every single article that I read had the four horsemen of the apocalypse being Enron, WorldCom, Global Crossing and Tyco. But think about that grouping — the *madness* of it...

**OID: Yeah — I didn't own Tyco...**

**Davis:** Three of 'em were bankrupt. And one of 'em at its dead low had an equity market capitalization of about \$17 billion! — that's \$17 *billion* with a "b". And again, that was at the dead *low*.

**OID: Like I said...**

**Davis:** So to me, it's truly mind boggling. And yet journalists and talking heads like to lump 'em together. Was that accurate reporting? Of *course* not.

**OID: You expected better?**

**Davis:** Not really. But what Kozlowski did was a wholly different thing than what happened at WorldCom. The scale of financial fraud at WorldCom...

As I like to say, the accounting adjustments that resulted from all of the audits at Tyco were a fraction — and not a large fraction — of what they had reported as earnings. Most of the compensation that shareholders will sue to reclaim — and rightly so — was expensed. [Davis lets out a belly laugh.]

It might have been expensed in strange categories or not disclosed. And listen, I'm all in favor of going after 'em. But the idea that the wrongdoing at Tyco was on a par with Global Crossing, Enron and WorldCom was just crazy. So you're right — the press was part of the Spitzer formula.

And in insurance, everybody understands bid rigging, but what the hell is a contingent commission? Just like everybody understands late trading, but what the hell is market timing? So make it simple. And then use the leverage of that outrage to force a change in a practice which, although it should never have been permitted in the first place, *was* permitted.

Again, *we* wouldn't have allowed it. But that has to do with how our money's invested. And again, I think the industry is *better* for not allowing it.

**OID: Sure. And I suppose that it can't hurt to get in a little preemptive sucking up to Spitzer.**

**Davis:** Every day, if you listen to the radio, you hear a guy with a surefire way to time the market and predict

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DAVIS ADVISORS'  
CHRIS DAVIS  
(cont'd from preceding page)

what's going to happen in the short term. Just look at all the day traders. I don't think that should've been permitted in mutual funds.

But given my assumption — that, in most cases, market timers lose money — it's hard for me to conclude that it's somehow significantly bad for other shareholders. At the very least, I think that you would have to work hard in order to show what the damage is.

**OID: Aside from additional transaction costs.**

**Davis:** That's right. However, don't get me wrong — I can't defend market timing — and I wouldn't. I think it's a sleazy, distasteful practice. I just think it's very different from late trading.

It's like the practice of paying contingent commissions in insurance. It's not my job to defend that practice either. It's been in existence since time immemorial. There was a closed-door settlement on a class-action lawsuit, as I recall, several years ago in San Francisco. So it's not like the world didn't know that contingent commissions existed.

Again, bid rigging is obviously grossly illegal. However, it seems it was a fairly narrowly-focused practice — an exceptionally rare practice.

**OID: Gotcha.**

**Davis:** As I said, I think that the world is better for having these sorts of practices cleaned up. So I think the outcome will be good. I just found the tactic Spitzer seems to use again and again very interesting and very effective.

**OID: And we agree on both counts.**

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WE DIDN'T THINK MARSH MAC WOULD GET THE CHAIR —  
AND FIGURED MOST OF ITS CLIENTS WOULDN'T WALK.

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**OID: Digressing for a moment, I understand that you've got three generations of insurance expertise coursing through your veins...**

**Davis:** Yeah. Unfortunately, it hasn't always helped lately. [He laughs.]

**OID: Given your track record as a money manager, your family's history, and the fact that you seem to have anticipated the issue of contingent commissions — in theory, if not in practice — I thought you might be just the guy to help us understand the implications of the recent developments in the insurance business.**

**And speaking of it not having helped lately, it looks like you bought over 10 million shares of insurance broker Marsh & McLennan during the second and third quarter of this year — a period during which the stock never got down as low as \$42.**

[Editor's note: Incidentally, other managers who we respect and follow were buying it in that same time frame, too. For example, in the third quarter, we estimate that

Marsh & McLennan was the second largest purchase (and ninth largest holding) of Jim Gipson and Michael Sandler's Clipper Fund. And during the second quarter, we estimate that it was their largest purchase — as well as the largest purchase of David Dreman's Dreman Value Management.

And someone else who knows a thing or two about the insurance industry who was aggressively buying Marsh & McLennan during the second quarter was Tom Gayner's Markel Gayner Asset Management. We estimate it was their second largest purchase (and sixth largest holding).]

**Davis:** We'd been investigating the issue of contingent commissions for some time. But what we didn't suspect was the bid rigging. That was the shock.

However, when something like that happens, what you have to do is array the probabilities. [He chortles.] One possibility is that the company gets the death penalty — like Arthur Andersen did. So that was the first thing that you needed to look at. And you also needed to look at short-term debt rolling over and things like that.

Then the other extreme is that a year from now, nobody gives a damn, they've eliminated contingent commissions and just replaced 'em with higher up-front commissions — and they don't lose any clients. The world just goes on.

*PORTFOLIO REPORTS* estimates the following were Davis NY Venture Fund's largest equity purchases during the 3 months ended 10/31/04:

1. IRON MOUNTAIN INC
2. IAC/INTERACTIVECORP
3. OCCIDENTAL PETROLEUM CORP
4. MARSH & MCLENNAN COS INC
5. COMCAST CORP CL A SPL
6. CARDINAL HEALTH INC
7. BLOCK H&R INC
8. DIAGEO PLC
9. HCA INC
10. HSBC HLDGS PLC

And using those two outcomes as the extremes — as low-probability outliers — you then try to fill in the scenarios in-between and assign probabilities to them. And when we did that, we felt like the death penalty was very improbable — because unlike the situation that faced Arthur Andersen, there weren't four comparable firms ready to take on the business.

Voltaire said it's good to hang an admiral every once in a while just to encourage the others. It's unfortunate, but it encourages the others.

**OID: Focuses their minds, maybe. I find it hard to believe that they would find it encouraging.**

**Davis:** That's the quote: *Pour encouragez les autres*. He'd say, "*C'est dommage, mais...*" That's too bad, but that's the way it is. At Arthur Andersen, you could afford to hang the company to encourage the others.

However, Marsh & McLennan is substantially larger than Aon, which is the #2 player in insurance brokerage — and five times as large as the #3 player.

**OID: That sounds like a big positive.**

**Davis:** There functionally are no others. You would

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DAVIS ADVISORS'  
CHRIS DAVIS  
(cont'd from preceding page)

be doing a *massive* disservice to U.S. business to put Marsh & McLennan out of business. So again, we put a very low probability on the death penalty.

Then, once you've eliminated the worst-case scenario, you start thinking about the client fallout. And what would you be saying to yourself if you were a rational client of Marsh & McLennan? You'd be saying, "The one thing that I know for sure is that I'm going to get a helluva sweet deal from Marsh & McLennan next year. And I'm going to have best-in-class governance and disclosure and information — because they're going to want out of this soup."

So if you think about it rationally, a year or two from now, you'll be looking at a company with best-in-class governance, providing the best service to customers. And you'll still almost *certainly* be looking at the largest company. They'd have to lose quite a lot of market share in order to lose their position of market leadership.

AND MARSH MAC'S NEW CEO GETS HIGH MARKS  
FROM THOSE WHO'VE WORKED WITH HIM.

**OID: What are your thoughts on the new CEO?**

**Davis:** Well, I don't know him. But all of our work on him indicates that he's a man of really first-class character and very sterling reputation — and that he's somebody you'd be proud to have running your company.

**OID: What's his background?**

**Davis:** He worked in the U.S. Attorney's Office under Bob Morgenthau — who, of course, for New Yorkers is one of the great citizens of the last 30 or 40 years — a really dedicated and incorruptible public servant.

**OID: Sounds like he'd make a great chief legal counsel. What suggests he'd make a good CEO?**

**Davis:** Well, Michael Cherkasky ran 800 lawyers at the U.S. Attorney's office. Then he went into Kroll, where he became the CEO.

**OID: Before Marsh & McLennan overpaid for it — according to Value Line.**

**Davis:** I don't have an opinion on the price they paid for Kroll. But if Cherkasky winds up being a great CEO, then it may wind up being a bargain.

[Editor's note: If it has another year or two of growth like it's experienced recently, it may be viewed as a bargain on a stand-alone basis, too. We understand that Marsh & McLennan paid something around \$2 billion for Kroll — or something like 22-1/2 times the operating income plus amortization Kroll reported earning during calendar 2003 (according to its final 10-K).

But in the third quarter, according to Marsh's CFO, Kroll's underlying revenues were up 29% (year over year) — to \$194 million. And she further said that Kroll's margins (excluding the amortization of intangibles) for the quarter were up around 18%. If so, then we guesstimate that at its current run rate, the multiple they paid would've already come down to "only" 14 times operating income plus

amortization — for whatever that may be worth....

However, whether the price Marsh & McLennan paid turns out to have been a bargain or not, Cherkasky has apparently had his share of on-the-job experience helping Kroll's clients handle crises. And given Marsh's need for crisis management skills today, their acquisition of Kroll may have been fortuitous.

Kroll's final 10-K shows a remarkable fit between the specific services it provides and those Marsh needs today in order to address its current crisis. Among them are Operational Turnaround Services, Strategic Advisory Services, Corporate Finance Services, Business & Financial Investigations, Forensic Accounting, Litigation Consulting, Due Diligence, Litigation Intelligence, Asset Tracing and Analysis, Monitoring Services, Employee and Vendor Background Investigation, including "compliance programs in regulated industries" — and Special Inquiries for clients who require "an independent fact finder to uncover and end fraud and implement systems that monitor compliance." The description of the Special Inquiries service continues, "Kroll serves as an objective fact finder whose work product could be turned over to a questioning government regulator or a skeptical and vocal segment of the public".

It's almost like Marsh knew Spitzer was on the way....

However, they're not relying *entirely* on Kroll. In Marsh's October 27th conference call, Cherkasky noted: "We're also in discussions with an outside group to come in and audit our processes so that we can not only [provide reassurance] that *we're* doing it, but [also provide reassurance] that we have another group who's outside looking at *how* we're doing it [making sure] that we're doing it fairly and appropriately."

**OID: How good a job do you think he did at Kroll?**

**Davis:** He was very well regarded there from what we've been able to learn. I've spoken to some people who've worked with him over the years. I also spoke to one person who'd known him back in earlier days. And they said they went out and bought the stock the day that the company announced he would become CEO.

They just couldn't say enough good things about him.

**OID: And presumably, they're not related.**

**Davis:** That's right. It wasn't his mother. So I look forward to meeting the new management. And I think Marsh & McLennan will remain a very powerful company by the time the smoke clears.

**OID: There certainly seems to be no shortage of smoke — between current goings on in insurance brokerage and past problems in their Putnam Investments sub. It sounds like Cherkasky should have his hands full for awhile.**

**Davis:** Absolutely.

BUT THE SITUATION IS FAR FROM PERFECT —  
FOR EXAMPLE, CALIFORNIA'S PROPOSED MANDATES.

**OID: And some suggest that the earning power of the insurance brokers may be subject to some additional uncertainty because of, among other things, a proposal**

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DAVIS ADVISORS'  
CHRIS DAVIS  
(cont'd from preceding page)

**by California Insurance Commissioner John Garamendi that apparently would make it a violation of the state's code for an insurance broker if any client doesn't select the "best available insurer".**

**Davis:** That's right.

[Editor's note: From the October 22nd edition of *Schiff's* [consistently excellent] *Insurance Observer*: His regulations would make it a violation of the insurance code if a broker does any of the following: "(1) Fails to provide the client with the proposal of a best available insurer; (2) Advises a client to select an insurer other than the best available insurer; (3) Advises a client not to select a best available insurer from among multiple insurers suggested to the client; (4) Fails to take reasonable measures to obtain a quote from an insurer that might be a best available insurer."]

**OID: What does "best available insurer" even mean?**

**Davis:** That's the problem. In other words, if you're the buyer of insurance and you have a choice between Chubb and Fred's Insurance Company in Bayonne, you're willing to pay a little bit more to be with Chubb — based on reputation, balance sheet and so on. So how do you adjust for rating and claim service? How do you adjust for the fact that boards of directors often want to know the insurance company — or that they may have a bias towards one vis-a-vis another?

[Editor's note: Also from the October 22nd edition of *Schiff's Insurance Observer*: "The problem with this definition is that the definition of 'best available insurers' is vague: 'the most suitable insurers for the client based on coverage, service, financial security and price....' Naturally, the regulation doesn't tell brokers *how* to figure out which insurance company is the 'most suitable'."]

**Davis:** You should make sure that the client has all the information. But you can't mandate the outcome.

**OID: Agreed. But I wonder if making sure they have "all the information" is so straightforward either. It certainly sounds like something about which reasonable people might differ — especially in hindsight...**

**Davis:** I always liked the way Progressive does it. When you call Autopro, Progressive's 800 number, they'll

(continued in next column)

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give you three or four quotes — one, of course, from Progressive and one from the three largest companies in your territory. And Progressive's quote is not always the lowest. However, they still give you that information.

And sometimes clients say, "Well, I'm going to go with Progressive anyway — because you were honest with me." That can happen.

**OID: Like Macy's and then Gimbel's in the old movie, Miracle on 34th Street.**

**Davis:** That's right. Again, you never want to mandate outcomes. It's like regulating profitability in insurance. That's very dangerous — because a company can make a lot of money by having low costs. You wind up with a utility framework if you regulate profitability versus regulating service or price or something like that.

**OID: At which point you wind up with United States Postal Service-type — with apologies for the oxymoron — service.**

**Davis:** Oh, yeah.

**OID: So that's part of the brave new world in insurance brokerage — in terms of the uncertainty regarding the implications for profit margins and, therefore, normalized earnings going forward.**

**Davis:** Yeah. That's true. I think that there is a lot of uncertainty. But investing is an uncertain enterprise. We deal in a world of probabilities.

AND THERE'S SOMETHING ELSE THAT'S NOT CLEAR  
— EXACTLY HOW THE INDUSTRY WILL SHAKE OUT.

**Davis:** So you want to look at the possibility that what Marsh & McLennan earned in contingent commissions disappears 100%, and they lose significant market share — both to competitors and new companies that start up with unblemished reputations — and get a sense of what their earning power would be under *that* scenario. What would their earning power be under the scenario that they lose all of the contingent commissions, but where they're able to raise prices slightly — but less than the lost contingent commissions — to claw back some of that lost business and they don't lose market share? And likewise, what would happen if they lose 20% market share?

**OID: We asked first.**

**Davis:** As Munger says, the most important question to ask is, "What then?" Let's say that's the new base. Well, what then? Does the company shrink from there? Regulators could force a breakup of the companies. What about companies that have both insurance brokers and reinsurance brokers?

**OID: What about 'em? And what then?**

**Davis:** A company may have an insurance brokerage business like Marsh & McLennan or Aon. But they may also have a reinsurance brokerage business which receives a commission for placing reinsurance for insurance companies. In that case, the purchaser of that reinsurance pays that commission, just as the purchaser of insurance pays the commission.

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DAVIS ADVISORS'  
CHRIS DAVIS  
(cont'd from preceding page)

Well, in the case of reinsurance, the purchaser is an insurance company. In regular insurance brokerage, the insurance company is the *provider* of the insurance. So you've got to watch for a practice by which there could be a conflict — because the placement of insurance with a carrier could be tied to the receipt of reinsurance commissions from that same carrier. As with contingent commissions, it's another way for an insurance broker to be paid by a carrier in return for getting volume.

**OID: Gotcha.**

**Davis:** On the other hand, the world is a messy place. And people like integrated, neat solutions. So while a lot of different possible scenarios could play out, I think one that says that Marsh & McLennan, at the end of all of this — when the smoke finally does clear — isn't a valuable enterprise [he laughs] is a very low probability event.

So I think the process you go through should be to say, "Let's assume that the profitability dynamics change. In what way will they change? And how much?" And then you have to quantify it.

FUTURE EARNINGS? NOBODY KNOWS EXACTLY.  
BUT WE DO EXPECT MORE (UGH) OPTIONS.

**Davis:** Remember that Marsh & McLennan used to trade at what — \$50 a share?

**OID: It got as high as \$67-3/4, but who's counting.**

**Davis:** That's the *all-time* high.

**OID: And in 2003, it looks like it got as high as \$55.**

**Davis:** So there's a lot of bad news reflected in the price — or a lot of change in the underlying profitability or dynamics of the business.

But when we looked at the different earnings scenarios, it was hard to get earnings below a *very* conservative estimate of \$1.70 and a more reasonable estimate of about \$2.00 per share.

**OID: It looks like \$2.00 is also the Street's average earnings estimate.**

**Davis:** I don't know exactly what year they'll earn \$2.00 in though. They could have a bad year in-between and a lot of write-offs.

**OID: Yeah. I understand that the 2005 estimates range all the way from 58¢ to \$2.80.**

**Davis:** Yeah. Bear in mind that when I talk about \$2.00, I'm talking about when they get through all this. But will that take one quarter, one year or some other period? I don't know. So there can be false precision in trying to guess whether they're going to earn \$1.63 this year and \$2.00 next year — or are they going to have big write-offs this year and then earn \$1.50 next year and then \$2.00 the year after that. So I don't have an answer for you there.

[Editor's note: We figure Davis paid something around \$45 per share, give or take a couple of bucks, for the

more than 10 million shares of Marsh & McLennan that he bought during the second and third quarter of this year. So for whatever it may be worth, to state the obvious, with the stock now around \$32, the current P/E on his assessment of normalized earnings is probably roughly the same or slightly higher than it was when he and other contributors were buying it earlier this year, and the price to book value is lower. That said, again, there's certainly no consensus at present on what the company's ROE and profitability are likely to be in the future.]

**Davis:** Incidentally, one of the real shameful things about this [he chortles] is that those numbers I gave you for their earnings per share exclude the impact of options — and Marsh & McLennan issues a lot of options. Also, one of the really horrifying outcomes of a scandal like this is that the company will issue *more* options to retain people.

**OID: Sounds lovely.**

**Davis:** It's really maddening. If the stock goes up, the employees get rich. And if the stock goes down, the company gives 'em *more* options. So I'd expect there to be a large option grant in Marsh & McLennan's future. And I think that punishes the shareholders twice. However, I don't really see a way around it — because it's critical that they don't lose a whole lot of people.

**OID: Would your \$2 estimate be for normalized earnings? I ask you that because that looks like it's giving them a pretty significant haircut from what they were expected to earn before the Spit hit the fan.**

**Davis:** Yeah. I think it's a conservative number. But like you say, there is a lot of uncertainty. And so you want to build in some margin of safety.

And I'm assuming that the \$2 they'll earn is after they get through the non-recurring charges, the special option grant, the big fines, anything they might have to pay for interest on the fines, the impact of any money they may have to raise to pay those, class action settlements and so forth.

So it could be \$1.70 or it could be \$2.40. I don't want to give a sense of false precision — because, again, there is a distribution of outcomes. And while I do think that the mean of those outcomes is somewhat higher than \$2.00, the actual number may be anywhere between \$1 and \$3.

However, like my wife always tells me, the secret to a happy marriage is having low expectations.

**OID: What I understand Buffett taught Sequoia Fund's Bill Ruane, and Ruane apparently passed on to Bob Goldfarb. Perhaps we should say "biannually, more or less".**

**Davis:** That's a very important principle to go through life with. [He laughs.]

**OID: And just in order to embarrass you as much as possible, the fact that you paid over \$42 per share for 10 million shares in the second and third quarter should suggest exactly what to us — that your clients should have low expectations?**

**Davis:** Feel free to rub it in.

**OID: Hey, I'm only rubbing it in out of affection — and to make myself feel better. But are you basically acknowledging that you overpaid initially — or that**

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DAVIS ADVISORS'  
CHRIS DAVIS  
(cont'd from preceding page)

***Marsh & McLennan's earning power is likely greater than you're letting on?***

**Davis:** Well, I do think that their earning power is going to be reset as a result of this episode. In other words, whatever we thought they were going to earn a year ago when we looked out three or four years, we think it's been lowered permanently. So if we originally thought the line would begin at \$3.00 and go up from there, we now think that it starts at something less. Unfortunately, you do have to shift that whole line down.

But as Legg Mason's Bill Miller once told me, whenever you start buying a stock, what you should be hoping like hell for is for it to start going down. And ideally, you should want it to go down a lot. And you should want it to go down right as you're buying it — because you don't want it to go down two years from then. You want it to go down right away — because then you're driving down your average cost.

***OID: We've got that first part down to a science...***

**Davis:** [Laughing] I seem to have managed to acquire that particular gift lately myself. So the key becomes to initiate a small enough position to be able to buy more if it goes down.

***OID: Now you tell me...***

**Davis:** Certainly, Marsh & McLennan is the sort of company that we'd want to buy more of as it went down. But if you can buy a company that is an industry leader, in a service business, that's not capital intensive, that has an attractive growth rate — and the stock gets as low as \$22 and you have a high probability that the company will earn \$2 a share within the next couple of years...

However, we aren't kidding ourselves about it either. Marsh & McLennan's franchise is less valuable than it was a year ago. And that decline in valuation isn't based on the lower stock price, but because the company's underlying earning power is lower. And there has been some impairment to the company's reputation. And there will be some permanent loss of customers.

***OID: And a settlement of unknown magnitude, and numerous lawsuits to follow.***

**Davis:** That's right. And the critical question is Marsh's ability to finance the settlement and reflect the cost of financing it in your future assessment of earnings.

***OID: Any thoughts about what the magnitude of the settlement is likely to be?***

**Davis:** I think a settlement in the low end in the hundreds of millions and the high end in the low billions would capture most of our expected outcomes. But anything's possible.

[Editor's note: Some of the uncertainty surrounding Marsh & McLennan's ability to finance a future settlement may have been answered — because on December 15th, Marsh announced that it had completed medium-term bank financings totaling \$3 billion.]

THE REASON AON DIDN'T FALL VERY FAR  
IS THAT IT DIDN'T HAVE VERY FAR TO FALL.

***OID: How differently do you see the story at Aon — because it looks like you were buying that one, too, albeit less aggressively?***

**Davis:** Let me just say that there's plenty of disappointment to go around. I think the opportunity that we saw at Aon was a dramatically discounted valuation relative to Marsh & McLennan.

***OID: It didn't go down nearly as much, obviously.***

**Davis:** No. It started out without any premium because people felt it's been significantly undermanaged. And they're right. It has been — for some time.

It's one that's been a consistent overpromiser...

***OID: I strongly resemble that remark.***

**Davis:** But yet there's certainly enormous value in Aon's franchise. There are many, many good people there — great brokers. And I think that there is a change in leadership happening there now. So there may be the opportunity to have more value created.

It just goes to show you that you can lose more money when a company is perceived as wonderful and falls from grace than when one is perceived as having troubles. Just like we said about expectations...

***OID: Yeah. As I recall, it was Buffett's friend, Marshall Weinberg, who said it's hard to fall very far off a pancake.***

**Davis:** That's exactly right.

[Editor's note: Incidentally, both Davis Advisors and Mason Hawkins/Staley Cates' Southeastern Asset Mgmt. added to their Aon stake in six of the last seven quarters — only selling (or not buying) shares when the stock price rose into the high \$20s during the second or third quarter. And based on public filings, we estimate it was Southeastern's largest position at the end of the third quarter.]

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ONE OF THE GREAT GLOBAL COMPANIES  
FOR LESS THAN 13 TIMES EARNINGS.

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***OID: Speaking of Eliot Spitzer, I see that you've also been buying shares of American International Group.***

**Davis:** Yeah...

[Editor's note: In fact, it looks like Davis Advisors has been buying it for at least seven straight quarters. And based on public filings, as of September 30th, we estimate that it was their second largest holding.]

***OID: Could you share your rationale with us there — especially given Spitzer's interest in the company. Schiff Interest Rate Observer's October 15th edition refers to a complaint filed by Spitzer that alleges that "AIG, ACE, Hartford and others' conspired with Marsh to restrain trade." And it says that "Two executives at American Home, a subsidiary of AIG, pled guilty to***

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DAVIS ADVISORS'  
CHRIS DAVIS  
(cont'd from preceding page)

**criminal charges in connection with the allegations" and that "[t]he Attorney General's office expects them to testify in future cases."**

**Davis:** That's correct.

**OID: And Schiff goes on to add, "Spitzer plans to pursue his investigation of the insurance industry. 'This is [only] day one.'"**

[Editor's note: To be fair, he does acknowledge that the problems are worse at Marsh & McLennan than they are at AIG. Says Schiff: "Certainly, the news is much worse for Marsh than for AIG. The allegations involve Marsh's core business whereas they only touch part of AIG's business. Furthermore, AIG is seven to ten times larger than Marsh (depending on how you measure), so the impact is likely to be less severe.

But the bad news is likely to linger. [W]e won't hazard a guess about its effect on the companies' stock prices...."]

The actual complaints (from Spitzer) are available on Schiff's web site — [www.insuranceobserver.com](http://www.insuranceobserver.com).]

**Davis:** We worry about *lots* of things. But AIG is one of the greatest companies in the U.S. and globally. That's just a fact. Under two CEOs, since it was founded in 1919, it's become one of the great global enterprises. I think though that with such a vast business enterprise — and a highly results-oriented culture — there will be missteps. However, the franchise durability and strength and underwriting culture at AIG are outstanding. And I think that it has an enormous ability to withstand shocks.

In fact, you could argue that underwriters will be beneficiaries of the intermediaries being weakened.

**OID: I could, but certainly not nearly as well as you.**

**Davis:** I'm not sure that any underwriter feels that they'd like to pay Marsh & McLennan *more*. [He laughs.] So now they'll pay them and Aon and others less. After all, who is it that actually *pays* those contingent commissions? And who benefits if they pay less?

**OID: Succinctly put...**

**Davis:** Those contingent commissions are paid by the insurance companies. So it's hard for me to believe that it's going to be bad for both the insurance brokers *and* the insurance companies.

**OID: And could the elimination of the payment of contingent commissions result in some insurers being hurt — because they relied on contingent commissions to acquire either the volume or quality of business they did in the past — and now, all of a sudden they're going to have to be more competitive?**

**Davis:** Don't forget that AIG's expense ratio is about 10 points lower than their competitors. So they usually don't have a hard time getting business. People want to be with AIG because they have a AAA balance sheet and they're a low-cost player.

And what's striking to me, frankly, is that for all of these issues at AIG, its stock didn't go down very much.

That's probably because it had *already* come down. And it doesn't hurt that the company should earn well over \$5 in 2005. So it's trading at only 13 times earnings.

**OID: Less than 12-1/2, but who's counting.**

[Editor's note: We'd normally insert a snide wisecrack at this point about most of the investment world's evils being caused by double-digit P/E multiples. But to be fair, we should point out that Value Line, when they look out several years, seems to think AIG is likely to trade for something around 23 times earnings.

And in our Year End 2003 edition, Gardner Russo & Gardner's Tom Russo laid out some of the reasons why.]

**Davis:** So with AIG, you've got a low multiple on a global business.

**OID: I suppose everything's relative.**

**Davis:** And by the way, unlike Marsh & McLennan, AIG gives out very *few* stock options. So what you've got is

PORTFOLIO REPORTS estimates the following were Davis Advisors' largest equity purchases during the 3 months ended 9/30/04:

1. CARDINAL HEALTH INC
2. MARSH & MCLENNAN COS INC
3. IAC/INTERACTIVECORP
4. OCCIDENTAL PETROLEUM CORP
5. COMCAST CORP CL A SPL
6. BLOCK H&R INC
7. IRON MOUNTAIN INC
8. AMERICAN INTL GROUP INC
9. AMERICAN EXPRESS CO
10. BERKSHIRE HATHAWAY CL B

a global business with enormous cost advantages and a great underwriting culture, that's very disciplined. And because it's a global business, it certainly benefits from any decline in the U.S. dollar. And best of all, you get it right now at a low P/E multiple.

THERE'S ALWAYS SOMETHING ELSE TO WORRY ABOUT.  
BUT THAT CAN BE THE SIGN OF A GREAT COMPANY.

**Davis:** Mind you, I would not say that it's impossible that there have been some bad practices happening there. With AIG having something in the neighborhood of 86,000 employees worldwide, if 99% of them are honest 100% of the time and 1% of the employees are honest 90% of the time, you could still wind up with plenty of problems just as a result of the company's scale.

So there will be some bad headlines. And I'm sure some bad things have happened there that were wrong. But they'll get cleaned up. And I think AIG is a strong, strong enterprise. So I think there is a low probability that recent events will deeply impact their competitive position negatively over the long term.

**OID: Speaking of bad headlines, weren't two of the chairman's sons heading up companies in the**

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DAVIS ADVISORS'  
CHRIS DAVIS  
(cont'd from preceding page)

**insurance industry?**

**Davis:** Yeah. But I think that's a soap opera headline — a gossip headline — with Jeff Greenberg having just left the helm of Marsh & McLennan, and Evan Greenberg running Ace. But I think it's outrageous to look at it in any way as a family dynamic. It's just unrealistic. It's a point of gossip, but not a point of substance.

There are always things to worry about at AIG. Something my grandfather used to say was that you can sometimes tell a great company because the bear case always changes. And he also said you can sometimes tell a terrible company because the bull case always changes.

Well, at AIG, there's always something that people are worried about.

**OID: It's true.**

**Davis:** However, it's a very powerful company — as shown in their performance. My grandfather used to say, "You want to separate the doers from the bluffers."

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

**Davis:** And AIG has a culture of doers. I think that they've created more shareholder value in absolute dollars than virtually any company in the entire history of the insurance industry.

**OID: You mentioned earlier that you thought developments in the insurance brokerage industry were likely to favor AIG and other insurers.**

**Davis:** That's right.

**OID: The flipside of what you said, by the way, in terms of implications for the industry.**

[Editor's note: Another *OID* contributor buying AIG for the last seven quarters has been Tom Russo's Gardner Russo & Gardner. And we estimate it's been the largest and second largest purchase for Jeremy Grantham's GMO in the second and third quarter, respectively.]

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OTHERS CAN PAY HUGE FEES TO HEDGE FUNDS.  
WE'LL TAKE WARREN AND CHARLIE AT A DISCOUNT.

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**OID: And speaking of great insurance companies with AAA ratings, another one you appear to have been buying quarter after quarter is Berkshire Hathaway. It looks like you've been buying both Berkshire Class A and Berkshire Class B for seven consecutive quarters or more. Combining the two classes, it looks like Berkshire would be your fifth largest position.**

**Davis:** What's not to like?

**OID: You're impressed with the management?**

**Davis:** Aren't you? I mean, it's a funny thing that investors are anxious to put pension funds and endowments and other money into funds of funds and hedge funds with fees of 3% that also take 30% of the profits.

And meanwhile, there sits Berkshire Hathaway with a fair value conservatively calculated somewhat above the stock price, with probably a 5% free cash flow yield. So they could pay a 5% dividend if they so desired. And as you say, they have a AAA balance sheet. In fact, I think they're the *only* two insurers with AAA ratings worldwide. And of course, that rating should be reflected in the rates that their clients are willing to pay.

[Editor's note: And perhaps increased pressure on insurance brokers to truly behave in a fiduciary fashion will result in AIG and Berkshire both getting more business than they would have otherwise.]

**Davis:** Also, Berkshire may be the only company that I know of that will become enormously more valuable if there are enormous disruptions in the capital markets.

**OID: Bad news would be good news.**

**Davis:** Exactly. And as Charlie said at the meeting last year, it's amazing to think that Buffett, after all of these years, is still getting *better* at what he does. And that's certainly been true in the last few years.

**OID: Yeah. Maybe he'll eventually get it right.**

**Davis:** So whether Berkshire's worth \$95-100,000 or whether it's worth \$130-140,000 depends on what happens to the cash that they have available to invest, but which they've chosen not to invest because of a lack of alternatives in the current market.

If they're able to invest that cash, Berkshire will be significantly more valuable.

**OID: You seem to operate with Berkshire the same way that Tom Russo does — which is just to buy it quarter after quarter, almost irrespective of price.**

[Editor's note: Interestingly, just like Davis, Russo's Gardner Russo & Gardner has purchased both Berkshire Class A and Class B for at least seven straight quarters. And as of September 30th, Berkshire Class A shares alone represent their largest position by far — nearly double that of #2 Altria Group.

And Tom Gayner's Markel Gayner Asset Management did the same in all quarters but one. And their combined Berkshire position is by far Markel Gayner's largest holding — well over double the size of #2 holding White Mountains.

Likewise, we estimate that as of September 30th, Berkshire Class A and Class B shares combined comprised David Winters' Franklin Mutual Advisers' largest position by far. There again, interestingly, the value of those shares was roughly 50% above that of Winters' #2 holding, White Mountains. And there again, Winters added to his position — in one class or the other or both — in every quarter but one since the start of '03.]

**Davis:** Again, what's not to like? Anytime we have new clients, we're comfortable with them owning shares of Berkshire anywhere near today's price.

**OID: Thanks for sharing some of your insights about recent developments in the insurance business.**

**Davis:** My pleasure.

—OID

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MARKEL GAYNER ASSET MGMT'S  
TOM GAYNER  
(cont'd from preceding page)

MARKEL GAYNER'S TOM GAYNER  
"INSURANCE IS IN THE DOGHOUSE TODAY.  
BUT THAT, TOO, SHALL PASS."

During the 13 calendar years (through 2003) that Markel Gayner Asset Management President Tom Gayner has managed Markel Corp.'s equity investments, they've grown in value at a compound annual rate of 16.1% — well above the 12.1% return generated by the S&P 500 during the same period. The numbers are no less impressive for the trailing 3, 5 and 10-year periods either — with Markel's compound annual growth on its equity portfolio of 11.8%, 9.6% and 14.1% thoroughly trouncing the -4.1%, -0.6% and 11.1%, respectively, the S&P 500 earned during those corresponding periods. (By the way, Gayner has also been Markel's Chief Investment Officer since January 2001.)

Our impression that he not only knows a thing or two about successful investing in general, but that he might also know his way around the insurance business was reinforced when we noticed four of his five largest holdings were insurance related. (And the folks at Davis Advisors apparently agree — because according to the most recent Davis New York Venture Fund annual report, Gayner is a director of it and 10 other Davis portfolios.)

Our suspicions were confirmed when we gave him a call, and he very generously gave us an eye-opening lesson on the insurance industry. The excerpts which follow were selected from a series of conversations with Gayner which took place from December 17th right up to Christmas Eve. (Thanks again, Tom, for going so far above and beyond.) We found what he had to say quite enlightening — and hope that you will, too.

LONG TERM, YOU ONLY NEED TO KNOW TWO THINGS:  
INSURANCE BROKERS WILL ADD VALUE AND GET PAID.

**OID:** *Happy birthday, again. I should confess that I was totally disgusted to learn that you're only 43.*

**Tom Gayner:** I don't look a day over 42. But I actually *read* at the 48-year-old level.

**OID:** *That's funny. I don't know what level I read at, but I seem to produce pages at a 2-year-old level. And sadly, the trend does not seem to be my friend.*

**Gayner:** Just consider yourself young at heart.

**OID:** *Changing subjects as quickly as possible, with Spitzer taking an interest in the insurance industry, I thought who better to talk with than you guys — since I've gotten the distinct impression that you know a thing or two about that business.*

[Editor's note: Understatement alert. We estimate that Markel's stock price is up over 23% per year since its initial public offering 18 years ago. And that has tracked

growth in book value pretty closely. For the 17 years ended 12/31/03, Markel's book value grew at an estimated compound annual rate of 23.7%.]

**Gayner:** [He laughs.] Well, our paths finally crossed, I guess. And I was just minding my own business, too.

**OID:** *You mean as an industry, I presume — because the only headlines I read about your company are about your continuing progress and success.*

**Gayner:** That's right. I meant industry-wise — although we are also Marsh & McLennan shareholders.

**OID:** *And I noticed that you appear to have been buying Marsh & McLennan during the second and third quarter — during which time the stock price never got as low as \$42.*

**Gayner:** That's correct. I'd say our average acquisition price is in the mid-\$40s. But whatever it is, the stock's certainly lower today.

**OID:** *I noticed. In fact, it looks like it was up near \$50 right before Spitzer made his entrance. So even after rising over 20% in the last six weeks, today's price is still below what it was by a third or more.*

**How have those events impacted the company and its prospects in your view?**

**Gayner:** Well, that's a very open question. Frankly, the honest answer is that I don't know. In the *short* run, clearly, their earnings have been impacted. Developments to date have caused some short-term pressure on earnings.

But at the end of the day, two factors will determine what the long-term impact will be. First, insurance brokers *do* add value. There is a reason why they've been paid what they've been paid over the years. And second, they can't, nor should they be asked to, work for *free*.

**OID:** *Absolutely not. If that's what they were after, they'd have gone into investment publishing...*

**Gayner:** So to the extent they add value in the chain, they need to be paid appropriately. Mind you, I do expect there to be a period of sorting out. And don't ask me whether that period will be three months or three years, because I don't know — although, frankly, it'll probably be closer to three years than three months. And after that, the industry will change the names and labels and definitions and calculations. But one way or another, those who perform the function of distribution in the insurance industry will still need to be compensated.

HAS MARSH BEEN OVERPAID IN RECENT YEARS?  
THE EVIDENCE WOULD SUGGEST OTHERWISE.

**OID:** *Two questions: First, once the sorting-out period is over, how high do you think the level of compensation will be relative to what it has been? And second, how much do you think the level of aggregate business they engage in will be impacted in the long term?*

**Gayner:** Well, I don't think the level of business that the industry does in the long term will be impacted at all — because that's really just a function of the overall demand for insurance. And I don't think that there are any industry-wide issues that will particularly disadvantage

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MARKEL GAYNER ASSET MGMT'S  
TOM GAYNER  
(cont'd from preceding page)

Marsh relative to the other insurance brokers out there — because contingent commissions cut across everybody.

**OID: And you don't think those contingent commission practices increased the level of aggregate insurance brokerage business to any significant degree.**

**Gayner:** No, I don't. I can't see why they would.

**OID: Have you, or anyone you know, looked at the take of the insurance brokers as a percentage of the insurance business they place today relative to what it's been historically?**

**Gayner:** I don't have any hard numbers. However, I'm under the impression that the percentage of insurance bought through brokers has increased over time.

**OID: How long have commissions been the primary form of payment that insurance brokers receive?**

**Gayner:** Forever.

**OID: Really?! So that's the way it's always been done?**

**Gayner:** Absolutely — because it's a sales function. And sales functions tend to be commission oriented — and not just in insurance, but in almost *everything*.

And because those commissions are established by buyers and sellers within the marketplace, they fluctuate. In fact, I think there's a cyclical pattern. Typically, what happens is when there's a "hard" insurance market — when insurance prices generally are rising — the percentage of the premium paid as a commission tends to go *down*. By contrast, when there's a "soft" market — when insurance prices generally are falling — the percentage of the premium paid as a commission tends to go *up*. And that pattern tends to even out or smooth the revenue flow to the brokers.

**OID: So the total fees paid to the insurance brokers tend to remain reasonably stable?**

**Gayner:** That seems to be the net effect — to keep the absolute dollars more constant.

**OID: All of which supports your contention that Marsh's fees are not above historical levels. So much for that theory...**

**Gayner:** That's certainly the way it looks to me. Also, under classic economic theory, the fact that those rates have been negotiated in the marketplace for many decades is evidence that these companies are performing an essential function and adding economic value. And again, they've done it for a long, long time. It's not something new.

IF INSURANCE BROKERS DID RIG BIDS,  
THEY SURE WEREN'T VERY GOOD AT IT.

**OID: What about the bid-rigging charges?**

**Gayner:** I just don't believe that the bid rigging was a pervasive practice at Marsh & McLennan. However, that remains to be seen. Nobody's had their day in court yet. But I'd be surprised if that were really systemic behavior.

**OID: When you say "systemic behavior", do you mean across companies?**

**Gayner:** I would be surprised if bid rigging were a pervasive practice at Marsh or other insurance brokers.

**OID: Spitzer's complaint definitely makes it sound like it was much more pervasive at Marsh & McLennan.**

**Gayner:** Clearly, [chuckling as he speaks] this wasn't what I expected when I bought Marsh — because I bought it before all of this stuff happened. And it's not exactly what I was *hoping* would be the case.

**OID: I'm sure.**

**Gayner:** As you said, Spitzer's complaint makes it sound like bid rigging was pervasive at Marsh. But I don't know what the real truth is. And I don't think anyone does — except the people who were there. However, as I read Spitzer's complaint, it's not something that would affect Marsh's profitability so much as it would that of the insurance underwriters.

**OID: The insurance companies themselves.**

**Gayner:** That's right. So if bid rigging had been a systemic practice in the insurance industry, I'd think that insurance companies would have made more money than they did. If they *did* rig bids, they weren't very good at it. Therefore, I don't think it was that pervasive.

[Editor's note: Gayner's assessment is consistent with what Marsh & McLennan's new CEO has had to say, too. On the company's November 9th conference call, he observed: "We have now reviewed over 2 million e-mails, done dozens and dozens of interviews and reviewed thousands of documents. And I'm cautiously optimistic as, so far, we have seen very limited price-fixing issues, confined to a very few people in a narrow practice line.... We see a *very, very* narrow problem in that area...."]

**OID: If you're correct, so much for part two of my initial question.**

**However, what about part one — which is, once again, the level of compensation likely to be captured by insurance brokers going forward? Presumably, you'll tell us it's going to boil down to market forces.**

**Gayner:** That's right. And there are cross winds — because on the one hand, pessimists would assert that with greater transparency, the insurance brokers' clients will say, "Holy cow! You're making *that* much money off my account?! I had no idea! Frankly, I don't think that you're worth that. So we're going to pay you less."

And certainly, their ability to raise those issues will increase with greater transparency. So that will probably represent a downward pressure. On the other hand, I'd posit that it's not unlike the stock brokerage industry on May Day with the elimination of fixed commissions and this whole blowing apart of the existing fee structure. And I don't remember May 1974 very well — in part, because I was in 7th grade at the time. But it seems to me that since that time, the returns on capital in the investment business have been OK.

**OID: Yeah. I don't follow the industry all that closely. But it seems to me that while commissions have gotten**

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MARKEL GAYNER ASSET MGMT'S  
TOM GAYNER  
(cont'd from preceding page)

**razor thin in that business, they've gotten other fees and other lines of business that have compensated — or even more than compensated.**

**Gayner:** I think to some degree that's true. So similarly, if they're going to do away with commissions — by rule, fiat or what have you — then I'd guess other fees are going to go up. I don't think the net cost of distribution is going to go down. I just don't logically understand why lower net distribution costs in the insurance industry should necessarily be the outcome.

IN CONTRAST TO THE POPULAR PERCEPTION,  
I THINK MARSH CLIENTS, IN AGGREGATE, PAID LESS.

**Gayner:** Also, when Marsh's new Chairman and CEO, Michael Cherkasky, had his first press conference, he spoke fairly persuasively about how they were going to continue with the Global Broking arrangement...

**OID: The centralized department within Marsh that directed its alleged misdeeds — as detailed within Spitzer's complaint.**

**Gayner:** Exactly. And let me stress that these points are Cherkasky's, not mine.

**OID: Now there's a powerful lead-in to remember...**

**Gayner:** However, one of the points that he made — and I thought he made it very persuasively — was that at the end of the day, Marsh's clients got a better deal on their insurance than clients who bought their insurance from other brokers — because they were able to use their economies of scale and buying power to provide them with a better price.

[Editor's note: Gayner may have been referring to the following comments by Cherkasky during his October 26th press conference: "I think that the [figures] are [certainly] complicated. [But] there are all kinds of economic models that, we'd argue, [suggest] Marsh clients get the best deal of anyone in the industry. And we're convinced that that's absolutely factually true — and we don't think it's close.

"So when people say, 'Give 'em back what they've lost,' we think in fact, overall, Marsh clients have historically — and, very specifically, [during] the last couple of years — done extremely well being Marsh clients.")]

**Gayner:** I think logic would indicate that his claim has some substance to it because they were number one. They were doing more business and more volume than anyone else. Why was that? I think it's reasonable to suggest that *part* of the answer is that they're getting their clients a better deal. But it's a relatively complex analysis. There are a lot of layers there.

**OID: Talk about a disconnect between perception and reality...**

**Gayner:** It really is. It's difficult to reconcile that contention with the Spitzer complaint — because they really are two diametrically opposite points. But despite

the allegations and examples within Spitzer's complaint, in aggregate, I believe that Cherkasky is correct — that Marsh's clients *were* paying a lower price for insurance than they would've paid had they bought it through other brokers. That's one of the reasons why they were doing business through Marsh.

If you were a victim of bid rigging — if that actually happened as Spitzer alleges — then that was not the case. In those cases, the clients wound up paying a higher price than they otherwise could have. So it was a *bad* deal. And that gets to the question of whether or not that was being done by a few bad apples or it was systemic. I don't think it was systemic.

**OID: Despite the existence of their top-down, centralized structure?**

**Gayner:** That's a very good question — and I can see why you would ask it — because the *odds* of a practice being systemic are increased by the fact that Marsh utilizes a top-down system. But I don't believe that it was systemic.

**OID: But given that Marsh's structure is centralized, how could the practice not have been widespread?**

**Gayner:** Where Marsh's centralized structure came into play was with contingent commissions.

**OID: In other words, you're saying the bid rigging wasn't handled centrally.**

**Gayner:** That's right. Bid rigging is clearly illegal under any terms, conditions or definitions. And despite whatever bid rigging may have taken place at Marsh, in aggregate, I believe it's likely that Marsh's clients were getting a reasonably good deal.

The payment of contingent commissions, on the other hand, was a much more widespread — and legitimate — practice. It's not *illegal*. There's no law against insurance brokers receiving contingent commissions.

**OID: No more than there is against having loads in mutual funds or higher fees to brokers for "advising" their clients to buy issues their company wants to sell.**

**Gayner:** Exactly.

**OID: In which case we're not talking about bad behavior as much as we are full disclosure.**

**Gayner:** That's right. And I think that's one of the *legitimate* issues being raised in this whole matter — which is the full disclosure of to whom the insurance broker owes their fiduciary duty. It's important to get that straight. And let's make sure that clients know exactly what duties are owed to them by their agents.

BEFORE SPITZER TARGETED INSURANCE PRACTICES,  
IT'S NOT LIKE MARSH WAS FIRING ON ALL CYLINDERS.

**OID: Prior to the arrival of Mr. Spitzer, Value Line apparently expected Marsh & McLennan to earn \$3.10 in 2004.**

**Gayner:** Yeah. That sounds about right.

**OID: How close to normalized earnings do you think that was?**

(continued on next page)



MARKEL GAYNER ASSET MGMT'S  
TOM GAYNER  
(cont'd from preceding page)

**Gayner:** I think that those old estimates were probably below Marsh & McLennan's normalized earnings.

**OID: Below?! Why do you say that?**

**Gayner:** One of the reasons why I started buying Marsh & McLennan's stock in the first place was because of the issues they were dealing with at their Putnam Group [money management/mutual fund investment] subsidiary. They were busy cleaning up that mess — paying fines, reorganizing, paying severance and all of that kind of stuff. So it was not as if the company was hitting on all cylinders.

[Editor's note: What Marsh & McLennan SVP & CFO Sandra Wijnberg suggested during the company's October 27th conference call: "We've been working hard even\* during the *hard* market to make sure that we were looking for ways we could streamline our cost structure and upgrade staff. And we've been absorbing a lot of severance charges across the whole organization, actually, pretty consistently over the last several years."]

**OID: Very interesting. And that may help explain why so many of the managers we follow had apparently been willing to pay 14 times earnings or more for it — what might otherwise appear to be a nosebleed price — earlier this year.**

**Gayner:** Yep.

**OID: What did you feel like normalized earnings were at that point?**

**Gayner:** [After a long pause] More...

**OID: ...I got that part. Could you refine it at all — even a rough range?**

**Gayner:** Not to give you a number that would have any meaning at all.

**OID: I don't want to be pushy. As Jackie Mason says, it's not in my nature. So I'll just accept that answer.**

**Gayner:** I appreciate it.

**OID: But strictly hypothetically speaking, if you found yourself cornered by a sleep-deprived financial editor who asked you for a very rough sense of what you were thinking — I mean, even the order of magnitude...**

(continued in next column)

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**Gayner:** Well, you know, my wife is an engineer. And we have a wonderful marriage...

**OID: Changing the subject won't help.**

**Gayner:** Again, we have a wonderful marriage, but she always yells at me when I use that phrase. She says, "Do you know what that means?" And I say, "Not really." And she says, "It means within a power of 10." That is the technical, scientific definition of an "order of magnitude".

**OID: Let's leave your marital problems out of it...**

**Gayner:** So by orders of magnitude, \$3.10 is correct — because \$3.10 is closer to normalized earnings in 2004 than \$31 or 31¢. But since I know I won't get to go home and be with my lovely wife unless I give you an answer...

**OID: You know me so well.**

**Gayner:** ...I'd say it's not a whole lot more than that — maybe something like \$3.50 or \$4.00.

[Editor's note: Unfortunately, we can't come up with numbers that high. (And it's not for lack of trying...)]

IT'S GOOD TO BE THE KING GLOBAL LEADER  
IN A HIGH-RETURN BUSINESS IN A GROWTH INDUSTRY.

**OID: If you think that \$3.50 to \$4.00 represented normalized earnings in 2004, before Spitzer began to target the insurance industry, how much do you think it's been impacted — not in any given year, but in terms of its long-term, normalized earning power?**

**Gayner:** You know, I always joke that if I get fired from this job, I'd very much like to have my next job be a maker of 12-year-old Scotch whiskey — because it'll be at least 11-3/4 years before anybody knows whether or not I know what I'm doing.

**OID: In other words, if you give us a 2016 figure, nobody'll know whether you're wrong for awhile.**

**Gayner:** Here's what really matters to me. And this is the reason why, at the moment, at least, I continue to hold the stock: I would say that the odds are relatively high that 10 years from now, Marsh will still be the premier insurance broker in the world, that they'll have a big-time and well-thought-of consulting business, and they'll still have a reasonably prominent money management operation. And the economic returns that go along with being at or near the top of the heap in those three businesses have been, and I think will probably continue to be, pretty good.

**OID: They better be. It's not like this is an asset play. I understand that Marsh & McLennan's goodwill and other intangible assets exceed its book value. So the company has no tangible book value whatsoever.**

**Gayner:** That's right. And a big chunk of that is the goodwill that came about from their acquisition of Kroll about two months before Mr. Spitzer entered the scene.

But as a broker rather than an insurance company, book value doesn't matter that much to them. It's like a law firm. What's the book value of a white shoe law firm like Davis Polk? It's probably not very much. Nevertheless, I suspect that the lawyers do pretty well.

I only wish I hadn't been caught in the lawn mower

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MARKEL GAYNER ASSET MGMT'S  
TOM GAYNER  
(cont'd from preceding page)

on this stock...

**OID: Meaning you wish you hadn't bought it earlier.**

**Gayner:** Exactly. I mean I'd rather buy it now than 12 or 14 points higher than now.

**OID: That's funny. I was kinda wishing that I'd called you with the stock down around \$27. I guess the grass is always greener...**

**Gayner:** Or even at \$27. However, my point is that 10 years from now, if you give yourself the fullness of time, I would suspect that this is an organization that'll earn pretty good returns on its capital.

[Editor's note: According to *Value Line*, Marsh's ROE over the last 10 years has ranged between 22% and 28% in every year but one. And although they've given a haircut to future profitability in their current (post-scandal) report, *Value Line* still projects an ROE of 20% looking out to 2009.

And of course, one advantage of being an insurance broker rather than an insurance underwriter is that there are no claims to pay — as the late, great *OID* contributor George Michaelis said in a conversation with us in our April 30, 1988 edition, "...Marsh is a pure service business. There's no insurance risk. [Therefore,] it's an extraordinarily high return business."

**OID: Has there been any kind of long-term trend in market share for Marsh over long periods of time?**

**Gayner:** I would guess that there has been a trend for Marsh to gain share. But I don't know that for a fact.

**OID: And presumably not based on acquisitions, but rather on organic growth?**

**Gayner:** That's the reason why it would be a guess — because if you include acquisitions, it'd *definitely* be true.

**OID: What exactly does Marsh supposedly do better than its competitors?**

**Gayner:** It has advantages related to size, sophistication, and specialized expertise. It's like an international law firm that's able to handle matters that a local country lawyer might not be able to handle.

**OID: But do they have a moat? I get the impression from their conference calls that if their agents leave and go to work across the street, those agents' clients are likely to go with 'em.**

**Gayner:** Well, you can say that. But for 130 years, that hasn't been what's happened. Again, think about the white shoe law firms. If someone leaves Davis Polk and goes across the street to Simpson Thacher, theoretically their clients would go with 'em. And to a certain extent, that may be true. But at the end of the day, there appears to be more or less an equal offset of clients back and forth — because both firms seem to continue to do well year after year.

Some folks from Marsh may say, "I think I'll go across the street and work in a more entrepreneurial place." But just as many associates of other firms seem to figure, "If I

can just get in with Marsh, I'll be able to go after bigger, more complicated deals." So long term, both do fine.

**OID: That sounds reasonable.**

**Gayner:** So as not to put too fine a point on it, let me just say that I believed Marsh's stock price was reasonable already. And I thought if the world continues to grow and the demand for risk management continues to grow around the world, which is a function of affluence, the people who already have a global business — which Marsh already does and is, in fact, #1 globally... Well, let me just say that seems like something that I'd like to be a part of.

[Editor's note: And we understand that, like the consumption of luxury goods, the consumption of insurance has historically grown *faster* than the corresponding standard of living.]

**OID: Other things being equal, absolutely. But then there's the sticky, not-so-little matter of price.**

**Gayner:** The stock was already sort of on sale because

*PORTFOLIO REPORTS* estimates the following were Markel Gayner Asset Management's largest equity purchases during the 3 months ended 9/30/04:

1. CARMAX INC
2. MCGRAW-HILL COS
3. COCA COLA CO
4. FAIRFAX FINANCIAL HOLDINGS
5. HARRAH'S ENTERTAINMENT
6. AFLAC INC
7. WP CAREY & CO
8. CITIGROUP
9. TRIBUNE CO
10. CHARLES SCHWAB

of the difficulties at their Putnam Investments subsidiary. So basically, that's the long and short of my thinking on it.

**OID: And I think that makes sense.**

AND HOW'S THIS FOR A WILD STATEMENT?  
MAYBE SPITZER WILL WIND UP HELPING MARSH.

**OID: But don't tell me that you thought you were going to be able to avoid answering my question about earning power post-Spitzer with simple misdirection...**

**Gayner:** It was worth a try.

**OID: "A" for effort. Now, for my question...**

**Gayner:** Let me give you a controversial answer. And that is that I think their normalized earning power will be *increased* by this action.

**OID: Really!?**

**Gayner:** There's your wild, inflammatory statement.

**OID: That sounds pretty wild, all right.**

**Gayner:** I don't mean immediately, but over time.

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MARKEL GAYNER ASSET MGMT'S  
TOM GAYNER  
(cont'd from preceding page)

**OID: Spoken like a distiller of 12-year-old Scotch.**

**Gayner:** You've got it. What I think will happen is that additional layers of regulation, oversight, disclosure — i.e., overhead — will go along with the business of insurance brokerage that didn't use to be there. And needless to say, that's harder on the little guys than the big guys.

So I think it will further the process of consolidation in that industry — which would tend to concentrate the returns up at the top end.

[Editor's note: At the October 26th press conference announcing the planned changes at Marsh, Cherkasky observed: "[B]y using a centralized placement process, we'll be able to create an audit trail of our work in placing our client business and, at the same time, give them access to the greatest purchasing power and expertise in our industry...."

"To further ensure compliance auditability, we'll record all telephone calls made at our central placement facility and monitor all e-mails — much like the investment industry has done for, I think, almost 30 years.

"We believe this combination of transparency, [accepting] compensation only from our clients and centralized placement that is auditable will keep Marsh ... the provider of choice in the brokerage industry."

And on the October 27th conference call, he added: "...We think that we are in a first-initiator phase of this industry.... [Again,] we're not going to have to do a model shift, but we'd expect our competition may have to. It's going to be relatively easy for us to audit what we put in place — because we already have it in place.... We think that's going to be a *great* model for our clients, and that they're going to see it that way.

"We know that we can do these things. And we have no question that we can do them faster and better than our competition.... So we think ... we have a business model that's going to be very powerful inside this industry...."]

**OID: I think that actually makes a whole lot of sense. And that would even suggest that not only did subsequent developments in the industry not make your original purchases look like a mistake, but that it made 'em look smarter.**

**Gayner:** They make me look like a backwards genius. [Gayner laughs.] But the truth is that you can't know everything that might happen — which is why I tend to use dollar-cost averaging to buy something gradually over time and thereby gradually accumulate a position.

However, at the end of the day, it really does get back to Buffett's point about what matters most is what you own — that reinvestment rate really dominates your returns over long periods of time. And I count among my blessings that I'm part of an organization that is long-term oriented. So if you wind up owning the right thing, and you use dollar-cost averaging to give yourself a reasonable average acquisition price over time, it'll all work out.

**OID: Again, that's pretty wild — because if you were right about the company's normalized earnings in**

**2004, then the current price for a high return business with some serious growth potential...**

**Gayner:** It would be all right, wouldn't it?

I HOPE IT'S AMEX'S SALAD OIL SCANDAL REVISITED —  
A SHORT-TERM CRISIS = A LONG-TERM OPPORTUNITY.

**OID: Yeah — at least fines and judgements aside. Speaking of which, do you have any thoughts about the likely settlement amount?**

**Gayner:** I don't really have a number in mind. However, I don't think it'll be crippling.

**OID: So you think it's more likely to be in the hundreds of millions...**

**Gayner:** That's right. I would not expect it to be in the billions. That said, it *could* be.

**OID: And how do you assess the likely magnitude of long-term damage to the franchise?**

**Gayner:** First of all, within the context of a portfolio... But I think it might end up being like the salad oil scandal American Express suffered in the 1960s. I understand that was a very rough time for American Express. However, at the end of the day, they did recover. And with the passage of time, people have largely forgotten about that episode. But I believe that was the time when Buffett accumulated his largest single piece of that company — while that cloud was hanging over it.

**OID: Of course, a difference is that American Express was not accused of taking advantage of its clients. And I don't think they found it necessary subsequently to change the manner in which they got paid.**

**Gayner:** Clearly, it's not a perfect analogy. However, I think it's roughly analogous — at least, I hope it is — although another way I suspect it's likely to prove different is that the salad oil scandal involved only American Express. I have to suspect that whatever wrongdoing Marsh Mac may have engaged in, they weren't entirely alone. And if I'm correct that it's an industry-wide issue — then there's no reason for Marsh's customers to desert in droves.

However, if it ends up being company specific, and everybody winds up thinking Marsh Mac is the bad guy, then this investment is not going to work. [He laughs.] But if it winds up being thought of as an industry matter and a change in industry practices, then I think it'll turn out fine.

**OID: One encouraging development in that regard... When Marsh announced that they would no longer seek or accept contingent commissions and would hereafter provide far greater transparency to their clients, we understand that within two days at least three of their four largest competitors did the same.**

**Gayner:** That's right. And that basically did make it an industry-wide change. So it's at least something of an industry-wide event as well as a company event. But where that line winds up being drawn, I don't know. However, I believe that will be what matters the most.

So it's certainly fair to raise that issue. But I'm willing to accept that uncertainty given the current stock price. After all, the only time that you're ever going to be able to

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MARKEL GAYNER ASSET MGMT'S  
TOM GAYNER  
(cont'd from preceding page)

buy a high-return business at this kind of price is when there's a cloud over it. If none of these issues existed, you know that Marsh Mac would not be a \$32 stock.

**OID: It sure doesn't sound like it.**

[Editor's note: Also interesting, while most observers of Marsh are focused on the revenue side of the equation, today's crisis is giving the company the need, as well as the opportunity, to accelerate efforts to cut costs at all levels. And Cherkasky sounds very serious about the company's initiatives in that area.

Here's what he had to say on the topic during their October 27th conference call: "...[We're] committed to looking very, very hard at our cost side to make sure that we're appropriately structured ... so that we can weather any eventuality that we see...."

And subsequently, on November 9th, the company announced that it would be "reducing staff by 5 percent, or approximately 3,000 positions" as part of a move which "should result in annual cost savings of approximately \$400 million when fully implemented".

On the other hand, they also announced that they "were in the process of developing compensation programs to retain, motivate and reward employees" — the expense of which, presumably, would offset the anticipated savings to some degree (at least in the near term).]

INCREASED REGULATION AND DISCLOSURE?  
THAT'S A GIVEN. BUT THAT'S NO BIGGIE EITHER.

**OID: Switching focus from the specific to the general, what kind of impact do you think additional layers of regulation would have on insurance companies? In Schiff's Insurance Observer, David Schiff points out that California Insurance Commissioner John Garamendi's proposed regulations would make it a violation of the insurance code if a broker didn't identify and recommend...**

**Gayner:** ..."the best available insurer" to their clients.

**OID: Exactly.**

**Gayner:** Well, let me ask you this: What did they do before? [He laughs.]

**OID: [After we stop laughing...] Of course, that depends on who you ask. One gets the impression from Spitzer's complaints that insurance brokers generally recommended the one that paid 'em the most.**

**Gayner:** Well, I know this sounds absurd, but who's to say that the one who was willing to pay 'em the most wasn't the best? Those are not necessarily mutually exclusive concepts — although, clearly, the idea of conflict of interest and all of that legitimately enters into it.

**OID: As you know, Charlie Munger was critical of the mutual funds for paying finder's fees to stock brokers to reward them for steering clients to their funds. He**

**called it "bribing the customers' purchasing agent". Are you suggesting that practice passes the smell test in the insurance business?**

**Gayner:** Again, I think the solution's more disclosure. Also, I think "the best available insurer" is going to be a pretty difficult thing to define...

**OID: You bet.**

**Gayner:** ...because what was their claims history, how much experience and expertise do they have — and what's the likelihood that the insurer is going to be around in five or ten years, whenever the claim might come up?

**OID: Exactly, although it's oh so obvious in hindsight — at least to plaintiffs' attorneys and players in the tort mills, and the plaintiff-friendly "journalists" and talking heads who seem to consistently predominate among the lamestream press.**

**And that kind of vague language — with its implication that you can even know in advance who "the best available insurer" is — sounds like an absolute godsend to plaintiffs' attorneys.**

**Gayner:** That's right.

**OID: But I imagine that you have no better idea than anyone else how all of that's likely to shake out.**

**Gayner:** I really don't.

**OID: Of course, that won't stop us from asking you. What impact do you think that's likely to have on insurers? And let me guess that the answer that you'll give me — at least after some fancy dancing — is that it depends on the insurer.**

**Gayner:** Well, no. The short-term picture is incredibly murky. And as you say, neither I nor anyone else really has anything very concrete on which to base good answers to these questions.

But when you get through the short term, at the end of the day, there will still be a need for insurance. There will still be a need for risk transfer. It still needs to get from the companies that provide it to those who buy it. And there's usually some intermediation and expertise that goes along with that process.

And so I guess that's a long-winded way of saying that I don't think this industry will look that much different in 10 years than it does today. Again, I'd be *quite* surprised to find out that there was actually systemic corruption in the industry today. That just doesn't seem likely to me.

**OID: Of course, it might not be corruption. It might just be a severe case of non-disclosure.**

**Gayner:** When your parents bought a house in 1952, I'll bet that that contract had the names of the sellers, the address of the house, the selling price and the date.

**OID: I'll bet you're right.**

**Gayner:** Today, that contract would be eight pages. And it'll have lead paint disclosures and representation that there's no radon, and flood plain information, and that the agent is representing the seller and not necessarily the interests of the buyer, and lots of other similar items.

So was the contract your parents signed in 1952 a fraudulent, deceitful, non-disclosing, hidden kind of thing?

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MARKEL GAYNER ASSET MGMT'S  
TOM GAYNER  
(cont'd from preceding page)

No. It's just sort of the way business was done in 1952. Those standards change over time.

**OID: That certainly rings true. And I think it puts it in perspective.**

**Gayner:** And no doubt, the standards and practices by brokers in real estate and insurance and everything else are going to be different fifty years from *now*. However, the same underlying transactions will take place.

I think that there'll be language of disclosure that will build up that says, "Best insurance" is a complicated term. We look at many markets and consider many factors including price, financial solvency of the insurer, claims paying history, experience, etc., etc." that would just be an additional type of disclosure in the transaction between the insurance broker and their client.

**OID: I think that makes all of the sense in the world.**

[Editor's note: Gayner told us he thought there was a better than 50/50 chance that any lingering uncertainties would accrue to the benefit of market-leading insurers. However, he also agreed that those same market leaders are more likely to have existing conflicts and deep pockets — a combination that plaintiffs' attorneys seem likely to find irresistible, sooner or later.]

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WHAT WOULD STOP OUR BERKSHIRE PURCHASES?  
BASICALLY A SIGNIFICANTLY HIGHER STOCK PRICE.

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**OID: Based on your SEC filings, you appear to have been a very persistent buyer of Berkshire Hathaway. You just seem to buy it quarter after quarter after quarter — like Tom Russo's Gardner Russo & Gardner and Chris Davis' Davis Advisors. Plus, I see that it's your largest holding.**

**Could you give us a nutshell summary of why?**

**Gayner:** Well, the combination of the track record, the integrity of the management, the balance sheet optionality that they have...

**OID: Balance sheet optionality?**

**Gayner:** There's something like \$45 or \$50 billion — whatever it is, it's a bunch — of money that can be deployed by a really smart guy when he thinks that ought to be done.

**OID: You think there's a really smart guy at the top?**

**Gayner:** [Laughing as he talks] I would say that the preponderance of the evidence would seem to suggest so.

**OID: You don't appear to have been price sensitive. Your purchases look almost automatic — similar to what Tom Russo told us he does: More money came in? It's time to buy more Berkshire.**

**Gayner:** That's pretty much what *we* do. We've been steady buyers of Berkshire for years. Markel is a business that produces cash flow. So when another quarter goes by,

we usually have more money to invest. And given Berkshire's stock price and business prospects, and the opportunity set of other things that are out there...

**OID: Or not out there, as the case may be.**

**Gayner:** ...it just seems to be a reasonable way to deploy some of that cash flow.

**OID: Given all of that, at what price would you not be a buyer of Berkshire stock?**

**Gayner:** I don't have a good answer for you there. They have a marvelous position in the insurance industry. They've clearly demonstrated that for years and years. And their size and scale is a significant advantage these days.

So what would it take for us to stop buying Berkshire? Let me just say that Berkshire's stock price would have to be *significantly* higher than it is today. Today's price seems eminently reasonable to me.

**OID: Thank you for some very thoughtful insights. And thank you also for taking the time to share 'em with us on your birthday.**

**Gayner:** Any time. The pleasure's been mine.

—OID

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Just as we thought we were putting the final touches on this piece, on December 22nd, it was reported that MMC had disclosed that the SEC had requested information about transactions in which an MMC executive, director or 5% shareholder had a material interest in MMC Capital's Trident Funds.

Forbes.com quoted *S&P Equity Research*: "We believe [the funds] have held investments in several reinsurers and property and casualty insurers." — adding it concludes that "the probe might be part of an industry-wide probe into possible abuses of financial insurance and reinsurance transactions in order to manipulate accounting and earnings."

When we asked Gayner about this latest development (for now) in this ongoing saga, here's what he had to say:

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MMC UPDATE: THE SEC JOINS THE FRAY.  
BUT I BELIEVE IT'S MUCH ADO ABOUT NOTHING.

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**OID: What's your reaction — when it rains, it pours?**

**Gayner:** Yeah. This is clearly a stock that has plenty of headline risk. And there's one more headline.

**OID: Headline risk aside, what do you view as the substantive implications of the latest developments?**

**Gayner:** I don't know how that's all going to sort out — because the fact that MMC Capital was doing these things was clearly well advertised and well disclosed. Marsh & McLennan Capital has been involved in forming insurance companies for a long time. And that fact was not exactly a secret to *anybody*. I mean, it's been going on

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MARKEL GAYNER ASSET MGMT'S  
TOM GAYNER  
(cont'd from preceding page)

for 25 years — at least. I just don't see anything wrong with that.

On the other hand, what gets reported as being wrong in today's environment [he laughs] is *another* matter.

**OID: Or treated as wrong in today's courts.**

**Gayner:** That's right. But when the period of piling on in the insurance industry finally plays itself out, the company's fundamentals will be what counts. And you know how I feel about those.

Meanwhile, as it plays itself out, I don't know what's going to happen. That's one more risk of owning this stock right now. But it's a risk I'm choosing to live with.

**OID: I believe Schiff's Insurance Observer reported\* that, among other things, AIG was being investigated for selling products that helped other companies manipulate their earnings.**

**Gayner:** That's right. But it's a very gray line. Clearly, there are some activities of that type that both of us would characterize as being clearly wrong.

I don't know the specifics of the allegations against American International Group in the Brightpoint case. But the very act of buying any insurance at all — any — is to smooth earnings. Insurance is a risk spreading, earnings-smoothing mechanism by its very nature. I mean, if you're an individual, you smooth your earnings whenever you buy a homeowner's policy. If you're a company, you smooth your earnings whenever you buy insurance, too — whether it's fire-related, liability-related or health-related.

**OID: On the other hand, when an insurance company sells an expensive insurance policy to a company after a potentially costly event that allows that company's management to mislead its shareholders by claiming that it has insurance coverage for said event...**

**Gayner:** That's right. One indication of whether or not there's some kind of intent to mislead those involved is whether the insurance is bought before or after the fact. But it's frequently not black and white. In title insurance, for example, either the title was clear or it wasn't.

**OID: What's the worst-case scenario for a company found guilty of helping other companies manipulate their earnings or otherwise mislead their investors?**

**Gayner:** Well, I suppose it's the death penalty — because you could say that that's what Arthur Andersen was accused of doing. And they no longer exist.

**OID: That certainly puts it in perspective.**

**Gayner:** However, again, that's not what I expect with Marsh.

IF THEY SAY WHAT MMC CAPITAL DID WAS WRONG,  
THEY'LL HAVE BEGUN UNRAVELING THE INDUSTRY.

**OID: But even if it doesn't result in the death penalty, you said before that if the current brouhaha winds up**

**being viewed as company specific, so that everybody winds up thinking Marsh & McLennan is the bad guy, then this investment is not going to work.**

**Gayner:** That's right.

**OID: Doesn't this latest development move the needle towards it being more company specific?**

**Gayner:** On this particular episode, yes it does — because it involves the Trident Funds. However, I think that other insurance brokers have been involved in the formation of other insurance and reinsurance companies, and that they engaged in similar related transactions, too.

**OID: Does it move your needle in any way, shape or form in terms of how much you worry?**

**Gayner:** No.

**OID: And that's because...**

**Gayner:** Because I've gotten *numb* to it all.

**OID: But personal nerve endings aside, in terms of the actual business and investment implications of the SEC investigation — settlement-wise or otherwise — do you feel like yesterday's developments are significant?**

**Gayner:** I really don't — not in the long term.

[Editor's note: Whatever else the result of the probe may be, for whatever it might be worth, a December 23rd NYTimes.com article suggests that one result is likely to be that Cherkasky will not be able to negotiate a settlement with Spitzer quite as soon as he'd hoped. The article says Cherkasky had set a goal of reaching a settlement with Spitzer by year end, but that he's begun telling employees that it may be at least early January. And "some people briefed on the Spitzer investigation" said that although "[t]hey're making progress ... a conclusion to the case could be even further away."] ]

**OID: And you say that because...**

**Gayner:** The Trident Funds and MMC Capital are the entities and structures that formed ACE and XL Capital, among other long-established, legitimate insurers. So if they're going to say that *this* kind of thing can't be done, then they'll have begun unraveling the entire structure of the insurance industry.

**OID: You don't think they'll get that carried away.**

**Gayner:** I don't think so. But that would be the logical conclusion of the process. And that's one reason why I don't expect them to go very far down that path.

However, whether they do or not, my approach is just to live each day, put one foot in front of the other and get through today's business environment. That said, I really do believe that it's the environment itself that's gotten somewhat poisonous.

But these episodes are going to occur from time to time. A year ago, it was the mutual fund industry on trial. Before that, it was investment banking. And today, it's the insurance industry's turn in the dog house. However, that too shall pass.

**OID: Thanks for the update.**

**Gayner:** My pleasure.

—OID



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

(All figures were provided by Southeastern Asset Mgm't.)

According to *Morningstar*, Longleaf Partners Fund has also significantly outperformed its peers for the prior 3, 5 and 10-year periods ending December 31st, 2004.

However, in 2004, Longleaf Partners Fund's returns lagged the average fund in its category for the first time since 1999. You may recall, back then, how many figured Hawkins, Buffett and others were out-of-touch, old fogies for not being willing to participate in the tech bubble. (And you may recall how much smarter those old fogies looked a mere four or five months later.)

This year, it appears that the folks at Longleaf have chosen not to play again — and elected to build cash rather than violate their investment discipline. In fact, Hawkins laments that in his three-plus decades of managing money, he's never seen the parity of value that he sees today — not only in the U.S., but across the globe.

As a result, Longleaf Partners, Longleaf Small-Cap and Longleaf International Funds reported having cash and cash equivalent balances of 27.8%, 22.2% and 21.8%, respectively, at November 30th. And needless to say, that hasn't done wonders for their returns in a rising market. However, with the passage of time, the folks at Longleaf have been proven right a whole lot more often than not. And we suspect this time will be no exception.

So without further ado, we're pleased to present the following excerpts of comments made by Mason Hawkins, Staley Cates, C.T. Fitzpatrick and associate Lee Harper at three Longleaf Partners client luncheons which were held between September 21st and October 26th. We hope that you find their perspectives as valuable as we do.

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TODAY, WE HAVE MORE CASH THAN IDEAS.  
AND OUR P-TO-V RATIOS ARE ABOVE AVERAGE.

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Right now, we have more cash than ideas...

**Mason Hawkins:** Since we were last together a little over a year ago, the Longleaf Partners Funds have made notable progress. Calendar year 2003 was the best year ever for compounding capital across the three funds. Each significantly exceeded our absolute return goal of inflation-plus-10%.... If you had equal amounts invested in each of the three Longleaf funds, your corpus grew 40.1% last year.

Year-to-date in 2004, we've made less progress.... And all three funds are now closed to new investors. Longleaf Partners and Longleaf International will remain closed until our investment opportunities exceed our cash reserves. Longleaf Small-Cap will not reopen because of its size — which we've discussed at length in times past.

Current cash levels are 25.4% in Longleaf Partners, 22.7% in Longleaf Small-Cap, and 25% in Longleaf International. We'll need four to five new names per fund to become fully invested in equities. And we will need to be that invested before we will consider allowing new partners to join us in International and Partners.

Values of the companies we own have progressed nicely.

**Lee Harper:** As Mason alluded to, there hasn't been a lot to do investment-wise — either internationally or domestically. But we've made a little bit of progress within the portfolios from a price-to-value standpoint. As you know, we talk a lot about the prices that our businesses are selling for versus our appraisal of what they're worth — or, as we call it, the price-to-value ratio. Those *have* made good progress this year.

The price-to-value ratio gets better as it gets lower — because it indicates that our holdings are cheaper. And the price-to-values in all three funds have come down some this year.... That has really been driven primarily by value growth at the businesses we own, not by new purchases.... The values of the companies that we own have grown nicely while their stock prices have remained somewhat stable or have not grown nearly as fast.

And their value growth has come from three sources....

**Harper:** That value growth has really come from several sources — one being top-line growth in a lot of the companies that we own. The economy's doing pretty well — and you're seeing earnings come through, and increased sales in units at a lot of companies.

The second thing we're seeing is that companies are finally reaping a lot of benefit from the cost-cutting that they did during the harder times of 2001-2002. So we're seeing margin improvement at a lot of companies as well as top-line growth.

And then thirdly, at a number of the companies that we own, we're also seeing the benefits of share repurchase. And the combination of those three things has really helped value grow in a more dramatic way than we'd normally expect on an annualized basis....

So we're excited about what we own. And we're looking for additional opportunities to put that cash to work.

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WE DIDN'T CLOSE BECAUSE WE GOT TOO BIG.  
WE JUST COULDN'T FIND ENOUGH BARGAINS.

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Our funds are being recognized by Morningstar and others.

**Hawkins:** *Morningstar* recently released their fiduciary grades for the fund industry, whereby each fund was ranked on five factors: regulatory issues, board quality, manager incentives, fees, and corporate culture. And we're happy to report that the Longleaf Partners Funds received *Morningstar's* highest rating — "excellent" — in 14 of the 15 categories. The fee category for International was the exception — and we think it's a *bargain*. As you know, we have no loads, 12b-1, exit or performance fees on any of the three Longleaf funds.

**Harper:** The International Fund got a B. And that was based on the fact that its fee is higher than the average international fund. But there's a break point that's about to kick in. So that fee issue to some extent is being addressed as we grow in size.

**Hawkins:** I think it's also important to say that Longleaf's partner orientation and integrity — something that your managers pretty much take for granted — has gained as much if not more notoriety over the past year-and-a-half or so than has our long-term performance. And to that I'd

(continued on next page)



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

say we believe the intense scrutiny of the industry's asset-gathering focus is quite well deserved.

We've labeled this, our 30th year, our year of gratitude.

**Hawkins:** Incidentally, this is Southeastern Asset Management's 30th year — hard as it is to believe.... And unofficially, we've titled this our year of thanks and gratitude. We're very, very grateful for some wonderful partners that *allowed* us to do intelligent compounding. Many of you gave us cash when you thought we had the requisite number of undervalued businesses to buy — and it's helped in the compounding.

We also think that we had a little bit to do with having a top 1% record in the last 20, 15, 10 and 5 years. But our partners have provided great assistance.

Size is an issue. But we don't think we got too big...

**Hawkins:** We've been asked on many occasions recently whether we closed our funds because we'd gotten too big. And our answer is no. We closed because we're having great difficulty finding the number of good investments that we want. Compounding is a function of supply and demand. And what we've found lacking is the requisite supply.

But our demand is bigger. And it is a lot more difficult to manage \$30 billion of assets than it was \$100 million. So the size of our demand is an anchor to our performance — there's no getting around that. But we'd submit that the lack of good investments is the real answer.

In fact, so far, so good....

**Hawkins:** And as I mentioned, 2003 was our best year, both on an absolute and relative basis — and 2003 was when we had the most assets under management....

So we do quickly admit that having more dollars to manage is a challenge.... On the other hand, we feel very confident that by looking around the world, if we're patient, good things will come to us. As Mr. Munger says: "Things show up." And hopefully we'll have more of that.

Also, I believe the last five years helps answer the question about size. For the last five years through September 30th, our Longleaf Partners Fund and our managed accounts exceeded the market's return by between 1,100 and 1,200 basis points. I think that that's quite a remarkable feat given our size....

ANOTHER BLOW TO THE EFFICIENT MARKET THEORY  
COMPLIMENTS OF PROFESSOR LOUIS LOWENSTEIN.

We leaned against the wind in 1999 and 2000.

**Hawkins:** In 1999 and early 2000, we said that we  
(continued in next column)

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thought indexing was one of the most harmful concepts ever sold to individual and institutional investors. And during that time, everybody was screaming at us that we had to be fully invested and that everything needed to be tied to the returns of the S&P or some index.

Our response was, (A) We think that's a false premise. (B) We believed there was *huge* risk in those markets. And (C) The threat of losing real money should affect you more than being like an index. Absolute returns are the goal that we seek to achieve, not relative returns — because you can have *terrific* relative returns and lose significant capital, as did occur.

We said at the time that we believed the market was not only terribly overvalued and inefficient, but that it was bifurcated as well. As a result, we were finding real businesses with real revenues and real profits — and we could buy them on our terms and conditions.

Lou Lowenstein blows a hole in the Efficient Market Theory.

**Hawkins:** As a follow-on to that, Lou Lowenstein, the eminent professor from Columbia, just wrote a great paper. It was an update of the piece that Buffett wrote entitled "The Superinvestors of Graham & Doddsville"....

Basically he posits that the Efficient Market Theory is pretty much a concept that doesn't hold true in all markets — that there's no way the Efficient Market Theory can be correct if the Nasdaq was supposed to be right at 1,200, right again at 5,000 and right again at 1,100, all within a period of a couple of years. And he suggests there are *many* times in markets — sometimes within industries and other times amongst individual companies — where fear and greed provide extreme amounts of mispricing.

They didn't just outperform, they blew the indices away....

**Hawkins:** He suggests there are rational investors who have benefited from that mispricing over long periods of time. And he selects 10 managers (Longleaf was privileged to be one of the 10) and shows that over that five-year period, what was *not* random — rather what was rational pursuit of intelligent investing — added about 1,200 basis points per year, or 12% per manager on average, over a five-year period, and refutes the theory that markets are efficient....

[Editor's note: A critic could point to the fact that the managers were selected after the fact. On the other hand, we're pleased to observe that all 10 are among the relatively short list of managers we've followed for years.]

MISPRICING AND VOLATILITY IS OUR STOCK IN TRADE.  
BUT TODAY, THERE'S PRECIOUS LITTLE OF EITHER.

We've never seen so little opportunity in so many places.

**Hawkins:** As I mentioned, we have 20+% cash on average amongst the three Longleaf funds. And we want to reiterate that we're not crazy about earning 1% on our assets. However, as Warren Buffett says, that's preferable to losing money.

So we're comfortable being patient. We are hopeful that next time we meet we won't have 20+% earning 1%. There are three ways that we can get to investment heaven with our cash. One is to find anomalies amongst the universe of great parity that exists in most markets.... There's not a lot of unique market opportunity in particular

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

segments of the globe....

If you hope to steal businesses, greed and fear are good.

**Hawkins:** The second opportunity would relate to volatility. And as we've written in this quarterly letter, there has been zero volatility in the last year. In 2003, the S&P and the Dow had 2% changes on 30 occasions. You may have read that in *The Wall Street Journal*. In 2004, there has not been one *single* day where the S&P or the Dow deviated by more than 2%....

In December 2003, I'd have been willing to give 100,000 to 1 odds that there would be at least one day of 2% variance in the indices over the course of the 365 days of 2004. After all, it was going to be an election year. There's terrorism. Mr. Greenspan is not a teenager. And we're at war. We have a Middle Eastern crisis that just seems to go unsettled. And Eliot Spitzer's on the loose. There are huge amounts of excess in the derivatives world. And international trade with China and India are big dynamics that are significant to our economic system....

So it's quite remarkable, if you think about it, that despite all these factors, we've had so little volatility. And we hope that changes. We like greed and fear being bandied about. We like mispricing and market volatility. And that's because without mispricing, it's very difficult for us to steal businesses in the market arena.

And then the third opportunity to get fully invested would be a bear market. They have not been outlawed. Many of our friends in the marketplace seem to think that they have, but they certainly have not....

Don't expect P/E multiples or margins to move up.

**Hawkins:** Now skipping over to the first question that we always get, which is our view of the stock market going forward, for those of you who may be interested, we refer you to the September 20th issue of *Fortune*. There's a terrific article there that basically says in simple terms, stocks are driven by profitability and P/Es. And if you look at after-tax corporate profits as a percentage of GDP, you will see in their graph that those profits were at the highest percentage of GDP *ever* in the second quarter of '04.

Then, of course, P/Es are a function of long-term interest rates. And you know that the 10-year Treasury is close to 4%. Therefore, there's obviously not a lot of room for P/E multiples to move up — i.e., for interest rates to move down — in our view.

So returns of 6-7%/year are about as good as it can get.

**Hawkins:** Meanwhile, the S&P 500's dividend yield is down around 1.8%. And going forward, we only expect earnings growth of about 4-5% per year. Therefore, since we don't think it's likely that P/Es will rise, we think the sum of those two is just about the best that you can reasonably hope for from the market in total annual return over the next 10 or so years.

So if you were to pin us down, we would tell you that a 6-7% per year total return is about as good as you can expect. And if interest rates were to rise during that time — and P/Es were to decline — clearly you would get even less.

A market decline would be helpful....

**Hawkins:** We're not clairvoyant — in fact, we're downright agnostic — when it comes to forecasting macro events, especially interest rates. But we can unequivocally state that a 10-year Treasury of 4% is a pretty low number, that inflation is pretty quiet at this point, and that corporate America is extremely profitable.

So we'll have to find exceptions — we'll have to find anomalies. And to that point, we can use all the volatility the market will give us. We'd even appreciate a *decline* that might give us an opportunity to put the foundation in place for our returns for the next 10 years or so....

We haven't given up our targets, but it's looking very tough.

**Shareholder:** So in that environment, is your traditional target of 10% real returns really achievable?

**Hawkins:** Well, our goal is to try to crank out 10% returns after inflation. So you can see the magnitude of the difficulty of our task if our assessment of the future is anywhere near the mark — although I guarantee you that it's no better than yours. Beating inflation by 10% is going to be quite a challenge....

THE FACT THAT WE'RE NOT FINDING MUCH  
CERTAINLY ISN'T FOR THE LACK OF TRYING.

And the lack of opportunity isn't just in the U.S.

**Shareholder:** How would you characterize market opportunities in non-U.S. markets compared to ours?

**Hawkins:** If you were to look at Longleaf International, you'd see we have a very significant weighting in Japan — with about 40% of our assets there. It was very criticized a year-and-a-half or so ago. However, markets have risen pretty significantly since then.

In my experience of three-plus decades, I've never seen markets as much in parity value-wise as we see today — whether it's Europe, Asia, Japan, Canada, or America. Our hunt around the world is ongoing. As you know, we have small offices in London and Tokyo to complement our Memphis team. And the report from each of those offices is pretty much the same [he laughs] — a lot of work and not much production....

Some of today's efficiency could be due to competition.

**Shareholder:** Regarding the parity across various markets, do you think that's a function of liquidity right now — or that compared to 20 years ago, the level of analysis going into stocks is much more detailed?

**Hawkins:** We've asked ourselves that [he laughs] more than you can imagine. However, we're not very good at macro things. We're not very good at understanding why markets might be at one level versus another, or efficient temporarily or at parity with value.

Clearly, you could state that 6,000 hedge funds trying to pair overvalued securities versus undervalued securities might have a little something to do with it. I went to the Graham & Dodd Breakfast the other day in New York City at Columbia. And we had some able investors there.

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

There were seats for about 300 people, but they had a list of 600 people who wanted to attend. So there are more people doing appraisals.

However, that doesn't give you the right answer — because value investors are a small part of the investment universe, as people here can tell you. But that may be *part* of the answer.

But there are other factors, too.

**Hawkins:** I think the other answer is we've kind of corrected the dot.com/technology bubble by washing out a bunch of those excesses. And although a lot of that money disappeared, some of it moved to real companies. As I mentioned earlier, the market was *very* bifurcated in late 1999/early 2000.

But you're right. Whether we go to Europe, Asia or Canada, there's a lot of parity in terms of price-to-values.

HEDGE FUNDS ARE A GREAT WAY TO GET RICH  
— AT LEAST FOR THEIR MANAGERS.

In hedge funds, there's a whole lot of mediocrity....

**Shareholder:** Five years ago, the S&P 500 was the no-brainer investment that our clients were talking about. You mentioned earlier how you felt about it then. Now hedge funds seem to be the new no-brainer. What is Southeastern saying about them?

**Hawkins:** Well, I have a daughter working for one. [He laughs.] She doesn't like me to talk about my thoughts concerning hedge funds.

We have some friends that we think are very capable investors in that world. We also have a belief that there may only be about 20 good investors at any one point in time in the world. And we think we can identify quite a few — and they're not all in hedge funds.

So if you've got 6,000 hedge funds, there's a lot of mediocrity out there — not to mention some unethical behavior to go along with the bad investing.

Since everybody loves hedge funds, it's time for caution.

**Hawkins:** However, it certainly provides something for discussion. It's very interesting to me that the concept

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that you sell short a bad company and buy a good one guarantees a profit — and many believe you ought to pay somebody a 2% annual fee and give 'em 20% of the profits for selecting the sales and purchases.

And, all of a sudden, everybody *wants* to invest in one — whether you're talking about an endowment, a foundation or a corporate retirement plan. So, as in other consensus-thinking kinds of situations, I'd be careful....

It's a great vehicle for compounding — for the managers....

**Hawkins:** Hedge funds are a wonderful vehicle for compounding — as far as the *managers* are concerned. But it's not necessarily a wonderful vehicle for the limited partners. So you have to ask yourself if you're getting value for the price you pay.

They ought to do twice what we've done for the money they make — but they haven't done as well. I'm speaking from a 30-year kind of perspective.

SPITZER'S INVESTIGATION IS AN OPPORTUNITY.  
INSURANCE BROKERAGE IS HERE TO STAY....

We view Spitzer's investigation as an opportunity....

**Shareholder:** Would you have any comment on the Spitzer investigation into compensation practices within the insurance brokerage business?

**Hawkins:** ...Spitzer's investigation is an *opportunity* for Southeastern. We bought every share that we could of Hilb, Rogal. And as you can see in our quarterly report, we backed the truck up at Willis.

If Hilb, Rogal and Willis aren't pursuing Marsh & McLennan customers, I'd be surprised. As [Willis CEO] Joe Plumeri said to us the other day, it's really tough to go from #3 or #4 in the industry to #1 unless something befalls your competitor. So we believe our two most recent investees — Willis and Hilb, Rogal — are going to have a reasonable opportunity to grow their intrinsic values....

We're watching Spitzer's investigations w/great interest....

**Harper:** We're watching Spitzer's accusations and investigations with great interest. Where will they end up? We don't have an answer for you. But in our appraisals, we've adjusted our valuations for contingent commissions — which everyone says are going to stop....

And each firm is different in what percentage of their revenues contingent commissions represented. However, in all cases, whatever percentage of revenues it was, it was a very profitable part of their business.... Therefore, it's a bigger piece of their profits than it was of their revenues.

In Aon's case — which is something that we've owned for a couple of years — that's about 20% of their profits. In Willis, it's a little smaller percentage.

**C.T. Fitzpatrick:** Quite a *bit* smaller.

**Harper:** And Hilb, Rogal's is smaller as well. So in the worst case, these contingent commissions go to zero. And that's a hit to our appraisal....

The insurance brokerage business isn't likely to go away.

**Harper:** We firmly believe insurance brokerage is a

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

necessary service because of terrorism, strike lawyers and a myriad of reasons that businesses and individuals need to transfer risk intelligently. Fortune 500 companies aren't going to try to place all their insurance needs themselves. The cost is just too huge. It makes so much more sense to have a streamlined intermediary do it for you.

So we don't believe the insurance brokerage business is going away. We think that model's still going to be there. It's just a question of how the payment system will work....

LEVEL 3 HAS THE PROFILE OF A BIG WINNER —  
THE LOW-COST POSITION IN A HIGH-GROWTH BUSINESS.

We've made a terrific amount of money on Level 3 debt.

**Shareholder:** Could you comment on Level 3?

**Hawkins:** The question is for us to tell our secrets about Level 3. And no, we won't. However, as you know, we've been big investors in the debt of Level 3. We made a significant amount of money in the debt. We bought the 9-1/8s of 2008 at 30¢ on the dollar. And they went to par. Then, when they went back to 60¢± on the \$1, we bought more. And now they're back to almost 80¢ on the \$1. So Level 3's debt has been a big friend of Longleaf.

We like being the low-cost firm in a fast-growing business.

**Hawkins:** We also bought the equity. And clearly, we bought it because we thought it was selling at a big discount to its intrinsic value....

We believe Level 3's far and away the low-cost provider in a commodity business — the transport of electrons around the world. And the demand for transferring voice, data and video is growing *very* rapidly — maybe not as rapidly as many wanted it to grow when billions of dollars were provided to lay fiber, but nonetheless, it's growing.

Huge growth in demand is a given....

**Hawkins:** Currently, America is only about 30% hooked up in the home for broadband. Eventually that's going to be a much bigger number. And the users of that connection to a fiber backbone are going to use a *whole* lot more of it than you can imagine. A phone call requires nothing, but a movie requires mega-capacity. And video-on-demand is at hand....

Prices will eventually stop declining.

**Hawkins:** So we believe that the unit growth versus price decline curve will finally move in the direction of Level 3. Right now, in the last two years, we've been growing units very rapidly — but declining prices have offset that growth. So revenues have been pretty flat.

But once you get below your competitors' cost of production in a commodity business, prices stop declining.

[Editor's note: Of course, among other things, that assumes the cost of production doesn't continue to decline — which is an assumption we're not prepared to make.]

And marginal revenue growth will be *terrifically* profitable.

**Hawkins:** Therefore, if you're one of the zombies with a bunch of legacy copper wires out there and you're operating at capacity and the going market price is equal to your cost, you can't cut your price anymore and survive. And then it gets into not only price, but service. And Level 3 is not only the cheapest provider, but they're the best provider with the best service.

We believe one thing is certain — Level 3's costs are mostly fixed. Marginal revenue growth is *terrifically* profitable. They have a 70% contribution margin on every additional dollar of revenue — versus a *much* lower number for their competitors. And we're talking *cash* costs, not accounting.

[Editor's note: Friend and long-time contributor Fairholme Funds' Bruce Berkowitz and an associate of his, who's as technologically knowledgeable as anyone we've ever encountered, emphatically disagree. They suggest that Level 3 is *not* the low-cost competitor, although that fact is disguised by Level 3's accounting (what costs are

PORTFOLIO REPORTS estimates the following were Longleaf Partners Int'l Fund's largest equity purchases during the 3 months ended 9/30/04:

1. OLYMPUS CORP
2. KONINKLIJKE PHILIPS ELECTRON NV
3. WILLIS GROUP HLDGS LTD

included and excluded when they calculate their margin).

They're much more positively disposed towards a Level 3 competitor, WiTel (which they originally owned directly and own today through one of their long-time favorite holdings Leucadia National) and MCI.)

WE UNDERSTAND WHY THEY'RE UNDER ATTACK.  
BUT WE BELIEVE LEVEL 3'S GLASS IS MOSTLY FULL.

Even in this environment, we think Level 3 can succeed.

**Staley Cates:** With Level 3, it's *far* more difficult to forecast what their units and prices are going to do than with any other company we own, obviously — because, as Mason said, the unit demand and the unit growth is off the charts, but the pricing is terrible. That results in flat revenues right now — which is a huge turnoff to the world.

But our feeling is, and they're planning accordingly, that if they stay where they are — which is flat revenues in their existing business as a result of huge increases in units and pricing that gives that all back — they will still benefit from growth in Voice over IP. So even if there's a continuation of this environment, as the main kind of wholesaler to all these different Voice over IP providers, including cable companies, they can succeed that way.

And we expect this environment to improve dramatically.

**Cates:** Now, having said that, we think long term, at some point, those revenues will begin to grow again in what has been their traditional business. And that's because when you do have this gigantic unit growth, and

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

that compounds, capacity utilization rates will begin to improve at some point.

Also, a lot of marginal providers are engaging in some kamikaze pricing. And we don't think that's permanent. So you just have to be positioned to stay in there long enough. And they are. We think that they're the best situated.

We don't worry about their unleveraged competitors.

**Cates:** Unfortunately, what gets all the attention is their balance sheet versus others who have come out of bankruptcy, for example, with little or no remaining debt. But when something that comes out of bankruptcy is still EBITDA negative, it really doesn't matter that they've purged all their debt.

People tend to look at the area like office buildings that are all the same. So if one of 'em goes through bankruptcy, it kills all of the other office buildings. And we just don't think that's really the right analogy....

Level 3's built it. Revenues and profits will come.

**Hawkins:** We just have to be patient. It's like a pipeline. You lay it. At 30% of utilization, you might cover just your interest and depreciation. When you get to 50%, you might begin to see some cash profits. And when you get to 60%, you might get to see some GAAP profits. We believe that analogy is applicable to Level 3.

We've got the best management in the business — the smartest, most vested, and aggressive. Jim Crowe, Walter Scott and Sureel Choksi are just wonderful, good partners.

[Editor's note: Most observers seem to agree that Level 3's management is the best in the business. But some suggest their compensation package is the best, too.

Other very astute observers, including the aforementioned folks at Fairholme Funds, don't believe Level 3 enjoys a qualitative advantage vis-a-vis WilTel or MCI — service-wise or management-wise.]

**Hawkins:** So we'll see. [He laughs.] We've placed our bet. We believe that cable will go their way, telephony will go their way, homeland security will go their way, you name it. There's going to be a greater and greater demand for moving data confidentially and efficiently around the world....

They're under attack for a reason. We still trust 'em.

**Hawkins:** And shorts are beginning to figure that out. There are 100-and-some-odd million shares short Level 3. And we'd love nothing more than for them to lose money.

**Cates:** Yeah. And at the risk of sounding like a bitter long person watching paper losses, if you look at the short interest — and you look at the articles and how they're placed and which sell-side analysts are writing the negative stuff and who they're tied to — it's pretty obvious to us that it's an orchestrated effort.

So you have to cut through some of the stuff you read and ask yourself, are these guys really good people or not? And we continue to firmly believe they are, although [CEO James] Crowe catches a lot of flack, and will most likely continue to do so, because of the short interest in the stock.

But we still believe long term that it's going to be an

important business — and it's cheap. We're only paying about a quarter of what it cost to build the network. We still like the people. And we think their balance sheet's going to be fine.

WE'VE MADE ENORMOUS MONEY IN LEVEL 3 ALREADY  
— AND WE EXPECT TO MAKE A WHOLE LOT MORE.

Did size keep us from selling Level 3? Nope, just price.

**Shareholder:** Longleaf Partners recently hit an all-time high in assets, while your turnover has been at all-time lows. If you were more nimble, might you have taken some money off the table for Level 3 when it hit \$6.80 a share?

**Hawkins:** No. It never got to what we think it's worth. And anyway, we're not in Level 3 to trade it quarterly. We're in it to make a lot of money in the next 10 years. Our time horizon is longer than anybody else's, I guess. [Laughing] We don't pay a lot of attention to the wiggles.

**Shareholder:** Plus, it would've been a short-term gain.

**Hawkins:** That's exactly right. It would've been a

PORTFOLIO REPORTS estimates the following were Longleaf Partners Small-Cap Fund's largest purchases during the 3 months ended 9/30/04:

1. HILB, ROGAL & HOBBS CO
2. HASBRO INC
3. JACUZZI BRANDS INC

short-term capital gain at that point even if it had been trading at our appraisal.

Why don't we buy more? We own close to 25% of it now.

**Shareholder:** If Level 3 is so cheap and you have so much cash, why don't you buy more of it?

**Cates:** That's a good question. The answer is that this was a peculiar animal to begin with — a small-cap private placement that happened in about 24 hours. And so it was unusual that the Partners Fund would even be in it in the first place. And so you have Partners Fund and Small-Cap with a combined position that's a large percentage of the company....

We now own between 20% and 25% of the company. And if we were to take that to a full position in Partners, we'd end up owning something like 40% of Level 3. So it's just an issue of size....

**Shareholder:** That sounds like a good answer.

**Cates:** Well, that's a bad answer right now. However, I hope it'll be a good answer.

And we continue to think there's a whole lot to like.

**Hawkins:** Well, I'd like to clarify. We've made a tremendous amount of money in Level 3 debt — which was our initial foray into Level 3. So we tripled our corpus and made a terrific income component return. And we've made another major investment into the debt that's been very, very successful. We've been less successful in the common. But it's still early innings. And we're convinced, as Staley said, that we've got terrific people and that Level 3 is by far

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

the low-cost provider.

And we don't think the system can ever be duplicated. America is not going to allow you to dig up all the streets again. And I don't think that the market's going to give anybody \$14 billion of free capital to do it. So it could be pretty exciting here....

IT'S GOING TO TAKE A LOT MORE THAN BANDWIDTH  
FOR CONTENT PROVIDERS TO BYPASS COMCAST.

Bypassing Comcast is much harder than it sounds.

**Shareholder:** I've read in the press that the holy grail of high-speed internet access is to have speeds so high that you can watch television over the internet — and if it ever occurred, that the content providers would just love to sell their content directly to the ultimate consumer and bypass cable television companies such as Comcast. Do you have any thoughts about that — and about Comcast specifically?

**Cates:** Your question is a good one. We don't profess to be cable experts. We try to be, but we probably aren't. However, our feeling is that they have such a power that is interrelated with the content now, that to make a black and white move would just not be possible.

For example, if Disney is working with these guys both on the internet stuff and what's on traditional cable, it'd be difficult to totally leapfrog Comcast and go straight to the customer and not feel a whole lot of pain in the interim. So we think they'll find a way to make a less painful transition.

In fact, more clout for Comcast means more content.

**Cates:** Also, as you probably know, Comcast is using their distribution strength to get more into content. They previously didn't have the ability to just start a channel — because they didn't have enough size, and their competitors might not take the programming. But now that they've passed the 20 million household threshold, it's a lot easier to get critical mass on day one.

[Editor's note: Of course, this was the strategy used by John Malone at Telecommunications, Inc. — from which Liberty Media was spun out in 1999 — to achieve extraordinary returns for many years.

And there seems to be a growing consensus among OID contributors regarding the attractiveness of Comcast. According to Portfolio Reports it was a top ten purchase in the quarter ended September 30, 2004 for no fewer than *nine* of them: Chieftain Capital Mgm't, Davis Advisors, Franklin Mutual Advisors, Gardner Russo & Gardner, Loews Corp., Meridian Value Fund, Oakmark Fund, Southeastern Asset Mgm't and Tweedy, Browne Co LLC.]

**Cates:** So they've started three channels since their AT&T deal. And they were obviously kind of interested in ESPN....

[Editor's note: Of course, Comcast made what many considered to be a lowball bid for ESPN's parent, Disney, earlier this year.]

OUR INVESTMENT IN DISNEY? SO FAR, SO GOOD.  
AND WE THINK THAT THE BEST IS YET TO COME.

Our Disney investment? So far, so good....

**Shareholder:** Can you discuss the valuation of Disney in light of the change of leadership that will occur, and any uncertainty over what a new leader's business plan might be with its assets?

**Hawkins:** ...As you know, we bought about \$1 billion worth of Disney from the time that there was a margin call for a major shareholder at \$18 all the way down to \$15. So we bought a heck of a lot of it at what we thought was less than 60¢ on the dollar vis-a-vis our appraisal. And clearly, the \$15 Disney we bought is very, very profitable at \$25 a few years later.

And we expect great compounding of value going forward.

**Hawkins:** We think Disney has unbelievably good assets, especially ESPN. And when we perform conservative appraisals on those assets, we get something in the \$30s. We're not going to tell you exactly what, but it's significantly more than the price today — *significantly* more.

And we believe that value will compound nicely going forward. The essence of a great investment is one that you purchase at a discount to its value today where its value is going to grow nicely in the future. So you get great compounding from the accrual of intrinsic value plus the accretion of the price *towards* that value as time goes on.

We're pretty sanguine about its current management.

**Hawkins:** We think that Eisner's been a pretty good steward over his history. We believe very few managers in corporate America are as hands on and as passionate as he's been about every segment of that company.

That's not to say *any* manager qualifies on every front in terms of operating and investing capability. But when we apply a broad test to Disney's management leadership, we're pretty sanguine about the current management....

There's nothing like ESPN....

**Hawkins:** ABC looks like they've got a good shot at really turning around the next couple of years. They've made some pretty good progress. And Bob Iger helped create the most valuable, rapidly growing company that Disney has in their portfolio — ESPN.... We don't have a business with large contractual price increases as far as the eye can see — nothing *like* it. There's little threat to it. I mean, they *dominate* sports broadcasting....

And Disney's got other irreplaceable assets, too....

**Hawkins:** When you look at all the parts of Disney, you've got ESPN, you've got ABC TV stations in the biggest markets, you've got their great library — and you've got a fantastic business in the theme parks where other people put up the money for the real estate and you collect a management fee in China and Japan as well as Paris.

So when you look at Disney, they've got some *very* competitively entrenched businesses that are going to grow their value for long periods of time. The company is irreplaceable. It's pretty unique.

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

In ESPN we trust...

**Shareholder:** What about the fight between Eisner and Roy Disney?

**Hawkins:** We're not too concerned. It seems to be evolving. We think there are certain board members that are good stewards of our capital....

**Cates:** This has to be the most common question about Disney and Eisner. We're not going to get into the details — and our long opinions would bore you anyway.

But the most relevant thing for you to remember is that we think it's highly unlikely that however it plays out that it will hurt the value of ESPN — which is by far Disney's most valuable asset. Despite all this stuff that Roy Disney says about animation — and Pixar and their movies — ESPN is the most valuable asset.

And however it turns out, we don't think it'll impact the company's capital allocation. There aren't a lot of well-founded accusations about these guys squandering money. Aside from paying too much for Fox Family, they've allocated capital well, especially at Cap Cities.

So in our main, simple outline of businesses, people and price, that soap opera really doesn't mean a whole lot.

We know that Disney's not perfect. Nothing is...

**Hawkins:** To get great investments, you never get 100% of everything. If you go back to Goizueta and Coke, you might have had a terrific investment with all the quantitative/qualitative factors considered. But it's very rare that you find a terrific business managed by a fabulous individual at half of value. Life's just not that perfect. [He fights back a chortle.] And for us to get an opportunity to buy Disney's pool of assets at \$15 a share — in our shop, there were no questions asked.

We don't mind looking stupid — at least in the short run.

**Hawkins:** When we bought it, of course, everybody thought we were nuts — because right after 9/11, the conventional wisdom was nobody was ever going to go to theme parks, and nobody was ever going to advertise on ABC or ESPN again....

And we couldn't disagree with that in the short run. But in our shop, we put those issues aside, because we thought the world would return to some degree of normalcy. So we plowed ahead and put \$1 billion in. And we're glad we did. Our time horizon is the next 5-10 years, not the next 10 days. That is a major difference, in our view, between Southeastern and many investors. We fully expect to look stupid in the short run. And it's painful [he laughs] — lots of times.

GM'S ABOUT AS CHEAP A STOCK AS WE OWN.  
AND GMAC'S NOT A BAD BUSINESS, EITHER.

Even given a valuation haircut, GMs worth twice the price.

**Shareholder:** I understand that GM was served with subpoenas for their pension plan?

**Hawkins:** Not to my knowledge. The SEC says they

want to talk to them about their pension plan, but I don't believe they were subpoenaed.

**Shareholder:** Okay. Could you discuss GM?

**Hawkins:** Well, GM has \$10 of earnings power. And under the worst of bets, they're going to earn \$6 next year. And \$6 divided into \$38 may be the lowest multiple on the New York Stock Exchange. It's the most disdained company in America. It sells for less than GMAC is worth.

Our appraisal takes into account its off-balance sheet, post retirement, medical and pension underfunding. And we're making very, very conservative assumptions on the actuarial rates of return. As you know, GM uses a 9% actuarial return assumption in its pension plan. We use 6-1/2% in our appraisal. But even when we do all of that, we still wind up with *twice* what the stock sells for.

So you don't have to love everything about it.

GM's market cap is 1/5th Toyota's — and its mgm't's great.

**Hawkins:** At its current price, it has a \$22-or-so billion market cap. Its market cap is half of Renault's, and one fifth of Toyota's. We think their Chinese interest alone is worth over a quarter of the current price. And their

*PORTFOLIO REPORTS* estimates the following were Southeastern Asset Management's largest equity purchases during the 3 months ended 9/30/04:

1. KONINKLIJKE PHILIPS ELECTRONICS NV
2. HASBRO INC
3. SAKS INC
4. COMCAST CORP CL A SPL
5. WILLIS GROUP HLDGS LTD
6. HILB, ROGAL & HOBBS CO
7. GENERAL MOTORS CORP
8. DIRECTV GROUP INC
9. DISNEY WALT INC
10. IHOP CORP

truck business is valuable.

And Rick Wagoner, John Devine and Bob Lutz are great managers. Put 'em in another company and they'd be recognized for the miraculous business people they are instead of their far different reputations today. Rick Wagoner has done a terrific job of moving that supertanker in the right direction.

We know it's not perfect; but it's very, very cheap.

**Hawkins:** That's not to say GM's a great business. We know it's cyclical, we know it's capital intensive — and we know it's labor intensive. However, it's also a very, very undervalued security. And that plus a nice dividend yield — up around 5% — is pretty appealing. It's certainly about as cheap a stock price-to-value-wise as we have around the world in our portfolios. And GMAC — which comprises the main part of our appraisal — is a pretty good business.

So once again, there's not a lot of perfection there — but there might be some profit. We're pretty much assured that we're going to make a reasonable return, we think, given the prices we paid....

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

GIVEN ALL THE CHALLENGES PFIZER FACES,  
WE DON'T THINK IT'S BARGAIN-PRICED TODAY.

Challenge #1: Companies don't grow to the sky.

**Shareholder:** Can you discuss Pfizer in more detail?

**Hawkins:** Well, we're not an investor in Pfizer. But it's a wonderful company — with \$55 billion of revenue. It has a market cap of \$250-some-odd billion. My friend Bill Miller just talked about the fact that there comes a point where size really restricts — and that's why his firm, Legg Mason, doesn't own the top five market caps: Exxon, G.E., Pfizer, Microsoft or Wal-Mart. In effect, it just gets very difficult to grow. And that's Pfizer's biggest challenge. So that's challenge #1.

And now Pfizer has to run hard just to remain in place.

**Hawkins:** And Pfizer has two other major problems. I was an ethical drug analyst in the '70s. I cut my teeth on Schering-Plough, Lilly and others. And one problem is that Pfizer's got to replace its reserves the same as if it were an oil company. Its reserve life is about six years. So when Viagra or Celebrex or what-have-you goes off patent, they've got to have another one just to stay even.

It used to be if they found a \$2 billion drug, boy, they could really move the needle in terms of intrinsic value. Now they've got to find six of 'em just to remain static. So that's challenge #2.

Meanwhile, we expect U.S. drug prices to decline....

**Hawkins:** And then challenge #3 is pricing. Access to the latest drugs has become a right and not an option for us. So how that plays out politically and businesswise is a qualitative assessment that you have to make.

And if we're selling drugs to the French and the Germans at 60% of what we're selling 'em to Americans, that pricing gap is going to close. And we'd hypothecate that it's more probable that it closes by American prices going *down* than French prices going up. That's all being discussed now about imports from Canada — you know, how can Pfizer sell the same patented, branded product to Canadians at a big discount to what they sell 'em for here?

But if the price were right....

**Hawkins:** So it's size, the real challenge of R&D to find a blockbuster drug, and it's pricing. They're going to have to basically find an answer for Alzheimer's and a number of cancers in order to stay the same company.

That's not to say that the market won't get it discounted cheaply enough to make it of interest to us.... However, at \$29, it's not cheap enough for us.

IT'S HARDER TO FIND SHARP MGM'TS IN JAPAN.  
BUT THAT'S REALLY A DOUBLE-EDGED SWORD.

We like it when Marty Whitman doesn't agree with us....

**Shareholder:** Do you find management in Japan and

other countries different than the managements you deal with domestically? Marty Whitman has *long* stories about how the Japanese viewed him as an investor. They basically told him, "It's nice that you're invested in our company, but we don't have to give you the time of day."

**Fitzpatrick:** We're *glad* that Marty Whitman doesn't like a lot of the Japanese management teams — because he's *really* good. [Ed. note: Amen.] So the further we can keep him away, the better. It leaves more for us.

It's harder to find great managements in Japan.

**Fitzpatrick:** Japanese management teams are different than those in the U.S. The cultures are different. That's why Andrew lives there. It's harder to figure out.

There are a lot of good managers in the U.S. And in part, that's because the U.S. market is highly developed. There are also a lot of managers that get headlines who we've all read about who *aren't* so great. But this country is blessed with a *tremendous* amount of management talent. And we do find a sufficient number of great managements that are wonderful partners for us.

PORTFOLIO REPORTS estimates the following were Longleaf Partners Fund's largest equity purchases during the 3 months ended 9/30/04:

1. KONINKLIJKE PHILIPS ELECTRON NV
2. GENERAL MOTORS CORP
3. DIRECTV GROUP INC
4. NIPPONKOA INSURANCE CO LTD
5. KONINKLIJKE PHILIPS ELECTRON ADR

It's harder in Asia. It's probably harder there than anywhere else in the world.

But when you do find a great manager there, you're in luck.

**Fitzpatrick:** What's wonderful about it, though, is that when you *do* find someone like a Ken Matsuzawa at NipponKoa that understands the value of their business — that understands both their strengths and their weaknesses, and *admits* their weaknesses and works proactively to improve the company operationally at the same time he allocates capital well and repurchases stock below book value for a business that's probably worth two times or more than book — it becomes very powerful....

WHAT DO WE LOOK FOR IN A MANAGEMENT?  
WELL, HERE'S OUR CHECKLIST....

We want a great operator as our partner.

**Shareholder:** What are some of the elements you look for in a management team? And how do you go about assessing a team to try to make sure it fits your criteria?

**Hawkins:** When we go see managements, we're primarily interested in two things: one is operating success and ability. You hope that they can market. You hope they can build incented management teams. You hope they can keep their costs down. You hope they can replace their products through research and development.

So you want a great operator as your partner.

(continued on next page)



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

And we want one who's passionate & properly incentivized.

**Hawkins:** And you want one who's *passionate* about it. You want him to be vested. You'd like him to work for free and own a big piece of the company that he purchased and was not given. You want to go to that proxy statement and make sure that the compensation is properly aligned with shareholder interests.

We *love* people to make a *heck* of a lot of money if they achieve objective hurdles of performance. We certainly prefer cash over options any day. We know the cost of that. When Microsoft was giving away tons of options, it was "costless". That's a misunderstood thing. If you give somebody a 200¢ dollar, [chuckling] it's not very costly — in fact, you're *adding* value — because you're not paying him essentially real economic value. But if you give somebody a 50¢ dollar and you think you're giving him \$1, then you're paying *twice* what you think you're paying.

But first and foremost is their ethical and moral position.

**Hawkins:** So you want 'em properly incented, you want 'em to be great operators, and you want 'em passionate about it. But clearly, the first thing is their ethical and moral position. We read everything that we can about them.

And we always talk to their board members about their character and their history. And we *always* talk to their number one competitor. We're interested about those things as character issues and as a gauge of their operating ability.

And we evaluate management's capital allocation skills.

**Hawkins:** The second major element we look for is investment acumen — their capital allocation skill set. And on that front, you can go back, and just as you looked at his operating history, you can grade his capital allocation skill historically. There are five things you can do with a retained earnings dollar:

(1) You can pay it out in dividends. (2) You can roll it into 1% T-bills. (3) You can put it into your earning asset base. And usually that's a pretty good opportunity if you have people demanding more of what you do, and you're at capacity and can add another level of volume to capacity. It's usually profitable and *relatively* low risk. (4) You can make an acquisition. By the way, that scares the dickens out of us — because sellers always know a lot more about potential acquisitions than buyers. And (5) as an alternative on the capital allocation side, you can buy your shares in.

Therefore, CEOs, ultimately, should be judged in part by how they've chosen between those five. And grades should be assigned to them based on their results in terms of risk and return — just like you judge us.

The process is both qualitative and quantitative....

**Hawkins:** And we look at their own actions with *their* dollars, not just our dollars, at the corporation. So if they decide to repurchase their shares, and insiders are buying too, that not only says [chuckling] that they believe their business is undervalued for us, the shareholders, they believe it with their own capital as well — which is incredibly important.

So when you assess management, you can do it quantitatively *and* qualitatively. We think that most of it's subjective and qualitative, but there's a lot of quantification there, too. How well did they compound their capital over the last five years? How much did they improve their profitability, their margins and whatnot? How fast did they grow their units versus their competitors? Those are all quantifiable things.

Did they take share? Did they take it sensibly through even better products and services as opposed to just cutting prices? If they did cut prices, did they have an opportunity to really drive the guy out of business so that you end up with a lot of it yourself? All of those things are quantifiable.

You won't find perfection, but all high grades is a must.

**Hawkins:** On the character and the integrity side, it's very subjective. Sometimes you can look back, and they've never done anything wrong in their history. However, if a lot of people tell you the guy cuts corners and doesn't play it down the middle of the court, you want to file that away and think about it. How has he lived his family life — and his life on the community side in terms of charitable involvement and all those things? Those are all really important. So what you want is a great operator as well as a great capital allocator.

Now you aren't going to find perfection. We haven't found any 100s yet [he chuckles]. But you don't want any 60s either. You want 'em to at least pass....

We make money with controversial managers, too.

**Shareholder:** I keep hearing you talk about having great management teams here. And yet you've got Eisner, Conrad Black, and Messier when he was with Vivendi. So you still seem to wind up with controversial leaders.

**Hawkins:** Well, first let me say that in Messier's case, we partnered with his successor at Vivendi. And in the case of Conrad Black, we made money in Hollinger because we bought it so cheaply relative to the value of its assets. And finally, we'd take exception with your inclusion of Michael Eisner in that group. We think that he's been a good steward over the long run at Disney....

**Harper:** When we're looking for a great business, with great people at a great price, we *know* that the hardest one is the people — because people are human....

With Hollinger, it turns out we had a bad partner with Lord Black. But as Mason said, we made money on it — because we paid such a cheap price, and because the actual newspapers they owned were good properties. And he did run those well, in spite of the other things going on. So that's what you've got to do — balance those three: business, people, and price.

—OID

For additional information  
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BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
(cont'd from page 1)

Equally remarkable, in our view, is the manner in which those returns were achieved. As we said last year, with so many corporate big shots and mutual fund execs under fire for having allegedly enriched themselves at their shareholders' expense, Buffett and Munger have enriched their shareholders at their *own* expense. Each receives a salary in the not-so-princely amount of \$100,000 per year. And neither of them receives any incentive compensation or perks whatsoever from Berkshire (unless you include the Cherry Coke and See's Candy the two seem to always be cherring down at public events).

Also hard to believe, they've apparently done it all without the benefit of a calculator, much less a computer. And despite the billions, Buffett and his life-style reportedly remain remarkably unchanged. Numerous anecdotes about the incredible economy and simplicity in his personal and professional life alike are enough to make a newsletter editor feel like a profligate spender.

As we've said before, we don't think it's a coincidence that one after another of the most successful managers we can find tell us that they model themselves after Buffett and Munger. And many of them tell us that there's no one they'd rather have manage their money than those two. More than a few of them take it a step further and let them do much of their heavy lifting. For example, the last time we checked, Chris Stavrou of Stavrou Partners had carried it so far as to make his position in Berkshire account for more than 40% of his portfolio.

Once a year, the two provide what has to be the world's best attended and most valued lecture on investing, business, human nature and the current investment, business and political scene to be found anywhere. (Reportedly, the attendance at this year's annual meeting nearly reached the 20,000 mark.)

In any case, we're very pleased to bring you excerpts from their latest — which took place on May 1st in Omaha. And we're very grateful to them for allowing us to share it with you. As always, we highly recommend that you read (and reread and reread) anything and everything that Buffett and fellow super-investor Munger have to say. And we hope you find it as valuable as we do.

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PHIL FISHER WAS A GREAT MAN & A GREAT WRITER —  
SO GREAT YOU CAN GET IT ALL FROM HIS BOOKS.

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You could really get it all by reading Phil Fisher.

**Shareholder:** Recently, Philip Fisher died. At this meeting many years ago, Mr. Buffett, you mentioned your fondness for the first edition of *Security Analysis*, chapters 8 and 20 of *The Intelligent Investor*, and Phil Fisher's first two books. You, Mr. Munger, have also been complimentary of Mr. Fisher's writings and investment approach.

I wonder if you would tell us of your experiences with Mr. Fisher and the circumstances of your meeting — and anything else you'd like to say about him. And did his

writings, or your discussions with him, start you thinking about the idea of the great business or franchise company, or was it simply an affirmation of thoughts which you had already begun to have?

**Buffett:** Phil Fisher was a great man. He died about a month ago well into his nineties. His first book, I believe, was *Common Stocks and Uncommon Profits* written in 1958. And his second book, *Paths to Wealth Through Common Stocks*, was written a couple years later. Those two books were terrific books. As with Ben Graham, you could really get it all by reading the books.

[Editor's note: Of course, the legendary Phil Fisher passed away on March 11th.]

**Buffett:** I met Phil Fisher just once. And don't get me wrong — it was great. I enjoyed it. I loved it. He was nice to me. But similar, actually, to my experiences with Ben Graham — where I worked for him, took his class and everything else — it was in the books. They were such good writers, and their thoughts were so clear, that you didn't *need* to meet 'em personally. I enjoyed meeting them personally, obviously, but they got it across in words.

I met Fisher the way I met a lot of people...

**Buffett:** The only time I met Phil was some time after that 1962 book (or whatever it was — '61 or '62). And it was in San Francisco (I think it was in the Russ Building, but I may be wrong on that) — and I just *went* there. I used to do that all the time [laughs] when I was younger. I'd go to New York and I'd just drop in on all kinds of people. I guess they thought because I was from Omaha, they'd just have to see me one time and they'd be rid of me. [He cracks up.] And I usually got in to *see* 'em. So I did that with Phil. And he was extraordinarily nice to me.

But it wasn't like I gained new ideas by meeting him — because I'd already read it in his books.

I was actually getting the Fisher doctrine in stereo....

**Buffett:** Actually, I met Charlie in 1959. And Charlie was also sort of preaching the Fisher doctrine to me — in a little different form, but his ideas paralleled those of Phil's. So I was getting it from both sides. And it made a lot of sense to me.

I don't know what Charlie's experiences were with Phil.

Charlie always thought Phil Fisher obviously made sense.

**Charlie Munger:** Well, I always like it when somebody attractive to me *agrees* with me. And therefore I've got very fond memories [he laughs] of Phil Fisher.

The basic idea that it was hard to find good stocks and hard to find good investments and that you wanted to *be* in good investments, and, therefore, you'd just find a few of them that you knew a lot about and concentrate on those seemed to me such an *obviously* good idea.

And indeed, it's proven to be an obviously good idea. Yet 98% of the investing world doesn't follow it. That's been good for us. And it's been good for *you*....

[Editor's note: We consider ourselves privileged to have had a feature with Phil Fisher in *OID* back in 2000 thanks to the trust and consideration of Jack McDonald — the highly esteemed IBJ Professor of Finance in the Graduate School of Business at Stanford. He allowed us to sit in on what we understand turned out to be Fisher's

(continued on next page)



BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
(cont'd from preceding page)

final visit with his class on May 5th of that year.

Professor McDonald told his students that Fisher, a 1929 graduate of Stanford Business School, "was the gentleman who got me interested in investing and opened up this world for me. I was fortunate to have [had] the opportunity to be in his class [in 1961].... He only taught that year and the next here.... So he had a very narrow window of exposure, but it had an impact on many of us — showing that even if you only teach once or twice, you can have a significant long-term effect."

We believe the impact Fisher has had, and will have, through Professor McDonald's class alone should not be underestimated. We understand long-time *OID* contributor Tom Russo is only one of *many* bright young stars in the investment field who have graduated from his class.

Professor McDonald continued: "[Fisher] has had quite an impact. He's played an important role in the intellectual life of the school and the teaching of fundamental investing as we teach it here.

"What's striking to many of us who teach investing ... is that business strategy practitioners and scholars have never adequately acknowledged their debt to Mr. Fisher for bringing together the notions of sustainable growth and competitive advantage.... [I]n the business strategy field, they brought those two things together and called it 'sustainable competitive advantage'.

"Mr. Fisher was a pioneer in the fundamental analysis of businesses as we know it.... [He] said that we ought to analyze the suppliers and competitors and customers. The idea of systematically looking at suppliers, customers and competitors is one of Phil Fisher's contributions.... So modern business strategy owes a lot to Mr. Fisher."

As we were heading to press, we asked Russo to review the preceding quote. He was struck by the fact that Buffett had just emphasized precisely this point at the Fortune Innovation Forum at Jazz at Lincoln Center in New York in November 2004. According to Russo, in the audio excerpt on Bloomberg, Buffett observed: "We're looking for companies with durable competitive advantage — that's *all* we're looking for, durable competitive advantage — run by people who will maintain that [competitive advantage] over time and keep the moats around the economic castles that they have."

Rereading some of the wisdom and insights the late, great Phil Fisher shared with Professor McDonald's class that day, we were reminded of just how impressive this extraordinarily humble, gracious man had remained so late in the twilight of his accomplished, groundbreaking career. Perhaps we'll even have the opportunity to revisit some of his thoughts and share them with you in a future edition.]

(continued in next column)

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THE BASIC PRINCIPLES ARE STILL BEN GRAHAM —  
AFFECTED SIGNIFICANTLY BY PHIL FISHER & CHARLIE.

I started out with the right principles — thanks to Graham.

**Shareholder:** I'll be graduating from Harvard College in June and beginning a career in value investing. So I sure hope we're all right in thinking that this century will be just as good as the last for value investors.

You've been doing this since you were my age, if not younger. So I'm wondering what habit, or habits, have contributed most to your ability to continue learning and improving your investment decisions in a changing business and financial environment?

**Buffett:** I would say, at least in my case, I *haven't* been continually learning in terms of the basic principles. You always learn a little more about given techniques. And I learn more about some industries over time. Therefore, maybe I've widened the universe in which I can operate — although having more funds narrows it back down, unfortunately. But I know more about businesses than I knew 20 years ago or 40 years ago.

However, I haven't really changed the principles. The basic principles are still Ben Graham. They were affected in a significant way by Charlie and Phil Fisher in terms of looking at the better businesses. But I didn't leave Graham behind on that. I really haven't learned any new *fundamental* principles, although I may have learned a little bit more about how businesses operate over time....

You ought to get an investment framework that, in my view, comes straight from *The Intelligent Investor* and from Phil Fisher — more from *The Intelligent Investor* actually. And then I think that you ought to learn everything you can about industries and businesses where you think you have the ability to get your mind around them if you work at 'em.

And with that arsenal, you'll do very well — if you've got the temperament for the business. Charlie?

If you don't keep learning, other people will pass you by.

**Munger:** Yeah. Well of course, I've *watched* Warren all these decades. And he's learned a hell of a lot — even in the last 20 or 30 years. It's a game of continuous learning. And he can denigrate the recently achieved skill that enables him to invest outside the U.S., for instance, in the biggest oil company in China, or this or that. But those basic principles that he knew a long time ago, unaided by later-acquired knowledge, wouldn't have given him the ability to make various recent investment decisions as well as he's made them.

It's a lifelong game. And if you don't keep learning, other people will pass you by.

Most important is temperament, but it takes more....

**Buffett:** I'd say temperament, though, still is the most important thing — wouldn't you, Charlie?

**Munger:** Yes, of course. But temperament alone won't do it.

**Buffett:** No, temperament alone won't do it.

**Munger:** You have to have the temperament and the right basic idea — and then you have to keep at it with a lot of curiosity for a long, long time.

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BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
(cont'd from preceding page)

YOU DON'T HAVE TO BE A ROCKET SCIENTIST.  
AND HERE'S A SIMPLE TRICK THAT HELPS....

You didn't need an 180 I.Q. to understand PetroChina.

**Buffett:** But you don't have to be blindingly smart or have any blinding insights or have a high I.Q. to look at a PetroChina, for example.

**Munger:** No.

**Buffett:** When you get a company that is producing 2-1/2 million barrels a day, that's 3% or more of the world's oil production, and they're selling based on U.S. prices using WTI (West Texas Intermediate) as a base price, and where they have a significant part of the marketing and refining in a country where the tax rate's 30% and they say they're going to pay out 45% of earnings to you in dividends, and they don't have unusual amounts of leverage — if you're buying something like that at well under half, or maybe a *third*, of what comparable oil companies are selling for, it's not rocket science.

You have to be willing to read the reports. But I *enjoy* doing that. However, you wouldn't say that requires any high level insights or anything, Charlie?

But common sense in investing is anything but common.

**Munger:** Well, when you were buying that block of stock, nobody else to speak of was buying it.

**Buffett:** Thank heavens.

**Munger:** So the insights can't have been all that common. No, I think that takes a certain amount of what an old Omaha friend used to call uncommon sense. He used to say, "There is no such thing as common sense. When people say 'common sense', what they mean is 'uncommon sense'."

[Editor's note: Of course, long-time *OID* contributor and living legend John Templeton has said the same thing.]

Part of it is about being able to tune out folly.

**Munger:** And part of that, I think, is being able to tune out folly, as distinguished from recognizing wisdom. You've got whole categories of things you just bat away so your brain isn't cluttered with them. That way, you're better able to pick up a few sensible things to do.

**Buffett:** Yeah, we don't consider many *stupid* things. I mean, we get rid of 'em fast. In fact, people get irritated with us because they'll call us, and when they're in the middle of the first sentence, we'll just tell 'em, "Forget it." We can see it coming.

That's how the best chess players do it....

**Buffett:** That's the way, actually the mind works. There was a great article in the *New Yorker* magazine about 30 years ago — maybe a little more than that — when the Fischer/Spassky chess matches were going on. And it got into this speculation of whether or not humans would ever be able to take on computers in chess. Here were these computers doing hundreds of thousands of calculations a second. And the article asked, "When all you're really

looking at is the results from various moves in the future, how can a human mind deal with a computer that's thinking at speeds that are so unbelievable?"...

Well, it turns out a mind like ... that of a Fischer or a Spassky essentially was eliminating about 99.99% of the possibilities without even *thinking* about 'em. So it wasn't that they could outthink the computer in terms of speed, but they had this ability of what you might call "grouping" or "exclusion", where essentially they just got right down to the few possibilities out of these zillions of possibilities that really had any chance of success.

Charlie and I can hang up very fast....

**Buffett:** Just getting rid of the *nonsense* — just figuring out that if people call you and say, "I've got this great, wonderful idea", you don't spend 10 minutes once you know in the first sentence that it *isn't* a great, wonderful idea.... Don't be polite [laughing] and go through the whole process. Charlie and I are pretty good at that. We can hang up very fast. [He chortles.]

**Munger:** Well, there you have it. All you've got to do is go at it in the way that Vassily Smyslov did when he was the world champion of chess — and just do the same thing in investments.... [Audience laughs.]

ASSET ALLOCATION? THAT'S PURE NONSENSE.  
THE BEST WAY TO MINIMIZE RISK IS TO *THINK*.

The best way to minimize risk? It's to think.

**Shareholder:** I'd like you to elaborate on asset allocation and capital allocation from a risk management perspective. Wall Street and financial planning firms charge a lot of money for their asset allocation models — in which they advise clients to allocate say, 50% in stocks, 40% in bonds, etc. I know that you take a more opportunistic approach to building your portfolio and managing risk....

Please elaborate as to how you use price and value as a tool of risk management and asset allocation, as opposed to coming at it with a preconceived idea of how much should be allocated to each asset class.

**Buffett:** We think the best way to minimize risk is to *think*. And the idea that you say, "I've got 60% in stocks and 40% in bonds" and then have a big announcement that "now we're moving our allocation to 65/35" as some strategists, or whatever they call 'em on Wall Street, do — that's pure nonsense. I mean, 60/40, or 65/35 — it just doesn't make any sense.

What you *ought* to do... Your default position should always be short-term instruments. And whenever you see anything intelligent to do, you should *do* it. You shouldn't be trying to match up with some arbitrary goal....

The folks at Google don't need Wall Street experts.

**Buffett:** I was reading an article yesterday, I think it was, about the two fellows at Google and all of the problems they're going to have because they're each going to get a few billion dollars. It made me want to send a *sympathy* card. I almost went down to the Hallmark store because this article went on about how they've got this terrible problem and that terrible problem and they're going to need lawyers and they're going to need financial advisors.

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BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
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Well, the fact is that they really don't need *anybody*. Those guys are smarter [chuckling] than the people that are coming to them. They do not have a big problem. And they're *very* capable of thinking it through themselves.

Investors need Wall Street strategists? That's a lot of bull.

**Buffett:** The people that have the problem are the people who want to sell their services to them, and are going to have to *convince* them that they have a problem. [He chuckles.] But when you talk about asset allocation or something like that, so much of what you see is just merchandizing. It's a way to make you think that if you don't know *how* to determine whether it should be 60/40 or 65/35 that you need these people.

Well, in reality, you don't need 'em at *all* in investing. Most of the professionals who tell you you're going to get in great trouble unless you listen to them and sign up for their services — you know, they're good at selling, but...

That's what my former brother-in-law who worked at the stockyards used to say. People would bring in cattle. And I'd say to him, "How do you get the farmer to employ *you* to sell to Swift or Armour or Cudahy instead of the guy right next to you? I mean, a cow is a cow. And Armour's going to buy it the same way." And he gave me this disgusted look and said, "Warren, it's not how you *sell* 'em, it's how you *tell* 'em." Well, [chuckling] there's a lot of that in Wall Street. Charlie?

Best way to make money from predictions? By selling 'em.

**Munger:** Yeah, people have always had this craving to know the future. The king used to hire the magician or the forecaster — and he'd look in sheep guts or something for an answer as to how to handle the next war. So there's always been a market for people who purported to know the future based on their expertise.

There's a *lot* of that still going on. It's just as crazy as when the king was hiring the forecaster who looked at sheep guts. If people have an economic incentive to sell some nostrum, it can be sold over and over and over again.

Absence of value added in the financial area is disgusting.

**Munger:** The really interesting figures are when you look at the underperformance of the market by the mutual fund industry, which is probably a couple of points per annum — and that *understates* it. And if you take all of those investors in mutual funds who are constantly being whipsawed from one fund to another by a bunch of brokers who want commissions, you now take a performance that's already subnormal and it goes down another three or four percentage points due to the shuffling of the mutual fund investments.

So the poor guy in the general public is getting a terrible result from consulting the experts. And these guys are heading the scout troop and the community chest drive and are locally reputable people. I think it's disgusting.

It's much better to make a living by being part of a system that delivers value to the people who are buying the product. However, nobody seems to refrain from creating gambling casinos or the equivalent based on my sort of

reticence. If it'll work to make money, why, we tend to do it in this country.

[Editor's note: Despite being unabashed fans of free enterprise, we can't help but add a hearty amen.]

HEDGE FUNDS ARE THE LATEST FAD —  
AND FOR INVESTORS, FADS DON'T END WELL.

Wall Street will sell what it can. Today, it's hedge funds.

**Shareholder:** Do you think it makes sense for individual investors to invest a part of their capital in hedge funds, or funds of hedge funds, somewhat like the \$600 million investment Berkshire made in Value Capital?

**Buffett:** You don't get smarter because you're running something called a "hedge fund" or something called "private equity" or something called an "LBO fund" or what have you. But what you *do* gain periodically is the ability to better *merchandise* those things. There are fads in Wall Street. And Wall Street will sell what it can sell. Just remember that. It's one of the most important things you should remember in investing.

And the hedge fund right now is in the midst of being a huge fad.

In aggregate, hedge fund investors will get a bad result.

**Buffett:** It's distinguished not by the ability to make more money, but by the extraordinary amount of *fees* that are collected. And believe me, if the world has \$600 billion of money paying 2% fees and a percentage of the profits, and the losers go out of existence and the winners continue for a while and take extra money from investors in good years and don't return it in bad years, it is not going to be a great experience in aggregate for investors.

Obviously, there are a few smart, honest people out there running hedge funds — and they will do quite well. But I'd say people now investing in hedge funds in aggregate are going to be disappointed — because if they buy them across the board, they're going to get a bad result in my view.

[Editor's note: Incidentally, Century Management's Arnie Van Den Berg has told us exactly the same thing — that it was the current fad and that it would not end well. And since *I'm* getting tempted to start a hedge fund myself, we know that he and Buffett are right.]

I think it's a basically unfair arrangement....

**Munger:** Yeah. Why would you want to invest with a guy whose basic thought process runs something like this: If a second layer of fees on top of a first layer of substantial fees is good for an investor, then a *third* layer of fees must be better yet. [He stifles a laugh.] Why would you invest with somebody with a proposition like that?

**Buffett:** Yeah. Just the idea of taking 2% plus percentages on top of that... It may be what the traffic can bear — Collis P. Huntington style — but that reflects an attitude toward people that we tend to regard as partners (the investors) that I just think is basically unfair. And, in general, I think it's a mistake to get in with people who propose unfair arrangements.

In effect, they're probably getting four times standard fees to *begin* with. And then on top of that, they say, "We

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BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
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want part of the action." And I'd guess that in many of those cases, they don't have all of their own money in the fund themselves. Maybe they have a substantial sum outside.

Our partnerships were similar, but our attitude was not.

**Buffett:** Charlie and I both ran partnerships in the '60s — and the '50s with me and into the '70s with him — that would generally be classified as hedge funds. They had somewhat similar compensation arrangements, although not like they are now. They had some similarities. But I don't think we had the attitude toward the people we were asking to join us that the present managers have.

And as Charlie said, the fund-of-funds-type stuff... It's really sort of *unbelievable* how they just pile on layer after layer of costs. It doesn't make the companies that are underlying these stocks they buy any better. And believe me, people don't become a genius just because they're in some office that says "hedge fund" on the door. What they may be very good at is *marketing*. In fact, if they're good at marketing, they don't have to be good at anything else.

[Editor's note: And putting "financial newsletter" on the door doesn't help either....]

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AS YOU KNOW, WE DO BUILD IN A MARGIN OF SAFETY.  
THAT SAID, WE TRY NOT TO GET CARRIED AWAY.

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Charlie calls an audible....

**Shareholder:** Mr. Buffett and Mr. Munger, when you assess a business and derive its intrinsic value, how do you estimate the future growth of the business — and how do you decide what margin of safety to use?

**Buffett:** Future growth and what, Charlie?

**Munger:** Well, I had difficulty understanding that question fully. He's asking how we combine our estimates of future growth with our passion for having a margin of safety. Surely you can handle that. [Shareholders laugh.]

**Buffett:** Well, I can certainly handle it as well as *you* can. [He and Munger laugh.] Every time he laterals 'em off to me, he calls those "audibles".

Graham's simple formula worked, but the supply dried up.

**Buffett:** I think you take all of the variables and calculate 'em *reasonably* conservatively — but you don't try and put too much windage in at every level. And then when you get all through, you apply the margin of safety. So I would say don't focus too much on extreme conservatism on each variable in terms of the discount rate and the growth rate and so on; but try to be as realistic as you can on those numbers, with any errors being on the conservative side. And then when you get all through, you apply the margin of safety.

Ben Graham had a very simple formula he used for just the most obvious situations, which was to try and buy things at a third of working capital. And overall that

worked for him. But that method ran out of steam when the sub-working-capital stocks disappeared.

We think about investing like we think about insurance....

**Buffett:** But it's the same thing we do in insurance. If we're trying to figure out what we should charge for, say, the chances of a 6.0 earthquake in California, we know that in the last century I think there've been 26 or so earthquakes in California that registered 6.0 or greater. And let's forget about whether they occur in remote areas. Let's just say we were writing a policy that paid off on a 6.0 or greater quake in California, regardless of whether it occurred in a desert and did no damage. Well, we would look at the history and we'd say, "Well, there've been 26 in the last century."

And we would probably assume a little higher number in the next century. That'd just be our nature. However, we wouldn't assume 50 — because if we did, we wouldn't write any business. But we might assume a little higher. If I were pricing it myself, I'd probably say, well, I'll assume that there are going to be 30 — or maybe 32 or something like that.

And then when I'm all through, I'll want to put a premium on it that incorporates a margin of safety. In other words, if I were to figure that the proper rate for 32 was \$1 million, I would probably want to charge something *more* than \$1 million to build in that margin of safety. But I want to be conservative at all the levels — and then I want to have that *significant* margin of safety at the end.

And as I understand the question, that would be my answer. Charlie, do you want to answer that?

We don't play lottery tickets. And you don't have to either.

**Munger:** Yeah. That book, *Deep Simplicity*, that I recommended to you says that you can predict out of those 26 earthquakes how the size is likely to be allocated. In other words, there's a standard power law that will tell you the likelihood of earthquakes of various sizes. And of course, the *big* earthquakes are way less likely to occur than the small ones. So you count the math, you know the applicable power law, and you guess as to how much damage it's going to cause. It's not that difficult.

**Buffett:** It becomes *more* difficult if somebody says they really want to protect against a 9.0 or something like that. Then, is it one in 300 years, or one in 1,000 years — when you get really off the data points? But that's not what you're looking at in investments. You don't *want* to look at the things that are that... You don't want to come up with companies where you make the assumptions that get that extreme in terms of their projected growth rate.

And you don't have to. That's the beauty about potential investments. You only have to look at the ones you feel capable of evaluating — and you skip all the rest.

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PROJECTING OUT RAPID GROWTH FOR LONG PERIODS  
HAS COST INVESTORS VERY, VERY LARGE SUMS.

The Petersburg Paradox....

**Shareholder:** My question is on business valuation and growth. In one of your letters, you mentioned a discounting formula — owner earnings divided by the difference between the discount and the growth rate.

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BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
(cont'd from preceding page)

However, if the growth rate is larger than the discount rate, and if we use this formula, then we get a negative number. And one way around this is to have two growth stages — the first with high growth and the second with low growth. The second way is to estimate how much the earnings will be in the third year for the company, and then multiply this estimate by the average P/E to get the price in the 10th year.

I don't know which of those methods you use, if either. But either way, how do you estimate how much a company is worth if the growth rate is larger than the discount rate?

**Buffett:** Well, you put your finger on an interesting mathematical relationship — because if you're using a present value discount formula and you use a growth rate higher than the discount rate, as you have postulated, the answer, of course, will be infinity. And there are a lot of managements around who like to think their stocks are worth infinity, but we haven't found one yet. [He laughs.]

That precise subject was covered decades ago in a paper called the "Petersburg Paradox" by a fellow named Durant....

[Editor's note: The article Buffett's referring to is "Growth Stocks and the Petersburg Paradox" — written by David Durant in 1952.]

**Buffett:** And somewhere we probably have a copy at our office. My guess is if you go to Google, and you put in the name "Durant" and you put in "Petersburg", you may be able to call up that article — although they aren't necessarily terrific on old articles. So if you'd like it, if you let somebody know in our office, we'll look around and see if we can find that article.

Projecting high growth way out has cost investors big-time.

**Buffett:** But it gets very dangerous to project high growth rates out over long time periods — because you get into this paradox. If you say the growth rate of a company is going to be 9% between now and judgement day, and you use a 7% discount rate, you get to a value equal to infinity. And that's where people get in a lot of trouble.

The idea of projecting out extremely high growth rates for very long periods of time has caused investors to lose very, very large sums of money.

Just take a look at the Fortune 500. Go back 50 years — they're commemorating that — and look at the companies that were there, and how many have really maintained rates much above 10%. That's not an easy hurdle. And when you get up to 15%, you're in a very rarefied atmosphere. So there's a real danger in projecting out high growth rates.

It's an unsuccessful practice. And that's why we don't do it.

**Buffett:** Charlie and I will very seldom — well, virtually *never* — assume a growth rate in the high digits. Again, you can lose a lot of money doing that. You may miss an opportunity sometime, but I haven't seen people who've been consistently successful doing that. And you do run into this paradox you mentioned. Charlie?

**Munger:** Well, you're obviously right when you get a mathematical result that is infinity to back off and realize

that can't happen. And of course, what people do is they project that the growth rate will decline and, indeed, eventually stop — and then you get more realistic numbers. What else could anyone do?...

DERIVATIVES LEND THEMSELVES TO MISCHIEF.  
FOR EXAMPLE, TAKE FREDDIE MAC...

It's fascinating to look at something like Freddie Mac...

**Shareholder:** I'm concerned about the future of America for a number of different reasons: the accumulating government and personal debt; the continuing stock buybacks which benefit the top executives; the insanity of derivatives; and the overpriced market with its insane P/E. Any comments?

**Buffett:** Which one do you want us to comment on? You only get one question. [Buffett laughs.]

**Shareholder:** Derivatives.

**Buffett:** Well, Charlie and I have expressed ourselves on derivatives. We don't think the probability in any given year is necessarily very high that derivatives will either lead to or greatly accentuate some financial trauma — but we think the likelihood of trouble is there....

It's fascinating to look at something like Freddie Mac, where you had an institution that many, many dozens — perhaps even *hundreds* — of financial analysts were looking at. You had an oversight office. You had a creature that was created by Congress, presumably with committees that would be interested in their activities. You had on the board two of the smartest and highest grade people that you could have in terms of fixed-income markets in Marty Leibowitz and Henry Kaufman — and a bunch of other very good directors, too.

Yet with an auditor present, they managed to misstate earnings by some \$6 billion in a fairly short period of time — which is real money in *any* place. Now all of that wasn't accounted for by derivatives, but a very large portion of it was facilitated by activities in derivative instruments.

Derivatives just naturally lend themselves to mischief.

**Buffett:** Now, you can look at the Freddie Mac annual report for 2001. And you can read the footnotes; you can read the auditor's certificate; you can look at a bunch of high-class, very smart directors; and you can be comforted by the fact that dozens of people on Wall Street who were paid just to follow relatively few stocks were studying this, and that they had conference calls all of the time. But in the end, what happened? It was \$6 billion — and it probably could've been \$12 billion. A lot of mischief can happen with derivatives.

And as we've pointed out, Charlie and I have seen it happen. When there's a derivative transaction, particularly a complicated one, trouble lurks. People will probably not get in big trouble on the plain vanilla ones. But when you have a complicated derivative transaction and a trader at investment house A is on one side and a trader at investment house B is on the other side — and they record a transaction which has to be a zero sum game between the two of them — *both* put a profit on the books that day. I've never seen a

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BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
(cont'd from preceding page)

case where they both put on a loss that day. This naturally lends itself to mischief. How could it be otherwise?

HUGE TRANSACTIONS, ONLY VAGUELY UNDERSTOOD,  
ARE BOUND TO CREATE HUGE POTENTIAL PROBLEMS.

Managements don't understand the derivatives they own.

**Buffett:** And the *scale* is absolutely huge — and getting larger all the time. I know the managements of some of the companies with big derivative activities. And they do not have their minds around what is happening. We didn't have our minds around what was happening at Gen Re Securities. We *tried* to get our minds around it, but we couldn't do it. And that was far from the most extensive or complicated derivative operation around.

We had the same experience at Salomon. But whatever the figures were at Salomon, they would be a great multiple of that today. And there was a Sunday in 1991 when we had our lawyers preparing bankruptcy papers at Salomon. And if the Treasury hadn't reversed itself, we would've found a judge someplace in Manhattan — he probably would've been watching baseball and eating popcorn — and we would've walked up to his door and said, "Here is the situation with Salomon. There are these \$1.2 trillion of derivative contracts that the guy on the other side thinks are good that *aren't* going to be any good. And it's your baby."

Financial world operates on a hair trigger to some extent.

**Buffett:** A lot of things correlate in the securities world that people don't *expect* to correlate. And there are people following similar strategies all over the world, as happened when Long-Term Capital had its problems. The financial world operates on a hair trigger to some extent. People want to jump the gun and move just ahead of the other fellow.

And when you get *huge* amounts of transactions which many people only vaguely understand, you're creating a potential huge problem that may come about because of some other exogenous event that triggers defaults on a huge scale. And that can be very disruptive to financial markets. So we think derivatives are dangerous as currently used in society.

We use them ourselves, incidentally — we get 'em collateralized. We've made money off of 'em. But I would predict that some time in the next 10 years, you will have some very big problems either caused by, or accentuated in a big way by, people's activities in derivatives.

And sophistication won't save you. It's best to just say no.

**Munger:** Yeah, I think part of the trouble resulted because people didn't think enough about the consequences of the consequences — about what are commonly referred to as unintended consequences. And that's a common error. You start trying to hedge against interest rate changes — which is a very complicated thing to do when you've got a mortgage portfolio where people have options to pay the mortgages off early.

And then under the accounting conventions, the hedges started making the quarterly results lumpy instead of nice and regular the way all the institutional analysts like them. So then you use *another* bunch of derivatives to smooth out the results. Well, now all of a sudden you've morphed into lying.

And it's complicated enough to start with, but when you add lying to the process, it's a mad hatter's tea party. And yet, this happens with eminent directors of vast financial sophistication sitting on the board. It shows that the sophistication won't save you. Somebody just has to have the common sense to say, "We're just not *going* there. It's too tough."

RISK MAY HAVE BEEN DISPERSED BY DERIVATIVES,  
BUT IT'S BEEN INTENSIFIED BY THEM EVEN *MORE*.

It was bonkers at Salomon. The accountants sold out.

**Buffett:** Charlie was on the audit committee at Salomon — and his presence changed it into six and seven-hour meetings. I think you found mismarks that were in the tens of millions of dollars on a single contract in a place with tens of thousands of contracts. Isn't that correct?

**Munger:** I think it's fair to say that it was bonkers and that the accountants sold out.

If you reward mismarks, then mismarks will be created.

**Buffett:** It's interesting stuff. If you feel in kind of a nasty mood, you might go to a shareholders' meeting of some company that has very large positions in derivatives and grill the CEO a little bit about some of the more esoteric transactions. They get *very*, very complicated. They get *mind-boggling* in terms of trying to figure out the consequences.

And the one thing you can be sure of is that the trader that puts them on will certainly want to mark them at a profit either immediately or within a year or two — because he gets his bonus based on the figures for that year, and he'll be gone in 20 years (because some of these are very long-dated). So the trader will be gone when the consequences fall to the firm.

Any time you have incentives to mismark things with people who are quite smart, you're going to get mismarks — or temptations to take on risk in an inappropriate manner.

They're designed to disperse risk, but they intensify it.

**Buffett:** Originally, with derivatives, the argument was made that it would disperse risk — because Coca-Cola faced foreign-exchange risk or some bank faced interest-rate risk. And the theory was that you would use these derivatives to spread risk around the system. And indeed, there are many people that make that argument now.

I would say that they may work in that manner a great percentage of the time, but the time that counts is when the system has *intensified* risk — and placed *enormous* credit risk on very, very few institutions.

Believe me, Coca-Cola is in a better position to accept foreign-exchange or interest-rate risk in a year than some derivatives dealer who has tons of positions on. And I think actually there is much more risk in the system because of derivatives than the proponents of derivatives would say has been *dispersed* because of the activities....

(continued on next page)



BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
(cont'd from preceding page)

I DON'T THINK WELLS IS A BIG PLAYER IN DERIVATIVES.  
AND I TRUST THEM TO HANDLE THE RISK THEY DO TAKE.

I don't think of Wells as being a big player in derivatives.

**Shareholder:** The quarterly report of the OCC [Options Clearing Corporation] on bank derivatives shows that Well Fargo has one of the largest derivatives portfolios of any U.S. bank. In spite of your high profile criticism of derivatives, Berkshire added to its position in Wells Fargo last year. What about Wells Fargo's derivatives portfolio did you find less objectionable, and what disclosure did you examine in considering the risks associated therewith?

**Buffett:** I don't have their report here. But without looking at it, I'd be willing to bet that JPMorgan Chase has a derivatives portfolio that's far, far greater than Wells. I may be wrong, but I do not think of Wells Fargo as being a big player. Now, all of the big banks have various derivative positions. But I don't think of Wells as being a big player in the derivative game.

Also, stated values of derivatives can be misleading...

**Buffett:** And there is no perfect measurement of the size of a derivative position. You hear all of these huge numbers thrown around. And while they may sound great, they tend to exaggerate things in a very dramatic way — because they're often stated in the trillions of this or that. But a \$1 billion notional amount of *one* kind of derivative can have less danger in it than a \$50 million position in some other type.

However, again, I really don't think you'll find that Wells — particularly compared to a JPMorgan Chase or a Citibank or something of that sort — is a very big derivatives player.

And Wells is an extraordinarily well-managed bank.

**Buffett:** I think — and I believe that Charlie will agree — that Wells is an *extraordinarily* well-managed bank. I disagree with them violently on the expensing of stock options. I mean, Dick Kovacevich, who runs that, and I would have an entirely different opinion. He's written about it in the last couple of annual reports. And as much as I think of management... I admire Wells' management,

(continued in next column)

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I really do. I think he's done a *great* job. But as much as I admire their management, I voted our Berkshire stock the other way for expensing options. And I noticed that 57% of the stock at their meeting just the other day voted to expense options.

But even though I disagree with him on that particular accounting point, Wells has an absolutely terrific record. Dick is a terrific businessperson. And I think in terms of handling the risk that he necessarily takes, I think that I'd rank him *way* up there in terms of bank managers. Charlie?

**Munger:** I've got nothing to add to that.

OVER TIME, THE BETTER SYSTEM WINS.  
THE LOW-COST MODEL IS THE WAY TO BET.

The origins of USAA...

**Shareholder:** Mr. Buffett, you have said that the nine most important words ever written about investing are: "Investment is most intelligent when it is most businesslike." [Ed. note: From Ben Graham's classic, *The Intelligent Investor*.] Mary Buffett also said you have built your entire business success upon these nine words.

For this reason, I started Businesslike.Com, looking up to GEICO and Dell as direct marketing models since they have the lowest cost structure. Please kindly share with us in elaborate detail the direct marketing methods of GEICO and your friend, Michael Dell.

**Munger:** [After a long pause] He wants you to analyze the direct marketing methods of GEICO and Dell.

**Buffett:** Yeah, well I'm not as familiar with Dell as I am with GEICO. The idea of direct marketing in auto insurance at GEICO came from Leo Goodwin and his wife, Lillian, who had come from USAA which had been set up some years earlier. GEICO was set up in 1936; USAA was set up, I believe, in the early '20s, because military personnel moved around a lot and had *trouble* getting auto insurance. Thus a great organization was established.

Leo Goodwin took that idea and decided to broaden it beyond the officer ranks of the military. And he first went to government employees generally — and now that's been extended dramatically over the years to the American public as a whole. It's a better system.

Auto insurance used to be a sideline business.

**Buffett:** By way of background, when auto insurance first came in about 100 years ago, it was sold by the casualty affiliates of the big fire insurance companies, which were the major insurance companies at the time. Casualty insurance was something that came along later. And it was sold through a system whereby the agent got large commissions, where there were sort of cartel-like rates established through something called The Bureau. And that system prevailed for several decades.

Enter one better mousetrap after another...

**Buffett:** And then State Farm came along, which was formed in the early 1920s by a farmer from Merna, Illinois in his 40s. He had no background in insurance and no

(continued on next page)



BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
(cont'd from preceding page)

capital, but he came in with the idea of having a *captive* agency force. And that brought down costs somewhat. And State Farm in time became the largest auto insurer in the country. And Allstate, which followed that system, became the second largest. In effect, that was a better system — a better mousetrap.

And then USAA, followed by Leo Goodwin at GEICO, came along with a *direct* marketing operation that bypassed the agent and brought costs down further.

Better systems (like GEICO's and Progressive's) win.

**Buffett:** Now every American family, virtually, wants to have a car. They don't want to have insurance, but they can't drive the car without insurance. So they're buying a product they really don't like very well. It costs them a significant part of their family budget. Therefore, cost becomes very important. It's not a luxury item — it's a mandatory item, virtually. And saving significant money makes a real difference in a lot of household budgets. So the low cost is going to win.

And Progressive has a wonderful direct operation competing with us — we're the two that will be slugging it out over the years. And that's because direct is a better system. And over time, better systems win.

Low-cost model is usually one for a very good business.

**Buffett:** Now again, I'm not that familiar with Dell. But I have the impression that Dell is a *very* low-cost operation that's enormously efficient with very low amounts of inventory. And I'd hate to compete with them. If they turn out a decent competitive product at the best price, that system will win.

You know, Charlie is a director of Costco which, along with Wal-Mart, figured out ways to provide things that people need and spend big money on at lesser costs. And those two companies are winning.

So we have a terrific marketing operation — and a terrific *insurance* operation — in GEICO. And in my view, it will grow very, very substantially. And we have a very tough competitor in Progressive because they've seen how well our model works, and they, in effect, have shifted over — I mean, not *totally* over, but they've moved — towards a direct operation and away from an agency operation.

It's always a good idea to go with a low-cost producer over time. You can mess it up in other ways. But being a low-cost producer of something that's essential to people is going to be a very good business usually. Charlie?

**Munger:** Yeah. You've chosen a wonderful field. And if you fail in it, it's your own fault. [Audience laughs.]

**Buffett:** Yeah.

Imitation Quotation is the sincerest form of flattery....

**Buffett:** I should say, also, that those nine words came from Ben Graham. They didn't come from me. But they are very important words, although they tie in with some other things he said. They're very important words.

**Munger:** Warren, I want to make an apology, too, because last night I observed that some of our modern

business tycoons, and I remembered particularly Armand Hammer, were the type that when they were talking, they were lying — and when they were quiet, they were stealing. [Audience laughs.] And some people got the impression that that was *my* witticism. Well, that was said a great many decades ago about one of the robber barons.

**Buffett:** Well, if we start confessing here to the number of quotations we've stolen, we'll be here all day. [He and Munger laugh.] So let's go on....

INCENTIVES HAVE BEEN NO SMALL PART  
OF NATIONAL INDEMNITY'S GREAT SUCCESS.

We know our underwriting incentives are very important.

**David Winters:** Have you altered the compensation potential for insurance underwriters to make sure — as Charlie has described — incentive-caused bias creates an environment that encourages writing new policies in the property and casualty business that minimize losses and maximize float for Berkshire, while compensating them for not writing business when the tide goes out again?

[Editor's note: Of course, long-time *OID* contributor David Winters is the portfolio manager of the Mutual Shares and Discovery Funds and co-portfolio manager of the Mutual Beacon and European Funds as well as being chief investment officer of Franklin Mutual Advisers.]

**Buffett:** ...That's a very important — *very* important — point you raise. We are very big in insurance. And having the wrong incentives in place could be very harmful.

We left a sinking ship to board a ship to the New World.

**Buffett:** Shortly before we bought National Indemnity, our balance sheet ... had just a few million dollars extra. We had about \$20 million tied up in the textile business.

And then I heard that Jack Ringwalt wanted to sell his company. Some of you here in the audience knew him. For 15 minutes every year, Jack would feel like selling his company. He would get mad at something or other. And so my friend Charlie Heider knew Jack pretty well. And I'd said to him, "The next time Jack is in heat, get him over here." And so Jack, early in 1967, came by at 11:30 or 11:45 in the morning and said he'd *had* it with insurance, with the insurance regulators and everything, and he'd like to sell. So we bought it....

That's when we really embarked. In the following year, the textile business made all of \$55,000. So sticking with textiles would not have been a great idea. And we spent \$8-1/2 million to buy National Indemnity....

National Indemnity's volume has doubled five times since.

**Buffett:** I don't think there's another insurance company in the *world* that has a record like National Indemnity has in terms of the premium volume growth in its traditional business....

By 1980, the company had \$79 million of annual premiums. (If you go all the way back to the time we bought it, it was \$16 million — but by 1980, we were up to \$79 million.) And in what was known as the hard market of the mid-'80s, we got premiums up to \$366 million.

And then we took it down — not intentionally, but just because the business became less attractive — all the way

(continued on next page)



BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
(cont'd from preceding page)

from \$366 million to \$55 million. And now the market's become more attractive in the last few years, and it's soared up to almost \$600 million.

But it's critical to let employees know what really counts.

**Buffett:** I don't think there's another public company in America that'd feel it could endure a record of volume going down like it did for us year after year after year. But that was the culture of National Indemnity. It was the culture starting with Jack Ringwalt, and the culture all the way through several other managers — from Phil Liesche and Rollie Miller to Don Wurster, who's done a fabulous job. So we don't worry about premium volume.

National Indemnity could write a billion dollars worth of business in any month it wanted to. All it has to do is offer silly prices. If you offer a silly price, brokers will find you in the middle of the ocean at four in the morning. Well, you cannot afford to do that. But if you're not going to worry about premium volume going down, and you're going to let your people lose their jobs when premium volume goes down, then a silent message has gone out to your employees that unless they write a lot of business, they're going to lose their jobs.

To avoid this result, what we have always told people in our insurance businesses generally — and specifically at National Indemnity — is that if they write no business, their job is not in jeopardy. We cannot afford to have our unspoken message to employees be that they either have to write business, or their job — or the job of the guy sitting next to them — may be lost.

So when we bulged up to \$366 million, employment went up modestly. And when we went all the way down, employment only trickled downward, all by attrition. We never had a layoff during that period. Other people would've — but we didn't. And now we're going back up some. And we'll go back down again at some time in the future.

We can afford high overhead; we can't afford bad business.

**Buffett:** But that policy created an expense ratio that went up dramatically — to as high as 41% in 1999 — as volumes shrunk back. And when we were writing a lot of business, our expense ratio was as low as 25.9%.

Now, some companies would feel that that sort of cost fluctuation was intolerable. But what we feel is intolerable is writing bad business. And again, we can take an expense ratio that's out of line, but we can't afford to write bad business. For one thing, if you get a culture of writing bad business, it's almost impossible to get rid of. So we'd rather suffer having too much overhead than teach our employees that to retain their jobs, they need to write any damn thing that comes along — because that's a very hard habit to get rid of once you get hooked on it....

And here's how that policy has worked out....

**Buffett:** Now, as a result of our policy, we had a few bad years in the early '80s. That's what led to that hard market. But even with a high expense ratio, we made money underwriting in virtually every year. In 2001, our combined ratio was 108.4. However, in my view, that will

come down. I think that'll turn out to be quite a good year. That year isn't fully developed yet.

Now, in 1986, we had this incredibly good year when we wrote at a combined ratio of 69.3. That's a 30% underwriting margin. And something else that's nice about it is we did it with the most volume we ever had to that point — \$366 million. So we coined money when we wrote huge amounts of business, and we made a little money when we wrote small amounts of business with high business-acquisition costs.

IN COMPENSATION, ONE TYPE DOESN'T FIT ALL.  
EVERY INDUSTRY/SITUATION IS DIFFERENT.

More important than our expense ratio is our message....

**Buffett:** So it's absolutely imperative in our view — and I think we're almost the only insurance company, certainly that's public, in the world that does it — to send the absolutely unequivocal message to those associated with us that they'll never be laid off because of lack of volume. We don't want 'em to write one bit of bad business.

Granted, we will make mistakes. And we'll have a high expense ratio when business is slow. But we'll win the game. And that's what National Indemnity has done over a period of time.

The result has been a record that left others in the dust.

**Buffett:** National Indemnity was a no-name company 30 years ago, operating through a general agency system which everybody said was obsolete. It had no patents, no real estate, no copyrights, no *nothing*, that distinguished it from dozens of other insurance companies that could do the same thing.

But they have a record almost like no one else's because they had discipline. They really knew what they were about. And they've stayed with that. In fact, they've intensified it over time. And their record's left other people in the dust.

It wouldn't be a record that would impress Wall Street. If you went to Wall Street with that record alone in 1990 or 1995, they'd say, "What's wrong with you?" But the answer is *nothing's* wrong with it.

It's all about tailoring policies to the specific situation.

**Buffett:** We have the incentives in place to write the right kind of business for the shareholders at Berkshire. We try to think those things through. You can't run an auto company without having layoffs. You can't run a steel company this way. However, this is the right way to run an insurance company.

And that's why these cookie-cutter approaches to employment practices, bonuses and all that are *nonsense*. You have to think through the situation that faces you in a given industry with its given competitive conditions, economic characteristics and so forth.

It's obvious, but nobody else does it....

**Buffett:** Charlie, do you want to come in on that?

**Munger:** Well, the main thing is that practically nobody else does it. And yet, to me, it's obvious that it's the way to go. There's a lot in Berkshire that is like that. It's just a little different from the way other people do it.

(continued on next page)



BERKSHIRE HATHAWAY'S  
WARREN BUFFETT & CHARLIE MUNGER  
(cont'd from preceding page)

It's partly the luxury of having a controlling shareholder with strong opinions that accounts for this. It would be hard for a committee — including one consisting of a lot of employees — to come up with these decisions....

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AMERICAN BUSINESS HAS NEVER LET INVESTORS DOWN. HOWEVER, THEY'VE DONE THEMSELVES IN FREQUENTLY.

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A softball question?

**Shareholder:** A couple of weeks ago, I was talking to a former manager of the Fidelity Magellan Fund who managed huge amounts of money. And he never met you. And I told him I may have a chance to ask Warren Buffett and Charlie Munger a question. What should that question be? I wanted to have some idea of something intelligent I could ask business-wise.

And he thought if he had the opportunity to talk to you, the best thing is to give you what would sound like a softball question: because you could maybe bring more profundness to this than we usually hear.

In view of the Iraq war, increasing consumer debt, declining job growth, declining pay in the jobs that are growing, prospects of increased interest rates, he has this view that the next five to 10 years are going to be very difficult. What would your view be about the investment future for the next five to 10 years in view of all these negative factors going on?

**Munger:** That one's too soft for me. I think Warren should take that one. [Buffett cracks up.]

You can always find positives and negatives....

**Buffett:** Well, I would say that at any given point in history — including when stocks were their *cheapest* — you could find an equally impressive number of negative factors. I mean, you could've sat down in 1974, when stocks were screaming bargains, and you could've written down all kinds of things that would've caused you to say the future was just going to be terrible. And similarly, at the top, or any time, you could write down a large list of things that would cause you to be quite bullish.

There have always been problems and opportunities.

**Buffett:** We really don't pay any attention to that sort of thing. You might say that our underlying premise — and I think it's a pretty *sound* underlying premise — is that this country will do very well. And then particularly, it will do well for business. Business has done very well. The Dow went from 66 to 10,000+ during the 100 years of the 20th century. And we had two world wars, nuclear bombs, flu epidemics, the Cold War — you name it.

There will always be problems — and there will always be opportunities in the future. But in this country, the opportunities have won out over the problems over time.

[Editor's note: Living legend/long-time *OID* contributor John Templeton used to say the same thing to

his shareholders every year.]

**Buffett:** And I think they will continue to do so absent weapons of mass destruction — which is another question. And business won't make that much difference if anything very drastic happens along that line.

I can't remember any discussions that Charlie and I have had — *ever* — going back to 1959 where we would've come to the conclusion at the end of them that we would've passed on a great opportunity to buy a business because of external conditions; nor did we ever buy anything we thought was mediocre simply because we thought that the world was going to be wonderful.

Just show us a good business tomorrow and we'll bite.

**Buffett:** It won't be America's economy, in my view, that does in investors over a five or 10 or 20-year period. It will be the investors themselves.

If you look at the record of the 20th century, you'd say how could anybody have *missed* owning equities during that time? And yet we had all *kinds* of people wiped out in the '29-'32 period. We had all kinds of things that were *bad*. But if you had just owned stocks right straight through and you didn't leverage 'em, you would've gotten a perfectly decent return.

So we're unaffected, in essence, by the variables you mentioned. Just show us a good business tomorrow and we'll jump at the hook.

Charlie?

Our expectations have been more modest lately.

**Munger:** I think that it's also true that both of us have said at various times over the last three years that we wouldn't be at all surprised if professionally-invested money in America had a pretty modest result over a fairly extended period into the future compared to the very dramatically high returns that it had achieved up to about three years ago. And so far, that's been proved out to be pretty much right.

Certain stretches are easier than other stretches.

**Buffett:** Yeah, our expectations were more modest than most people's two years ago. We didn't say the world was coming to an end or anything. We just said that people had gone crazy in certain sectors — and that anybody that thought that you could sit at home and day trade and make double-digit returns over time, or that you were *entitled* to that by just sticking a little money in your 401-K or something, was living in a fool's paradise.

But that was never accompanied by any predictions of disaster for the American economy as a whole or for American business as a whole.

What's let investors down has not been American business.

**Buffett:** People get crazy notions from time to time in financial markets.... They just believe things that it's hard to understand how they could believe. Now to some extent they get *sold* that by other people. But American business really has never let investors down as a group. On the other hand, investors have done themselves in quite frequently....

—OID

(Wesco Annual Meeting coverage begins on next page)



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

WESCO FINANCIAL'S CHARLIE MUNGER  
"WE DON'T BELIEVE IN MASTER PLANS,  
JUST DOING WHAT LIES CLEARLY AT HAND."

As you know, in the foreword to Janet Lowe's excellent biography — *Damn Right! Behind the Scenes with Billionaire Charlie Munger* — Buffett credits Munger with shaping his thinking in a major way. Says Buffett, "...Berkshire clearly is a much more valuable and admirable company because of what he taught us."

Elsewhere, Buffett credits Munger with expanding his horizons. And he says he slowly came around to his point of view on many issues. He even says: "Boy, if I'd listened only to Ben [Graham], would I ever be a lot poorer."<sup>1</sup>

As long-time subscribers know, Munger has been right again and again about the major issues of the day — the savings and loan scandals, debacles in derivatives, misleading accounting and outrageous self-serving compensation to name only a few — before they became front page news. And of course, he's been an equally astute observer and teacher of such important topics as physics, thermodynamics, gambling and human nature, and how one should organize important principles related to each to function effectively in business, investing and life. As we've said before, ignore Munger at your own peril.

The following excerpts were selected from his comments and his answers to shareholder questions at Wesco Financial's latest annual meeting which took place on May 5th in Pasadena. As always, we heartily second Buffett's compliments about the enormous value of his counsel and highly recommend a careful reading (and re-reading, etc.) of anything and everything he has to say. We hope that you find his insights and observations to be as entertaining and valuable as we do.

<sup>1</sup> Carol J. Loomis, "The Inside Story of Warren Buffett," *Fortune*, April 11, 1988, p. 26.

WHAT THE HELL IS GOING ON HERE?!  
OUR CULT AND WELCOME TO IT....

Why the Berkshire meeting is the way it is...

**Charlie Munger:** ...This, of course, is the aftermath of the Berkshire Hathaway shareholders' meeting held in Omaha four days ago. And there were 19,500 people at that meeting. It absolutely went to the gills of the new convention center in Omaha — filling the main arena with 2,500 or so more in a separate room with video.

When something that unusual happens — 19,500 people attend a shareholders' meeting of an American corporation — and everybody's having a whee of a time, with a lot of them attending year after year after year, it's such an unusual phenomenon that it's useful to ask two of my favorite questions. The first is: What the hell is going

on here? And the second is: Why did it happen?

And what's going on, of course, is that alone of all corporations that have ever existed in the history of the capitalist world, Berkshire Hathaway has created an annual meeting that has cult-like dimensions and attracts an enormous crowd of people. It's a mixture of party and intellectual quest, like a chautauqua with lectures and so on — and also subsidiary events, which is very chautauqua-like.

And then there is discount shopping — on which Berkshire makes a very substantial profit, in part because we've got so many different subsidiaries.

It's very simple. It's all about our value system.

**Munger:** But the reason why this particular thing happens is that there's a well-regarded value system within Berkshire. And of course, its subsidiary, Wesco, has the same system. That value system is adored by this group of shareholders. Partly they adore us because they're so mad at the rest of corporate America (which is not entirely flattering to us). And partly they like us because a lot of them have been around for decades and made an enormous amount of money. That's an expected result.

But IBM in its prime made more money for shareholders than Berkshire did. And people did not adore the corporate personality of IBM. In fact, it was respected, but sort of ridiculed. They had quasi-religious sales meetings. And the elder Watson was not a barrel of laughs. It was a severe culture. And it had an enormous conformity required of the salesmen and everyone else. At any rate, Berkshire's created this personality that a great many shareholders love.

Analysts aren't easy to love. But our shareholders...

**Munger:** And the intellectual content of Berkshire's personality has been limited to a fairly short catechism, including low pay for the people at the top and a high sense of duty to shareholders — many of whom trusted us when we were young and poor with money that was very important to them. So our shareholders aren't a faceless group represented by analysts. We know the human stories behind about half the shares outstanding. And I think that helps the ethos of Berkshire and Wesco.

It's hard to love a group of analysts representing institutions. The analysts who are here are not representative of the genre. They're oddballs much like us. But the ordinary analyst would sell his mother to get some corporation to report an extra 10¢ a share some quarter to make him look a little better.

And in a sense they can't help it. They're in a crazy system that just evolved. Be that as it may, the result is that the analysts that represent institutions, by and large, are not liked by the CEOs of America. Now, they're smart enough to pretend to like them — but few analysts are fooled. And of course, many corporate meetings are set up to avoid groups like you. Meetings are held in inconvenient places and at inconvenient times — and managements hope nobody comes.

You can't base a cult entirely on discount shopping.

**Munger:** Berkshire, on a different path, morphed into these almost ridiculously enthusiastic meetings, which at this point not only make money for Berkshire, but have the

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

people in our subsidiaries coming with their families. So our meetings have become big events.

And it's *enormously* useful to Berkshire to have this festival-type of annual meeting. I don't think our system would work if it were just a festival with discount shopping. It takes some central ethos that people like in order to get people to come. So in that sense, you could say that we're cult-like, or religion-like, depending on your point of view.

OUR BEING WISEASSES DEFINITELY HELPS.  
BUT EXTREME DISCIPLINES ARE REQUIRED, TOO.

You can define us in large part based on what we don't do.

**Munger:** One of the things we've tried to do to justify this confidence is to run the place for our shareholders. That means keeping out a lot of activity you see elsewhere. We don't hire compensation consultants. We don't hire financial relations people. We don't have a house counsel — not that there's anything wrong with house counsel, by the way.

And Louie Vincenti, who used to sit in the chair I occupy today, used to say, "If you tell the truth, you don't have to remember your lies." So we try and keep it simple by telling it like it is at all times.

Having so many longtime loyal shareholders means that we have never given a damn whether any quarter's earnings were up or down — at least we don't care in terms of their effect on shareholders. We prefer profits to losses, obviously. But we're not willing to manipulate in any way just to make some quarter look a little better. And that's a very different ethos from the standard.

People know that we try to do things right.

**Munger:** And in terms of intellectual content, I think the place tries harder to be rational than most places. And I think it tries harder than most places to be ethical — meaning to tell the truth and to not be abusive. Now with 175,000 employees, or something like that, at Berkshire, I'll bet as I sit here at least *one* of them is doing something that I would very much regret. However, despite the presence of some human failing, we've had an *amazingly* low amount of litigation or scandal or anything of that sort over a vast number of decades. And people notice that.

Honesty is the best (and most profitable) policy.

**Munger:** We think there should be a huge area between ... what you're *willing* to do and what you *can* do without a significant risk of suffering criminal penalty or causing losses. We believe you shouldn't go anywhere *near* that line. You ought to have an internal compass. So there should be all kinds of things you won't do even though they're perfectly legal. That's the way we try to operate.

I don't think we deserve a lot of credit for that because we early understood that we'd make more money that way. And since we understood it so well, I'm not sure that we're entitled to credit for such morality as we have.

Of course, it is hard to know your own motivations. But I'd like to believe that we'd behave well even if it *didn't*

work so well financially. And every once in a while we get an opportunity to behave that way. But more often we've made extra money out of morality. Ben Franklin was right for us. He didn't say honesty was the best morals, he said that it was the best policy. [He chuckles.] And he's been deeply criticized for saying just that.

[Editor's note: In effect, you have to be stupid — or very nearsighted — to intentionally do anything dishonest.]

It helps that we're wiseasses....

**Munger:** At any rate, our shareholder festivals happen only once a year. And their popularity is enhanced because three or four factors work together.

[Editor's note: Of course, the term Munger has coined for factors which reinforce and greatly amplify each other is "lollapalooza effects". (See Munger's classic lecture entitled "Worldly Wisdom Revisited: Lesson #2, Part 2" in our March 13, 1998 edition.)]

**Munger:** I don't think we'd have as much attendance as we have at the Berkshire meetings if Warren and I didn't each have a significant wiseass streak — because to sit for six hours with no wiseassery at all is unendurable. [Audience laughs.]

But extreme disciplines are involved, too — like frugality.

**Munger:** However, I don't think it would work either if there were no central ethos to the place. I think people can sense that we're trying to do it right. And, of course, we've had fairly extreme disciplines throughout the place. You'll notice at the Berkshire meeting that the chief financial officer is running around doing ministerial things just to make the meeting work. And, of course, at Wesco you'll notice similar things.

We don't have an isolated group surrounded by servants or anything like that at Berkshire. Berkshire headquarters is just a tiny little suite. At the directors' meeting I just left, with what is now a bigger board, we had to move up to the boardroom of the Kiewit Company which they furnished for nothing. And I was actually uncomfortable in the better space.

In Wesco's early days, every savings and loan that went public promptly put in a fancy boardroom. Louie Vincenti just made his own office extra large so he could bring extra chairs in for the board when he needed a room to house their meeting. He wasn't about to pay for two separate rooms. So not only did we always have this culture, but we selected additions with the same ethos.

We understand why lots of professionals attend...

**Munger:** We now draw a tremendous number of stock brokers, investment counselors, analysts, etc. I suppose many of them hope they'll learn something. Part of that came about because the stock *did* so well over 40 years. After all, if one guy had won 50% of all the bass fishing tournaments, and he said that he was having a little meeting to discuss how he twisted his reel, a lot of people would come. And I think we get some attendance like that.

So due to a combination of factors, we get our festival meetings. And I think they work enormously well for everybody — even being a big source of good morale for the troops in all the subsidiaries.

The Wesco meeting gets the hard-core nut cases.

(continued on next page)



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

There's a small local group that comes because they've had shares in Wesco since Vincenti's time. But we've got a bigger group of people — some of them from Europe — who first go to the Berkshire meeting and then they come here.

WE'VE HAD LITTLE EFFECT ON INVESTMENT ACADEMIA.  
THEY'RE MOSTLY BONKERS PEOPLE W/BONKERS IDEAS.

Almost all good records will involve little diversification.

**Munger:** We're sort of like the Catholic priest — we just keep saying the same old catechism. We don't have much new to say. In terms of managing our portfolios, of course, we don't believe that markets are totally efficient. And we don't believe that widespread diversification will guarantee you anything but an ordinary result. In fact, we believe that *almost* all really good investment records will involve relatively little diversification.

So we say that year after year. And yet, I'd say that only about 2% of people have come into our corner of the tent, whereas most of the other 98% continue to believe what they were taught in graduate school.

Most of investment academia makes no sense at all to us.

**Munger:** We have had *very* little effect upon the nation's economics departments and business schools. And these are, by and large, staffed by very smart people who are trying to think carefully and do right. However, they just don't *get* it.

It's odd. We may misjudge academia generally — misjudging it as being worse than it probably is — because the part of it that interfaces with us is bonkers people with bonkers ideas like beta and modern portfolio theory.

And *none* of this stuff makes any sense at all to us.

If you think like us, there's not that much to teach.

**Munger:** We're looking for competitive advantages that are as enduring as possible. And we're trying to buy shares for less than they're worth — or even to pay a *fair* price for them if we admire what we see.

I think academia is defective in creating basic doctrine in our field partly because if you believe like us, you've got nothing new to teach. You come in and speak your two sentences — but what do you do the rest of the semester? In contrast, with their doctrines, they have all these mathematical formulas and what have you so they can test students to make sure they've memorized them, etc. But rewarding people for spouting back formulas that don't work in real life is a *disastrous* way to educate people.

But there are exceptions — like Stanford's Jack McDonald.

**Munger:** Stanford Business School is very interesting. Jack McDonald thinks a lot the way we do. He's probably the single most popular professor in the Stanford Business School. And he carries twice the normal teaching load year after year. He gets voted year after year among the top, or at the very top, in terms of popularity with the students.

Well, the school can hardly *wait* for Jack to get old enough to leave. He's totally out of step with modern

academia — the business school version. I'm not inventing these stories — it's *reality* that is so ridiculous.

At any rate, Berkshire has never believed in this extreme diversification....

[Editor's note: On the other hand, should your judgement resemble that of a super-investor less and that of, let's say, a financial newsletter editor (God forbid) more, then concentration may be very hazardous to your wealth.]

WE DON'T BELIEVE IN MASTER PLANS —  
JUST DOING WHAT LIES CLEARLY AT HAND.

Given its textile roots, Berkshire's done all right.

**Munger:** The interesting thing about the Berkie story and, to a lesser extent, the Wesco story is how it happened. A little company was in the New England textile business, sure to go to blooey because of power costs. Textiles are congealed power — and the New England textile mills were absolutely doomed.

And when Warren bought control of Berkshire, if he'd just stayed in the textile business, he would have lost virtually 100% of his investment. Instead, he wrung a little money out of the textile business as it shrank. And he invested that money in an Omaha insurance company — and one thing led to another. The end result was this dramatic change where you had a market capitalization that was at one time about \$10 million that grows to something way in excess of \$100 *billion*. And there aren't all that many more shares outstanding now than then.

How was it done? Very patient opportunism....

**Munger:** Well, how did this happen? What caused the result? One interesting thing about the extreme outcome is that if you took the top 15 decisions out, you would have a pretty modest record. So success wasn't based on hyperkinetic activity. It was achieved through a combination of non-diversification, a hell of a lot of patience, and intensely opportunistic behavior on a few occasions.

You kept principles and you kept intellectual discipline. Then you waited for something that you could do in accordance with your principles and your intellectual standards. And when opportunities came along, you pounced on them with vigor. And with all that vigor, you made a sensible big deal about once every two years.

Lately, we've been making deals a little more often than that, but they're often very small in relation to the size of Berkshire.... It *looks* like there's been a lot of action — we have all these subsidiaries and over 175,000 employees. But the record happened as the result of a relatively small number of decisions, staying the course relentlessly decade after decade after decade, and holding our fire until something came along worth doing.

It's not about master plans, but what lies clearly at hand.

**Munger:** And there was never a master plan — *ever*. In fact, anybody that wanted to do master planning, we discarded because we thought it'd be so counterproductive. The trouble with master planning in most places is that the process takes on a life of its own. It becomes a sacred text. So everybody winds up trying to find the answer to life's immediate issue by looking at the old master plan.

But the guy who wrote the master plan wasn't facing

(continued on next page)



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

the new reality. He was just guessing forward as well as he could. And we want people taking the new information into account.

And it wasn't just Berkshire Hathaway that got this attitude about master planning. The model medical school for the modern world was Johns Hopkins. The modern Johns Hopkins was created by Sir William Osler who quoted over and over again one line from Carlyle: "The task of man is not to see what lies dimly in the distance, but to do what lies clearly at hand."

Well, that's the attitude that created this record.

If IBM had a master plan, it might've been a scale business.

**Munger:** And if you look at other records, you'll find that Sir William Osler was onto a good thing. I frequently cite the case of the elder Watson, because over at the Computing, Tabulating and Recording Company that became IBM, he had three equal-size businesses when he took over. The elder Watson had come out of cash registers, and he was drawn into his new business partly because they had a weighing scale business — butchers' scales and so forth — that was sort of like the cash register business. And they had a time clock business for which they gave a substantial block of IBM shares, thereby making an obscure family rich. Watson's third business in his new company was the Hollerith machine company that evolved into the modern IBM.

Well, Watson didn't know that the Hollerith machine was going to work so well. He very well may have been charmed with the butchers' scales. After all, he'd made his way in cash registers so far. But when the Hollerith machine took off, Watson had enough sense to pour resources and energy into what was plainly working. And IBM kept learning.

And of course, IBM learned again when computers started to replace the Hollerith machines — the punch card machines. So IBM had a very, very long run. And at least in the early days, it was enlightened opportunism that caused that result, *not* some master plan.

I happen to think that great cities often develop more the way that IBM did and the way Berkshire did — and that the master plans of many cities do more harm than good. At any rate, we don't have a lot of master plans at Berkshire. So you don't have to worry about their ever coming as long as we're in place.

The world is awash in capital — and promotional types.

**Munger:** I wish there were more obvious opportunities for our form of enlightened opportunism today. But I don't have the slightest glimmer that things are getting a lot better.

The world is awash in capital. And we have an *amazingly* large promotional class of people — and it's getting larger all the time. It seems like every university has to have a fixed-income arbitrage department and a first-stage venture capital department and a mid-stage venture capital department and a leveraged buyout venture capital department and a foreign small-cap department and a foreign large-cap department. And, of course, they have to have layers of consultants to tell 'em how much of

their assets to have in each category, etc., etc.

We have an enormous and growing share of our bright manpower going into all these paper shuffling activities. And very few of them do a lot of good for the surrounding civilization. If you had to get into heaven based on your contributions to fixed-income arbitrage, it might well be a tough sale.

At any rate, that's the state of the culture. And this near-worthless activity just keeps growing.

CORPORATE SCANDAL'S NOT SO BAD — YET.  
BUT BEWARE — IT'S A VERY SLIPPERY SLOPE.

It's not just corporate scandal that's risen in recent years.

**Munger:** Another thing that's very interesting now, that people often ask about, is the enormous amount of corporate scandal. For the best historical precedents, you have to go back to Jay Gould and people like that....

We have had an *enormous* degradation of corporate and professional behavior in this country over the last 10 or 15 years. And it's affected the lawyers, it's affected the accountants, and it's affected the investment bankers. Actually, the investment bankers really *never* behaved all that well — although they used to behave better than they do now.

[Editor's note: We can't help but wonder whether or not many lawyers ever really behaved all that well either. But since lawyers enjoy an effective monopoly not only on writing the laws governing our society, but also the same monopoly in contesting them in nearly all court cases, ruling on them as judges in nearly all of those cases and even the final say as judges on appeal — if absolute power corrupts absolutely, it's hard to imagine that the behavior of lawyers as a group *wouldn't* worsen over time, too.]

CEOs' time horizons in many cases are all wrong....

**Munger:** There's been a tendency to have every CEO try and be a Jack Welch, and to have the income reported in his tenure go up and up in as regular a fashion as possible. The incentives are getting so extreme that many people fudge, partly because their *time* horizons are wrong.

The guy at Royal Dutch Shell who made the decision to fudge the reserves was within maybe four years of retirement. He'd been knighted by the Queen. He'd risen about as high as he could go. He didn't have to answer for the next 20 or 30 years. He just had to get through the next three or four. And so, his time horizon was wrong.

If Royal Dutch is doing it, you know many others are, too.

**Munger:** With modern corporate management, where will it stop? Royal Dutch Shell, averaged out over its long history, was about as ethical a big company as existed in modern capitalism. It was a rigid meritocracy, peopled almost exclusively with engineers. And yet their lying about their reserves got so extreme that the #2 guy created a written record in which he told the top guy, "I'm *tired* of lying about our reserves." And eventually they discarded 20% of the company's total reported reserves — so this is not a small event.

And one thing I can promise you is that if Royal Dutch

(continued on next page)



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

is so misbehaving, a significant fraction of other people are doing something similar.

And beware — bad behavior can even become the norm.

**Munger:** Of course, it doesn't happen to just CEOs. The people running the pension plans in the municipalities have also done terrible things lately. In the New York Police Department, they have a simple system. Your pension is based on your pay in your final year. So when anyone reaches the final year, everybody cooperates to give him about 1,000 hours of overtime. And he retires — in some cases after a mere 20 years of service — with this large income.

Well, of course his fellow employees help him cheat the system. In substance, that's what's happened. But the one thing I guarantee you is that nobody has the least sense of *shame*. They soon get the feeling they're *entitled* to do it. Everybody did it before, everybody's doing it now — so they just keep doing it.

And corporate America is much the same.

ACCOUNTING FIRMS HAVE A VERY RESPECTABLE PAST.  
BUT THEY SOLD OUT — ONE LITTLE STEP AT A TIME.

Accounting firms used to be quite ethical places.

**Munger:** One of the very worst things that happened is a deterioration in behavior in our country's major accounting firms. When I was young, the senior partners in many cases were Scottish. I think about half of the accounting firms had a man of Scottish ancestry as the senior partner....

And the major accounting firms of yore were quite ethical places averaged out. Nobody got filthy rich. They were places with many Indians and few chiefs. The chiefs earned good incomes and had a *very* liberal pension arrangement. As a young lawyer, I probated the estates of two retired Price Waterhouse partners.... So I know something about this. Many were highly ethical places.

But they sold out....

**Munger:** However, in the space of about 25 years, just one firm after another sold out into perfectly terrible behavior just one little step at a time. And of course, once you're already doing something remunerative but bad, some other remunerative thing is just a tiny bit worse — so you do that. And once 25 years go by, even if you started out as an upright firm, at the end you're a moral sewer. And this happened to some important degree in all of our major accounting firms.

The major accounting firms of the country eventually sold obviously fraudulent tax shelters, where the chances of success were heavily dependent on them being made so obscure that the IRS wouldn't find them. That's what they were selling at large prices. In effect, what they were saying was: (A) We'll vouch for it — which means you won't go to jail if anyone digs it out. And (B) we'll make it so obscure that no one is likely to dig it out.

One after another of the accounting firms went into that dirty business. And of course, lawyers were also

helping by providing phony opinions for large fees. The outcome was disgusting.

And sadly, they only stopped to avoid failure and disgrace.

**Munger:** It just went on and on. And I don't know where it would've stopped if we hadn't had a cascade of failure and disgrace. Deloitte — Wesco's accountants — has now cashiered its most extreme tax partners. But they waited until that was obviously the prudent thing to do. It would've been more creditable if they'd never let them in in the first place. However, Deloitte is no better or worse than the other accounting firms — they *all* slipped into bad behavior. It was a major scandal.

Banks also got into the act. For example, J.P. Morgan's old bank formed a little firm in the Canary Islands with no economic substance at all to help Enron chisel on its taxes — and then finally to lie about the fact that Enron was borrowing money. What the hell was the bank *thinking*?! How could corporate behavior just morph lower and lower?

THERE ARE ENORMOUS PRESSURES ON EXECS.  
WE PREFER TO BE A LITTLE CONSERVATIVE.

We haven't seen the last person succumb to temptations.

**Munger:** Now, however, as a consequence of catastrophe and disgrace, I do think we're coming back from the worst of that. Long ago, when the G.E. and Westinghouse people left their boy scout troops and went off to the penitentiary to pound rocks for fixing prices in hotel rooms, that changed corporate behavior about price-fixing. And I think a goodly bunch of these modern people going to prison *will* change corporate behavior.

But we still have these *enormous* pressures. So much money swings on what you report. And it's so easy to report a little more or less by making judgement calls in grey areas like they did at Royal Dutch Shell. I don't think we've seen the last person succumb to the temptations....

Conservative accounting is best....

**Munger:** The best accounting is consistently conservative. Conservatism in accounting is profoundly right, provided it is *consistently* conservative. But if you make it conservative when you want to stash earnings away and loose when you want to report more, why, that's plainly wrong. But if you're *always* conservative, and you only release redundant reserves when it gets to be obvious that they're too high, that's an admirably consistent and desirable accounting policy.

[Editor's note: A la Berkshire Hathaway and Wesco — based on observation and by all accounts.]

**Munger:** And it's sad that we don't now see more of that. Instead, many modern CEOs want to push accounting to its legal limit in order to report more earnings when such a report is desired. I think the world would work better if *everybody* had consistent, conservative accounting. But I think we're a long way from that result, because we have this modern deterioration.

And I think that we've had *enormous* deterioration also in the union and political structure of the country. In fact, I'd argue that the union that represents the guards in California's prisons is a very low-life, destructive thing....

So there's a lot wrong in a lot of places....

(continued on next page)



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

HOWEVER, THERE ARE HOPEFUL SIGNS —  
LIKE REFORMS IN NEW ZEALAND AND CALIFORNIA. ↘

But strange and wonderful things can happen....

**Munger:** However, there are some hopeful signs. For example, New Zealand got an extreme socialist culture, that gradually accumulated until sometime in the 1980s, which made Sweden look like it didn't know how to have a socialist culture. New Zealand had currency controls, as well as defective import controls. Everything that could be regulated was regulated. Almost every sin you could imagine in socialism gone mad was committed in New Zealand.

Well, today New Zealand has a top income tax rate for earned income of 30-something percent.... It's got a 10% consumption tax for everybody. And the result has been that it runs a surplus. Its debt has gone way down. Its school system, which was a disaster, was reformed in one fell swoop in a way that conservative economists like Milton Friedman would have liked....

The Labor Party in New Zealand out-Thatchered Thatcher.

**Munger:** And this reform was actually led by New Zealand's Labor Party! So strange and wonderful things can happen. And New Zealand is now very much better for everybody — in terms of the amount of income per person, the amount of self respect per person, and the quality of the education in all the schools. So there's some hope for the rest of us if a highly socialized place like New Zealand can suddenly change its ethic. New Zealand makes Thatcherism look like Thatcher wasn't *trying*. She didn't get all that far in England. She just got some of the worst folly out of the system.

[Editor's note: Of course, by helping the late, great President Reagan win the Cold War, she helped spread some freedom to Eastern Europe and made possible huge cuts in future defense budgets in the U.K., the U.S. and elsewhere, including Russia — and at least some pale semblance of free enterprise in, and increased trade with, the latter.]

**Munger:** But New Zealand took folly by its neck and wrung it out. New Zealand had one government department where the employees went from about 20,000 down to one person. They had one person left at the end. [He laughs.] That was a works ministry. It was doing civil engineering through civil servants. In effect, they just said, "To hell with it". They just started hiring private firms to do it — and that worked way better.

And by the way, they had terrible unemployment with all of their socialism — like 12%. *Nothing* was working. That is probably what caused the labor party, of all things, to just finally say, "This isn't working. We're all on this little island together. *Someone* has to be responsible here." And by God, they've pretty well fixed it. So there is hope that some of our worst excesses will eventually get fixed.

[Editor's note: And we understand that Russia has implemented a flat tax and China is reportedly studying this approach, formerly espoused by President Reagan.

Hopefully, both countries will also eventually embrace democracy — in contrast to the pale shadow of it currently in place in Russia — not to mention a truly free press.]

Incredibly, there's even a ray of hope in California.

**Munger:** We seem to be in a situation where the scandal and dysfunction have to get very extreme before people will do anything. Take the workman's comp situation in California.... To say it was sinful would be an understatement. There were crooked chiropractors, crooked doctors, crooked lawyers, crooked union representatives and dishonorable employees all feeding unfairly on the system. And, of course, legislators were never going to change anything so long as large contributors liked the system the way it was.

It was a *miracle* that California suddenly got about 20% of the reform it needed. It took that crazy recall of a recently elected governor. And then it took the threat of a similar initiative petition to get the Democratic legislature to take some of the juice out of the system for the chiropractors and the trial lawyers. But it *happened*. So we do get reforms.

And my guess is that one way or another, some of the other bad behavior that we see in modern professions will eventually be reduced.

LAWYERS HAVE BECOME PART OF THE PROBLEM.  
THEY SHOULDN'T TAKE ON SKUNKS AS CLIENTS.

Law firms should know to avoid skunks as clients....

**Munger:** The law business has so far been pretty well exempted from criticism. However, all of these crooked tax shelters had leading law firms writing favorable legal opinions. And almost every miscreant that you see in the paper had a fairly highfalutin lawyer who was at his side all the way.

I've often wondered why *more* law firms don't just vote with their feet — or decline the business of their most defective clients in the first place. A lot of these clients might as well wear signs: "I'm a skunk who's going to be hard to handle." And yet those skunks find substantial law firms who will take them on.

I've noticed that the firms that *avoid* trouble over long periods of time tend to have an institutional response that tries to prevent the worst kind of clients from coming in. And if I were running a substantial law firm, *boy*, would I want a system like that — because there's a lot to be ashamed of in the conduct of a lot of modern clients, and in the cognition of lawyers who think they can serve knavery without becoming knaves.

It looks like Martha Stewart's lawyers gave her bad advice.

**Munger:** I also think people go dysfunctional out of pomposity. When Martha Stewart got in her trouble, what she'd done is panic into selling a few shares because she'd heard that the guy who got her to buy it was now selling. And she vaguely thought there was something a little disreputable about her selling. However, all she'd done is panic and sell out because her mentor was selling. So she wasn't going to be in trouble for insider trading. That would've never been successfully prosecuted under the circumstances. But when the investigators came to call,

(continued on next page)



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

she invented a totally phony story and told it to them. And telling a phony story to an investigator is a felony.

The interesting thing about her story is that she did the acts which will probably send her to prison *after* she'd hired highfalutin lawyers. [Munger's look of incredulity draws laughter from some of the attendees.] I didn't *invent* these stories. And the lawyers billed her heavily. And from their point of view, they did nothing wrong. They believed her — and good lawyers are *supposed* to believe their clients. This is their catechism, even when it needlessly sends their clients to prison.

What Martha Stewart's lawyers should have told her....

**Munger:** However, the lawyers of yore, whom I loved well, if they had a client like Martha Stewart would say the following: "Martha, that's a very interesting story. And I'm your lawyer. So I *have* to believe it — but nobody else will. Therefore, it won't fly. So if you tell that story, you're going to have to tell it to a different lawyer — because I don't like to lose cases."

That approach works almost 100% of the time. And where it doesn't work, you wisely get rid of the client. And it's such a simple thing to do. But here was a client that would pay. The invoices would be paid by return mail.

And so, Martha Stewart will go to prison for her behavior *after* she consulted a talented lawyer.

President Clinton's lawyers should have known better, too.

**Munger:** And of course, former President Clinton should have settled that Paula Jones case that caused him to lose his law license. The perjury that caused him to lose his ability to practice law was a significant disgrace for an incumbent President of the United States. All the lawyers had to do is just say, "Bill, I believe you, but nobody else will. And so maybe we'd better settle this case so you won't have to go to court and tell a story no one will believe." [Munger fights back a chuckle leading attendees to laugh.]

Don't let your ego keep you from admitting a little failure.

**Munger:** So everywhere you turn, you find these mad hatters' tea parties. And you learn the wisdom of Louie Vincenti's rule — that if you tell the truth, you don't have to remember your lies. It's such a simple concept.

Because once you start... Imagine what it was like at Royal Dutch by the third or fourth year. At that point, the thing is *really* getting dangerous. What seemed like a good idea in year one is starting to get very uncomfortable.

Suppose you've been knighted by the Queen and you have to report your oil reserves went down instead of up. You could just frankly say, "We did our best. We have this problem at Royal Dutch Shell. We're working on it, etc." What would've been so terrible about that? Why get your ego so involved with reported earnings that you can't *ever* admit a little failure....

[Editor's note: In some activities, you have no choice. Like the old saying goes, "Doctors bury their mistakes. Newsletter editors publish theirs."]

**Munger:** At any rate, these things happen over and

over again. But if you notice, the plots are very similar. The same plot comes back time after time.

Well, that's my brief bit of rambling. I feel *obligated* to ramble on about a subject or two [to which the audience responds by applauding in approval.]

MUTUAL FUND BUSINESS HAS RAISED TO AN ART  
EFFECTIVELY BRIBING INVESTORS' PURCHASING AGENT.

A question few economics professors can answer....

**Munger:** In that case, I'll go on with one more interesting anecdote. I have some fun occasionally when I get before a bunch of graduate students, sometimes even professors — particularly economics professors and students. I'll say, "Well, you all understand supply and demand curves?" And of course, they'll say, yes, they do. "And so you all understand that ordinarily when you raise the price of something, you can sell fewer units at the higher price than you used to sell at the lower price?" They'll say, yes, they all understand it.

And I'll say, "Well, give me four instances where if you want to sell more units, the correct answer is to *raise* the price?" Well, they give me this blank look. And it's a very important question. Do you really understand a rule if you don't know where it applies and where it doesn't — and under what conditions?

And yet I've done that about four times now, and maybe one in 50 can give me one reason that's correct — whereas I can easily name at least four or five.

But the one solution that I love, that is drawn out by an additional question, is when I ask, "Suppose you were selling widgets at \$10 a widget — and most of the widgets were bought by X." And I say, "Suppose you were to bribe X's purchasing agent while you raised the price. Do you think you'd sell more widgets?" They say, "Oh, *yes!*"

That's not some pie-in-the-sky situation....

**Munger:** And I say, "Well, is the functional equivalent of that kind of situation present anywhere else in the American economy?" Of course, those of you who are in the mutual fund business will know where I am heading. The mutual fund business has obviously raised to an *art* what in substance amounts to bribing the other guy's purchasing agent. They say to the stock broker, "Your ordinary commission is 1/2 of 1%. (It used to be 8/10s of 1%, but now it's a mere 1/2 of 1%.) So they say, "We'll pay you a 5% commission if you'll buy this wonderful mutual fund instead of other securities or another mutual fund *without* a 5% commission on it." So, in substance, they're really bribing the other guy's purchasing agent.

And some mutual fund execs don't stop with bribery....

**Munger:** Now, a lot of these places are very ethical once they've surmounted that terrible inelegance in the sales system. Once they get the money in, I think a lot of mutual funds try and behave well with it. But, of course, even *there* we've had big scandals. Can you imagine? Of all the overpaid people in America, perhaps the most extreme are the people that own the management companies that serve the major mutual funds.

(continued on next page)



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

And in that position, many took a bribe, in essence, to permit stealing from their own mutual fund. A big fraction of the mutual fund management companies so behaved. This is not a minor sin. It's *amazing*.

[Editor's note: Although it looks like a public service in comparison with trial attorneys who in the course of representing plaintiffs routinely receive 33-40% of the award — off the *top*. And unlike individual investors, who can rationally elect to invest themselves, plaintiffs, for a variety of reasons, by and large cannot.]

In some ways, at least, the trial lawyers as a group make the bad actors among mutual fund managers and corporate executives look like rank amateurs in terms of looting America. And best of all — from their perspective anyway — they make it legal to boot. It's good to be king.]

**Munger:** I think [Davis Advisors'] Chris Davis is here. I told this story at the Berkshire meeting and got back an interesting story from Chris. At Chris's shop, the short-term traders came in and offered them an extra \$40 million of funds if they'd let 'em do improper trading of the fund. This went through two *layers* of people who didn't want to say no to \$40 million before it reached a guy [chuckling] who said, "Are you out of your mind? Of course we won't allow this."

That's a lot like some guy coming to you and saying, "I've got a wonderful proposition. Why don't I murder your mother and we'll split the insurance money 50/50?" Instead of saying, "Are you out of your mind?" you say, "Well, I have to talk to my siblings — and are you sure that a 50/50 split is fair?" [The audience cracks up.]

But that's the way a lot of mutual fund management companies have operated.

Stealing \$500,000 more when you're already rich is nutty.

**Munger:** In addition to being immoral, it's so *stupid*. Imagine being as far ahead of your just desserts in life as Richard Strong was — and then stealing \$500,000 more?! Why do people so nutty rise so high? It's always happened in capitalism, but it certainly is very peculiar.

I think mutual fund behavior is going to get a lot better — because I think people will notice and create more danger for those who misbehave.

Do you really think mutual fund directors are independent?

**Munger:** We ended up with something in the mutual fund business that we didn't intend. It was originally set up for investment counseling operations to be a pooled account for their smaller clients. And they threw in this independent director thing — that a lot of the directors had to be independent.

Well, if mutual fund directors are independent, I am the lead character in the Bolshoi ballet. [Both Munger and attendees laugh.] And of course, once you have such a totally fictional system, it can lead to a lot of peculiarities.

I don't think that they ever should have been allowed to *sell* mutual fund management companies. I think Capital Guardian and the other people who refuse to do that are on the high ethical ground....

But you can't expect most people who work for a

lifetime to not go to the legal limit in maximizing their economic outcomes. Everybody else is doing it. So people wind up drifting into very imperfect behavior over time.

Okay. Enough for the ramblings of Charlie Munger. We'll now take your questions....

BEN FRANKLIN HAD IT RIGHT ABOUT DIRECTORS —  
BOARD MEMBERSHIP IS ABOUT MORE THAN MONEY.

Having a board seat doesn't mean you have influence.

**Shareholder:** What's a realistic expectation of finding outside directors who are knowledgeable enough to judge whether management is acting on shareholders' behalf to grow shareholder value — outside directors who know the business as well as management and, therefore, can hold them to account?

**Munger:** Generally speaking, as a shareholder, if you're counting on the outside directors to fix deficiencies in management, you're in trouble. The de facto rule in America, by and large, is that the directors only act when the management embarrasses the directors significantly. Before that, they go along.

My friend Joe Rosenfeld used to say: "They asked me to be a director of Northwestern Bell — and it was the last thing they ever asked me." [Audience laughs.] [Ed. note: Similar to what Buffett says about him and Munger rarely being asked to serve on compensation committees.] So even when they *have* knowledge, they aren't very effective.

The best directors are the ones that money can't buy.

**Munger:** You raise a very interesting question, though, about how we can get better governance. I don't think we're going to get better governance by getting people who really *need* the directors' pay (which is pretty liberal) like university professors and other similar people. You'll find an occasional person in that category who's truly independent. However, if it's half of someone's income and much of their retirement, then facing down a CEO who has the power to remove them from the board is going to be a rare occurrence. I don't think you should expect too much real independence from *that* source.

You get more independence when you've got people who are demonstrably very smart and very rich. They don't need any of the money you're paying them. Those people tend to have existing reputations which are personal to them that they don't want to lose. That's an ideal board.... Those directors aren't really in it for the money at all.

I would argue that that's exactly the kind of board Berkshire, and to a lesser extent, Wesco has. Warren at one point said that he felt that the Berkie board was the best board in the country. And Warren wouldn't say that if he didn't believe it. They're *awfully* high-grade, smart people. And of course, they're serving with no D&O insurance and no pay to speak of.

It works for England — and Harvard....

**Munger:** But that is not the conventional wisdom. You can go to all the business schools in the country, and nobody will talk the way I've just talked. I think we'd have better directors in our major corporations, on average, by

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

*miles* if none of the outside directors were paid at all — if they got expense reimbursement and no money. I meet *tons* of eminent people who'd be glad to serve for no pay on the board of directors of Exxon and so on.

The lower criminal courts of England are staffed by lay magistrates who get expense reimbursement, but no pay. For the judges of the whole municipal court system for the lesser crimes in England, it's been that way for about 600 years. And *nobody* wants to change that practice — because it works fine. There are all *kinds* of wonderful things that work that way. Harvard has been pretty well run by a bunch of people who not only don't get paid, but have to *give* enormously to stay there. [Attendees laugh.]

So I don't think that any likely legislative response is going to make governance better. I think it would get better if more boards were like Berkshire's board, and if our major corporations' boards were run more like the lower criminal courts in England as something people did out of duty and to enhance their significance but not their economic rewards.

The CEO washes the directors' hands and vice versa.

**Munger:** Reciprocity comes in strongly when the CEO keeps suggesting that the directors be paid more, and then in turn the directors keep raising the CEO's compensation. So it goes tick, tick, tick, pitty-pat, pitty-pat. Then they hire consultants to make sure that nobody else at other companies is getting ahead of them in this game of pitty-pat. And pretty soon you get the compensation so high — even in cases where the executive is an obvious klutz, and a little dishonorable to boot — that it destroys the whole reputation of capitalism for fairness and decency.

So I think that the existing system is very bad — and I think that my system would work a whole lot better. But it's not going to happen.

Franklin had the same idea that I do...

**Munger:** By the way, Franklin basically suggested as his final wish at the Constitutional Convention that the United States government be run on a non-paid basis, that is by people like Franklin. And he got his wish in the Mormon church — where they have no paid clergy. And the ruling apostles aren't paid either. But apart from that, a different model has come into being.

(continued in next column)

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SARBANES-OXLEY ISN'T GOING TO BE A CURE ALL,  
BUT IT WILL MAKE SOME CONVICTIONS EASIER.

Just because it's called a reform doesn't mean it will work.

**Shareholder:** Do you think that maybe the moral compass of this country and corporate management would change if we had excessive pain in the country? Would that possibly help to cleanse the system?

**Munger:** Well, pain is helping to cleanse the system. But of course, with all this prejudice and ignorance in many power centers, a lot of the would-be cures will be counterproductive. By *no* means will everything that's done be an intelligent response. So I wouldn't get too optimistic. You can *call* it a reform, but it isn't necessarily going to *work* as a reform.

I think Sarbanes-Oxley will help a little...

**Munger:** I don't think Sarbanes-Oxley is going to work very well in terms of increasing the accuracy of the accounting knowledge in the CEO. The CEO can't *possibly* attest to those figures as he's required to do by law except by trusting other people who present the figures.

The one place it will start binding is if the CEO is personally engaged in some shenanigans that are inconsistent with the figures. Now if he signs that thing, the government has a much easier case to prosecute than it did before. So I think Sarbanes-Oxley will have an *enormous* effect, in that kind of circumstance, on outrageous crooks.

If you take an extra million dollars through your expense account you shouldn't have — and then you sign something that the books are right — *that* before a jury may be an easy conviction. And that wouldn't have been so true before Sarbanes-Oxley. Before, you could have said, “Well, the directors understood what I was doing and so forth and so on.”...

It will make some convictions easier...

**Munger:** Dennis Kozlowski's defense was amazing. He got to feeling so entitled to take whatever he wanted and do whatever he wanted that one of the jurors said that he couldn't *possibly* have been criminal — because he possessed no sense of shame. [Shareholders crack up.]

Well, you can laugh. But you know, if he'd *furtively* done it all, why she would've convicted him. But she said he couldn't have had an evil intent given that he did it with such an obvious sense of entitlement. At least that's the way this one juror felt.

I think that Sarbanes-Oxley is going to make some of those convictions easier — just as it was easier to get Martha Stewart for lying to a federal agent than it was to convict her of insider trading. Will it outsmart the crooks? A little bit — a little bit. But I think it's greatly overrated if you assume that it's going to have a dramatic effect.

PREDICTING CORPORATE FRAUD WASN'T SO HARD —  
AND PUNISHING THE WRONGDOERS WAS GREAT FUN.

Corporate fraud was easy enough to predict.

**Shareholder:** I was at the Wesco shareholder meeting in 1998. And you distributed a little story that you wrote about a fictional corporation that fudged its accounting and

(continued on next page)



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

built a system of phony accounting based on a legitimate and profitable business.... Well, I read it a few weeks ago. And it was amazing how the story basically outlined the status of today's accounting fraud and how accounting got so corrupted. I thought it was amazing how accurate it was. It was like you got the *Wall Street Journal* three years before everybody else.

**Munger:** Given the accounting convention that was being used for stock options, it wasn't hard for a person with any mathematical training to see the scale of the misleading that was possible. All I did in that story was to escalate the scale of the misleading while conforming to the accounting convention. And of course, what I wound up with were ridiculous results and a great denouement.

Per my story, I think the accountants deserve much blame.

**Munger:** And of course, since I was writing the story, I could punish the miscreants at the end — which I did.... I said that everybody else was less disappointing because the accountants were the custodians of a great profession. And I said we *expect* investment bankers to behave terribly. [Audience laughs.] But when the accountants sold out... If I recall correctly, I said remember that traitors occupy the lowest circle in hell. And these plump accounting partners who lived in nice neighborhoods were the worst traitors of all. Therefore, in my story, at the end, God sent the accountants to the lowest circle in hell.

It's *fun* to write a story where you get to put people where you think they ought to go. I had a lot of fun writing that story....

But the best way to teach ethics is by example.

**Shareholder:** There was a lot of talk about ethics at the *Berkshire* annual meeting. That subject's come up in our business quite a bit. And I keep going back to the idea... My son's a teacher — and they're not *allowed* to teach ethics in school anymore. You're not even allowed to say that something is good or bad....

I wanted to know what you thought about the idea of instituting some ethics classes — because you can't legislate ethics. Therefore, I believe you have to teach it from an early age. Would you comment on that?

**Munger:** I think the best single way to teach ethics is by example. And that means if you take in people who demonstrate in all their daily conduct an appropriate ethical framework, I think that has enormous influence on the people who watch it. Conversely, if your ethics slip, and if people are being rewarded for ethical slips, then I think your ethics cascade downward at a very, very rapid rate.

I think ethics are terribly important, but I think they're best taught indirectly by example. If you just sort of learn a few rules and remember 'em well enough to pass a test, my guess is it doesn't do all that much for people's ethics. But if you see people you admire behaving a certain way — particularly under stress — I think you're likely to remember and be affected by that for a long, long time....

THERE'S MORE TROUBLE TO COME IN INSURANCE  
— AND THE WORST OF IT WILL BE IN DERIVATIVES.

Insurance broker customers are big, sophisticated places.

**[Davis Advisors'] Chris Davis:** With the model of bribing purchasing agents in mind, I wonder if you could speak a little bit about what's happening in the insurance brokerage business — where there seem to be far fewer institutions with more power....

Then, unrelated to that (or distantly related) is the idea that reinsurance, like derivatives, can be used to spread risk — or it can be used for all sorts of malicious reasons like smoothing earnings or manipulating the liability side of the balance sheet. I thought maybe you could speak about that line in reinsurance and how you see it playing out?

**Munger:** As regards your first question, the use of contingent commissions has long been widely known. And a lot of the customers are big, sophisticated places that know the customs of the industry. So I don't think it's similar to the little old lady who meets the broker in church and buys the mutual fund with a commission. I think that, by and large, the situations are quite different.

Gen Re & Berkshire are way more conservative than most.

**Munger:** With regard to reinsurance generally, it's a field where de facto you get a fair amount of discretion as to what you report — because it's based on estimates. That's the nature of the game.

And I'd bet a lot of money that both General Re and *Berkshire* from this time forward are *way* more conservative than most people. I'd also bet that they'll stay that way — even if they have terrible quarters to report.

A litmus test from Munger of mental and moral quality....

**Munger:** However, generally speaking, I don't think that you've had your last trouble in insurance. When the financial types want to report a lot of earnings — and they can jiggle figures around to amorphous standards — there will be occasional scandals.

The *really* awful scandal that I believe will come in due course is in the derivative books of some of the major financial institutions. Of course, General Re's running off its derivative book. And we're losing a lot of money compared to what ... was on General Re's books ... under Generally Accepted Accounting Principles. And I'd bet General Re's books were more conservative than most.... But even so, we're losing money running it off.

I think you could have a litmus test of mental and moral quality if you went to the major institutions and asked, "Do you *really* understand exactly what you're doing in this large derivative book?" And if anybody says, "Yes," you should assume that they're either crazy or lying.

INCENTIVE-CAUSED BIAS HAS AN AMAZING IMPACT  
ON BAD APPLE AND GOOD APPLE ALIKE.

Incentive-caused bias does amazing things to the mind.

**[Franklin Mutual Advisers'] David Winters:** You've talked before about incentive-caused bias. How have you learned to use incentive-caused bias to your advantage?

(continued on next page)



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

**Munger:** Well, incentive-caused bias is routinely used in all incentive systems. In other words, if you're rewarding a man for believing that his mutual fund is the very best mutual fund in the world, that makes him a better salesman — and he *believes* it more because he's getting a substantial commission income which he's using to feed his family. So the routine incentive arrangements of the world cause a *lot* of incentive-caused bias....

Incentive-caused bias is sort of like gravity. It's out there in human nature. It has strong effects for both good and ill. And it's *amazing* what it does to the human mind.

[Editor's note: Amen.]

And it warps bad apples and good apples alike.

**Munger:** Think of all of those fraudulent tax shelters. I talked to one accountant — a *very* nice fellow. I'd be glad to have his family marry into mine. And I happened to grumble something to him. This was early in my criticism of how so many accounting firms were selling these fraudulent shelters in exchange for large contingent fees. And he actually said to me, "Charlie, look — what these *other* accounting firms have done is very unethical." He said, "That scheme works best if it's very unlikely to be found out. And the way to have it not be found out is to tell only a few of your very best clients — keep it away from all the others — and swear your best clients to secrecy. That way, it's less likely to be discovered.... And that is the high ethical path that my firm follows." [Attendees laugh.]

I'm not *kidding!* How's that for incentive-caused bias? Again, he was a perfectly nice man. You'd be delighted to have his family marry into yours. It's just that over time, the incentives and the social milieu create these effects — and the mind just drifts off course in a ghastly way.

The kind of toast you'll seldom hear in corporate life....

**Munger:** One of my favorite stories on this subject happened when Arco was celebrating their huge triumph of making a lot of money out of the North Slope oilfields in Alaska. And the house counsel there was an Irishman who was very outspoken and had a fair amount of charm. And he was highly regarded. So he could get by with talking frankly. And the whole group was toasting one another: "Aren't we great people for having done this great thing?" And this Irish house counsel raised his glass and said, "Well, I'd like to toast the man who really caused our triumph." He said, "Here's to King Faisal...."

He said, "Every calculation we made was off by 200%. All the costs were way higher, and the difficulties way greater than we ever conceived. All the predictions we made were totally asinine and wouldn't have worked with the oil prices we projected. But along came King Faisal and the oil cartel and raised the price of oil so high [Munger cracks up] that they made us all look good. Let's honor the proper man here tonight."

That is the kind of toast you will seldom hear in corporate life — because for most people, a toast like that will get you fired. And a guy who's bringing reality into a pleasant party, and making people face their own

limitations and errors, will have poor prospects.

But I *love* the kind of a man who makes a toast like that. And I think he's a credit to the human race and an ornament of the civilization. If any of you can join him, why, more power to you.

DEEP SIMPLICITY IS A WONDERFUL BOOK.  
THEN AGAIN, I AM SOMEWHAT BIASED....

A lot of what's in *Deep Simplicity* is well worth knowing.

**Shareholder:** Are there any new mental models that you've incorporated in the last year or so that you'd be willing to share with us?...

**Munger:** The mental model that I've taken on in the last year is that one in the book *Ubiquity*, and also in the book *Deep Simplicity*, where they figure out that you can't predict when the earthquakes, for instance, are going to occur. You know that they're going to occur over time with a certain frequency, but you don't know at any given time when one is going to come.

But you can predict the distribution of size among the earthquakes that are going to occur. And the distribution of size follows what's called the power law. Well, that is a very useful idea.

In fact, a lot of what was in the latter part of that book, *Deep Simplicity*, is very well worth knowing. And that book can be bought, I'm told, through Amazon....

I can't afford too many friends like Peter Bevelin.

**Munger:** I'm somewhat prejudiced because I paid part of the research expenses for that book. That I owe to Peter Bevelin, who's here and keeps sending me books. And I end up sending them to all my friends and paying for their copies.

Well, now I'm starting to send grants to the people who write the books. I can't *afford* too many friends like Peter Bevelin....

It's a wonderful book, but it's not for everyone....

**Munger:** Not everyone will like *Deep Simplicity* — because it's pretty hard to try and understand it all the way through. However, that is truly a wonderful book. And if you do try to understand it and find you can't — well, you can always give it to a more intelligent friend....

YOU CAN LEARN FROM YOUR OWN MISTAKES —  
OR THE MISTAKES AND SUCCESSES OF OTHERS.

LBJ never told the truth when a lie would do better....

**Shareholder:** Last year I asked you if you'd read Robert Caro's work on Lyndon Johnson. You said in fact that you had, but you didn't comment on whether or not you liked it. Also, how did you like Mr. Isaacson's book about your friend, Dr. Franklin?

**Munger:** Well, those are easy questions. I *loved* Caro's book. I thought it was very well done. I thought the Lyndon B. Johnson biography was very useful to anybody who wants a correct view into the human condition. I think it is pretty much true that Lyndon Johnson *never* told the truth when a lie would serve better. And he had

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

unlimited brass in doing it. And he went through his whole life following that exact pattern.

And yet he had this high intellect and this extraordinary energy. He did a lot of good as well as harm in the world. And I'm not at all sure that the good doesn't outweigh the harm.

It's an appalling story of pathological lying over a lifetime.

**Munger:** All that said, I think it's an *appalling* life when you lie as continuously as Lyndon B. Johnson did. It reminds me of something I said at the Berkshire meeting which was said about one of the robber barons: "When he was talking, he was lying. And when he was quiet, he was stealing."

But that's a wonderful book — the Caro biography of Lyndon Johnson — but it's an appalling story in terms of the pathological scale of the lying throughout his career.

It's hard to write a bad biography on Ben Franklin.

**Munger:** As to Isaacson's book on Franklin, I thought it was a *terrific* book. But then he has a terrific subject. It's hard to write a bad biography of Franklin.

My favorite Albert Einstein quote....

**Shareholder:** I know you're a student of science and have an affection for science and math, as do I. And one of the greatest scientists of all time, of course, was Einstein. I wonder if you would comment on what you've learned from his discoveries, and what sort of things he's added to your mental models and your knowledge of reality?

**Munger:** My favorite remark from Albert Einstein, that he may not have said, but he's widely quoted as saying, is: "Everything should be made as simple as possible, but no more simple." If he didn't say that, he *should* have. And I say that because even though it's a tautology, it's a helpful tautology. So that would be my favorite.

You must be able to destroy your own best-loved beliefs.

**Munger:** The other thing he said that I like very much is that success comes from curiosity, concentration, perseverance and self-criticism. And by self-criticism, he meant the ability to change his mind so that he destroyed his own best-loved ideas. If Berkshire Hathaway has made a modest progress in the world, a good deal of it has been because both Warren and I are very good at destroying our own best-loved ideas.

So if you really want a practical thing to take home from this meeting that's rooted deeply in Einstein, it's this: Any year in which you don't destroy one of your own best-loved ideas is probably a wasted year. You want to get good at destroying long-held ideas that you love.

Philip Wiley once talked about a man where "you couldn't squeeze a dime between what he didn't know and what he'd never learn." You do not want to be like Philip Wiley's man. You want to be the guy that can destroy his own well-loved conclusions.

IT'S NO SECRET THAT WARREN IS IRREPLACEABLE.  
BUT OUR CULTURE SHOULD LAST A GOOD, LONG TIME.

As with Wal-Mart, I think Berkshire's culture will endure.

**Shareholder:** There was a discussion concerning the Berkshire culture on Saturday — and maintaining that culture once Mr. Buffett and you aren't around any longer. Sometime in the distant future, I assume at some point a Buffett or Munger descendent will be outflanked about maintaining the culture — similar to what's happened with Disney or Hewlett-Packard over the last year. Do you have any advice for your future heirs who might be managing the Munger Foundation? Would you recommend that they perhaps diversify when that point comes? And would you have any other advice for them?

**Munger:** I am not worried about the Munger family having a huge concentration in Berkshire stock long after I'm dead. I think the Berkshire culture will last just as the Wal-Mart culture has now lasted beautifully for — whatever it is — 12 or 14 years after the death of its founder. I think the situations are quite similar. Indeed, the percentage holdings are rather similar. So I believe that the culture will endure.

I think what you will lose at Berkshire is that the top guy won't be as smart as Warren.

We're way more like Wal-Mart than we are like Disney.

**Shareholder:** I'm looking about 30 or 40 years out.

**Munger:** Well... [Then, after a long pause] you know, I have enough difficulty answering for my own conduct here between birth and death. And if you make me add a little responsibility for what my children do, I don't even like *that*. But when you get into nieces and nephews and second cousins, I *really* don't want to be blamed. [Attendees roar with laughter.] I mean, 40 forty years after I'm dead, I'm not going to answer for the culture.

I think Berkshire has a better chance of maintaining a desirable culture than most places with desirable cultures now — a *way* better chance. I think Wal-Mart is a better example than anything else I can name. And I think we're way more like Wal-Mart than we are like most other places.

You're not entitled to two Warren Buffetts....

**Munger:** I think that what we will lose is not culture — I think that will last a long, long time. But I don't think we're going to replace Warren with somebody just the same.

You know you're not *entitled* to do that well — you shareholders. It would be foolish to say, "What kind of a world is this that gives me a Warren Buffett for 40 years and then some bastard comes along who's not quite as good?"

—OID

As always, the preceding has been reviewed and lightly edited by Warren Buffett, Charlie Munger (and OID) and printed with their permission.



OAKMARK FUNDS'  
BILL NYGREN  
(cont'd from page 1)

However, the fund was not a standout in 2003 — in the 40th percentile in its category — despite earning a return for its shareholders of 29.0%. And its 9.7% return in 2004 lagged the category average of 12.9%. (All performance figures were provided by *Morningstar*.)

One reason, Nygren hints, for the fund's relative underperformance in 2004 was Nygren and co-manager Henry Berghoef's almost total lack of exposure to cyclical and commodity-related businesses which, of course, generated outsized returns for the year. And Nygren goes on to point out that an aversion to those areas is something they at Oakmark share with like-minded value investors — a group he calls "the usual suspects" — composed almost entirely of managers we follow.

A usual suspect (in *OID*) himself, we're very pleased once again to include excerpts from Nygren's comments on Oakmark Select's latest conference call, held October 13th, as well as select comments from his two prior calls. Incidentally, if you were one of those investors who were disappointed to learn Oakmark Select had closed its doors to new investors back in May of 2001, you might be pleased to hear that the fund re-opened them — albeit to direct investors only — on November 10th.

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OUR MARKET VIEW REMAINS BASICALLY UNCHANGED.  
WE'RE NOT INTERESTED IN THE MARKET LEADERS.

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Valuation-wise, nothing much has changed...

**Nygren:** For the last couple quarters, we've been saying that stocks don't appear to us to be bargain priced, but that they do appear to be sufficiently attractive that a long-term investor should earn higher returns in stocks than in bonds or in cash....

And the fundamentals haven't changed enough for us to alter our valuation estimates. Prices haven't changed enough to alter our view that stocks are generally selling at modest discounts. So I really don't have anything new to say about the market level, the lack of dispersion across different securities, or our thought that, in general, quality premiums for many stocks aren't quite as large as they deserve to be....

We're not interested in electric utilities, energy and cyclicals.

**Nygren:** And looking at our relative performance year-to-date, it isn't clear cut how to evaluate our year. Relative to our *Morningstar* peer groups, Oakmark is very slightly below average relative to large-cap value funds — and Select is near the bottom of the mid-cap value funds. That comparison to us is disappointing.

However, relative to the list of value managers that have done well over a long period of time — and that's the group we've discussed frequently on this call, the names that I refer to as "the usual suspects" — Oakmark and Oakmark Select are right in the middle of the pack.

I think the reason that the comp groups are giving such different readings is the strong performance so far

this year of electric utilities, energy and cyclicals — industries that both we and the usual suspects have historically underweighted. We continue to believe other sectors of the market offer more opportunity than do the sectors which have led so far this year.

SINCE IT DOESN'T COST THAT MUCH TO UPGRADE,  
WE'RE BACKING UP THE TRUCK ON BLUE CHIPS.

We're still finding opportunity in higher quality companies.

**Nygren:** Like many of our peers who've turned bearish, we are frustrated with a market that has shown more measured reactions to disappointments. This has prevented the creation of a lengthy list of new bargain opportunities. However, as the spread between prices for high and low quality businesses continues to contract, instead of moving to cash, our response has been to increase our holdings of higher-quality businesses....

For example, we believe Citigroup's discount is undeserved.

**Nygren:** For example, we added two new names in the second quarter — Citigroup and Wal-Mart — that exemplify these declining quality spreads. Citigroup sold four years ago at roughly twice the P/E of the average financial services stock. And as much as we admired their global franchise, we couldn't justify paying that much of a premium for what we readily acknowledged was a superior business.

Now, at just 12 times expected 2004 earnings, Citi is priced the same as most financial service companies, and at a discount to the market multiple. And, obviously, we believe that discount is undeserved.

[Editor's note: Bill Miller recently seconded the motion on Citigroup when on October 29th he noted to a Wharton University audience, "I think right now some of the best opportunities are in financials. You can buy Citi at 10 times [next year's] earnings with a close to 4% yield and a 20% ROE. And they'll grow the dividend 10-15% a year."]

We believe Wal-Mart deserves a much bigger premium....

**Nygren:** Similarly, four years ago, Wal-Mart peaked at 55 times earnings. By contrast, it's now priced at about 19 times expected next-year earnings. One way to think about that P/E compression is as follows: In 2000, Wal-Mart's P/E was a little over twice the market's P/E. If Wal-Mart's earnings per share grew as expected — which was about 700 basis points per year faster than the growth expected for the S&P — it would have needed more than 10 years of that excess growth in order to eliminate that P/E gap. So Wal-Mart now needs only about *two* years of excess growth to eliminate the premium.

We believe that it is highly likely that Wal-Mart will still be viewed as an above-average company two years from now. And unfortunately, we know some grocery store and toy store executives who would agree with us.

And we upgraded from Kroger to Limited Brands.

**Nygren:** As a final example, in the Select Fund in the second quarter, we sold our position in Kroger and replaced it with Limited Brands. So for a very modestly higher P/E, we were able to move from a franchise that has labor cost disadvantages and is under attack by the world's largest retailer to a retailer with strong brands — Victoria's Secret

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

and Bath & Body Works — each of which dominate their respective categories....

UNFORTUNATELY, QUALITY ISN'T ALWAYS ENOUGH.  
IT HASN'T BEEN WITH FNMA, MERCK OR CHIRON.

Some recent buys and sells in Oakmark....

**Nygren:** In the Select Fund in the third quarter, we neither added any new names nor eliminated any existing positions. In Oakmark, we added Coca-Cola Enterprises. And to preempt a question, we felt that at two thirds the multiple of Coke, the bottler was the more attractive value. We also added Viacom and JPMorgan.

Sales of successful holdings included Boeing and small positions in Clorox and Hospira. We also sold Schering-Plough which, despite a good rebound, had been a mistake.

We think Fannie Mae's price gives us a margin of safety.

**Nygren:** A couple of our holdings were in the news in a negative way. Fannie Mae lost 10% in the third quarter after a regulatory report raised accounting questions. We hope and expect that most of those issues will prove to have been complexities about which reasonable accountants could disagree. If not, it may require a reassessment of management quality.

At a single-digit P/E, we think the valuation for Fannie Mae leaves room for some changes — such as a higher required capital level. Even if that were to occur, we would still consider the stock to be attractive.

Merck, Chiron took big hits — stockwise and valuewise.

**Nygren:** Merck lost 30% of its value after Vioxx was pulled from the market. We thought Vioxx was only worth about half what Merck's stock fell. However, unfortunately lawsuits could be negative enough to account for the rest of that decline. Net net, we don't find Merck significantly more or less attractive now than we did three weeks ago.

Just after the end of the third quarter, Chiron was hit after their British regulator banned the shipment of this season's flu vaccine. Though we would love to dismiss this as a market overreaction to a onetime issue, we think there is a reasonable probability that Chiron's share of the flu vaccine business will now be permanently lowered in the U.S., as the U.S. seeks to avoid ever again being so dependent on one supplier. Therefore, our estimate of Chiron's business value has declined. And we don't find that stock much more attractive or less attractive now despite the lower price.

The good news is that these negatives were offset by

(continued in next column)

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good fundamental performance across the rest of our portfolio, and our returns this year continue to be similar to the market despite the blowups....

WAMU WAS A DISAPPOINTMENT, TOO  
— AND IN MORE WAYS THAN ONE....

First, the good news — WaMu's retail banking business....

**Nygren:** Finally, there is Washington Mutual.... On the plus side, its retail banking business continues its above-average growth. And in the second quarter, we saw several more retail banking transactions occur at good prices — at book value plus a 20-40% premium on deposits. That premium to book value correlates pretty well with a number like \$2,000 to \$3,000 per checking account. So we monitor checking account growth. We think that's also the best indicator of customer satisfaction with WaMu — because it is the primary banking relationship for an individual.

Tangible book value plus 20% of deposits would value WaMu's retail bank alone at about \$48 per share today. And each quarter that passes, with deposits growing and shares outstanding declining, causes that value to increase.

On the other hand, mortgage banking has disappointed.

**Nygren:** Offsetting that positive, mortgage banking's been a disappointment. For some perspective, WaMu built its mortgage business, starting just a few years ago, largely via acquisitions. And the rate of return on these investments has been very favorable despite the recent disappointment.

At the risk of oversimplifying this disappointment, when WaMu made these acquisitions, they believed that their downside was covered by the mortgage servicing rights they acquired, and that the upside was quite large if they succeeded at the originations business.

WaMu's hedges were disappointing on a couple of counts....

**Nygren:** To further protect that downside, WaMu entered into financial hedges in order to protect the value of the mortgage servicing rights against declining rates. And remember that declining rates are a negative for mortgage servicing rights because refinancings increase as rates fall — which eliminates the existing mortgages which WaMu services.

And that financial hedge has been effective. However, it worked against the natural business hedge of combining an originations business with a servicing business. I think in hindsight, WaMu management made two mistakes: First, as success at originations became apparent, continuing such a large financial hedge was no longer the conservative course of action. Second, I don't believe their strategy on hedging was ever well communicated — either to us or to the general population of shareholders.

WE EXPECT THE MARKET TO REWARD US,  
BUT IF IT DOESN'T, THEN AN ACQUIRER WILL.

There's been much sound and fury, but it signifies little.

**Nygren:** Needless to say, these mistakes are frustrating to us. But in the context of the big picture, they've caused a very small hit to WaMu's business value. We continue to think that something like 75% of WaMu's

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

value is in the retail bank side, while 75% of the earnings volatility is created by the mortgage bank. And we are supportive of WaMu's goal of continuing to grow their retail banking while they work to cut costs and improve their mortgage banking profitability.

But we don't see a reason to change our posture on WaMu.

**Nygren:** Some of our clients have suggested that they'd like to see us do something — either sell the stock, buy more, work to remove management — just do *something*. However, since we agree with the path management is pursuing, we have no interest in trying to change them. We still believe the valuation suggests WaMu deserves to be our largest holding, and the relatively muted price reaction to a large earnings miss was, in our judgement appropriate, given that the miss was confined to the less valuable piece of the company. We don't think the stock has reacted in a way that creates opportunity — in a way that allows us to change our position in *either* direction in a way that we think benefits our shareholders.

Either the market will reward us or an acquirer will.

**Nygren:** WaMu's stock today trades at about 9 times expected earnings, yields over 4% and has a dividend that we believe is not only safe, but likely to continue increasing. And it appears to have an acquisition value that is well above the current price and is growing. We'll continue carefully monitoring results — especially watching for continued growth in retail banking, as measured both by the dollar amount of deposits and by the number of checking accounts.

Management still has a very large personal investment in WaMu's stock. And we expect them to make better efforts at communication that is more candid — especially regarding the risks and thought process behind their hedging activities. If the retail bank continues to grow, both earnings and business value will move higher. As with many of our holdings, we believe that if the market doesn't reward that growth, then an acquirer will....

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SOME MANAGERS PREFER TO WAIT IT OUT IN CASH.  
WE BELIEVE WE'VE FOUND A BETTER PLACE....

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We were finding lots of opportunity during the tech bubble.

**Shareholder:** A number of other value investors have been having a tremendous amount of trouble finding stocks that are worth buying. A number have indicated to me that they don't believe there are any bargains out there at all. And their mutual funds are up to 25% or more in cash. Looking at your latest quarterly report, I noticed that you're about 10% in cash. Why do you have a different point of view than they do?

**Nygren:** I think that's probably one of the most interesting questions right now — because there is such a divide across value investors as to what we should be doing, given that the dispersion across stock values has declined

so much over the last few years. I've said many times that ironically, it was easiest to find really cheap stocks at the peak in the market, because it was almost like there were two markets. Tech and telecom were selling at real expensive levels, whereas everything else was priced as if it were in a different world — many at single-digit P/Es.

Unfortunately, it's now hard to find really cheap stocks.

**Nygren:** In the last four years, we've seen a collapse of that spread as the expensive names have come down, and the more inexpensive names have gone up in price. So I think what we're left with is a market level that we think looks appropriate — with P/Es only a tad above historic averages, and interest rates substantially below recent historic averages. So I think investment in the market is likely to provide a better return for long-term investors than investment in long-term bonds or cash.

On the other hand, it's hard to find really, really cheap stocks.

We think we have a better place to wait it out than cash.

**Nygren:** Now, I think one of the reasons we've been able to find names that fit our criteria while some managers haven't is that we have a willingness to pay higher prices for higher quality businesses. Most of the

*PORTFOLIO REPORTS* estimates the following were Oakmark Fund's largest equity purchases during the 3 months ended 9/30/04:

1. VIACOM INC CL B
2. JPMORGAN CHASE & CO
3. DISNEY WALT CO
4. COCA-COLA ENTERPRISES INC
5. CITIGROUP INC
6. WAL-MART STORES INC
7. LIBERTY MEDIA CORP CL A
8. COMCAST CORP CL A SPL
9. GENERAL MILLS INC
10. MCDONALD'S CORP

names we've been adding in Oakmark over the last year to year-and-a-half have fit that kind of profile — like Anheuser-Busch, where it wasn't selling at much of a discount to the market, but where we think it is a *much* better than average company.

[Editor's note: Gardner Russo's Tom Russo has told us much the same thing about Anheuser-Busch. And he's owned it for more than a few years.

However, for those willing to shop overseas, both Tweedy, Browne's Chris Browne and First Eagle Global Fund's Jean-Marie Eveillard have recently pointed out that Heineken Holding is a cheaper way to buy many of the attractive attributes of BUD. And based on their recent portfolio activity, Nygren's colleagues, David Herro and Michael Welsh, at Oakmark International — as well as Tom Russo and New York Venture Fund's Chris Davis — would seem to agree.]

**Nygren:** Wal-Mart, a name we added in the second quarter — we paid a *very* slight premium for a company we think is a far superior company. I think that the value managers who have been willing to pay that premium have

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

had the easier time staying invested.

I understand the willingness that some of them have to draw a line in the sand and say, "I'm going to earn 1% on my cash until great values appear again." However, I think the opportunity to buy really good businesses at average prices is a better place to wait it out until mediocre companies sell really cheaply again....

[Editor's note: Of course, Century Management's Arnie Van Den Berg represented the other school of thought in our April 30th edition when he, in effect, suggested that (1) interest rates are below normal levels and (2) an ebbing tide could lower all ~~ships~~ stocks enough — meaning soon enough and/or low enough — to make cash the better bet.]

WAL-MART'S PRICED LIKE AN AVERAGE COMPANY,  
BUT WE LEARNED THE HARD WAY THAT IT'S NOT.

We say we want a 40% discount, but it really depends....

**Shareholder:** I know that you require a 40% discount to intrinsic value. However, in the case of Citigroup and Wal-Mart, can you explain to me how one could get to that 40% discount on these stocks, or if something maybe has fundamentally changed in terms of the intrinsic valuation discount you find acceptable?

**Nygren:** There are answers on both sides of that. I don't think we have made a fundamental change in the kind of discount that we are looking for. But the purchase at 60% of business value has always been something we've used as kind of an *average* for a new position.

So if a company needs to have a transaction or some other transforming event to achieve its business value, then we would demand a *larger* discount. So maybe we'd only be willing to pay up to 45-50% of its value if we thought we either needed a different owner or some other major change to happen.

With Wal-Mart and Citi, our required discount is less.

**Nygren:** On the other side, when our business value has been based on a public market exit price and we thought it was *above-average* quality, we've been willing to not demand a 60% of value entry price, but rather to go up more towards 70% of our business value. So the 60% of value figure has been an average of that 50-70% range.

And given that our business valuations of Wal-Mart and Citi depend on public market value comparable sales, as opposed to transactions — and both, we believe, have unusually high quality — we'd be willing to pay an average price of more like 70% of business value for those two.

And our valuations aren't rocket science....

**Nygren:** How do we get there? Basically, with Citigroup, we just assume it's worth a very small discount to the market multiple on numbers out a couple of years. Under that single assumption, the current price is less than 70% of intrinsic value.

And with Wal-Mart, our belief is that the abnormally high growth that they've enjoyed the last couple of decades

can continue long enough that they deserve to be selling at a premium to the market of at least, say, 50%, as opposed to the near zero percent premium on two-year out earnings that the stock is trading at now.

We learned how good a company Wal-Mart is the hard way.

**Nygren:** I think our experience on the negative side is how difficult Wal-Mart has been as a competitor for Toys "R" Us as they have attempted their turnaround, and also how difficult they've been as a new entrant in the grocery business. In the case of the latter, its advantages seem to be structural because of their nonunion setup relative to the grocery stores who are still largely union. And the grocery stores' unions are unwilling to try and maximize their long-term value as opposed to their short-term value. So all of those things have made us more confident that unlike most retailers, Wal-Mart's advantages truly are structural — even against competitors with good MIS systems and good internal cultures regarding costs.

So we believe Wal-Mart is truly a superior company. We think that the chance of it showing only average earnings growth the next two years is remote. And the thought of buying it as if it's only an average company out two years from now to us is an exciting opportunity. This is the kind of company that, if price weren't an issue, almost *anyone* would want to own. To be able to purchase it on terms where you don't need to assume that it's a much better-than-average company for it to give you average returns is an unusual opportunity — and one we haven't seen in years.

WAMU'S MORTGAGE BANKING? WHO CARES?  
TO US, IT'S ABOUT CHECKING ACCOUNTS PER SHARE.

It's not what's focused on, but the value's in the retail bank.

**Shareholder:** Do you have any fresh comments on Washington Mutual that you could share with us — even if they're redundant — given the size of that position?

**Nygren:** Sure. And I'll try to make my redundant comments as fresh as I can.... Our confidence in WaMu comes from how large a piece of the value and overwhelming majority of the value growth comes from retail banking as opposed to mortgage banking.

The company has had a goal of becoming a nationwide bank for the middle class. They have used what is often the initial contact with the customer — the mortgage application — as a way to introduce the customer to the bank. Then, they go after the customer [to make WaMu the place where they have their] primary checking account....

By the most important measure, value is growing rapidly....

**Nygren:** WaMu has somewhere between 8 and 9 million checking accounts now. They are growing that number at about 1 million per year. So they have a growth rate in checking accounts of something like 12%. Even better, they're doing that while they're shrinking the equity base something like 5-6% per year. So the measure we're focused on — checking accounts per share — is growing in the mid-teens per year....

[Editor's note: Based on WaMu's third quarter

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OAKMARK FUNDS'  
BILL NYGREN  
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earnings release, for the 12 months ended September 30th, their total checking accounts grew just under 9.3%. Meanwhile, WaMu's shares outstanding declined almost 4.5% during the same period. Thus, we estimate that checking accounts per share during the period were up slightly over 14.4%.

On the other hand, their growth has slowed during recent quarters, as have share repurchases, along with the rest of WaMu's business.]

AND I DON'T WORRY ABOUT DERIVATIVES AT WAMU.  
BUT EVEN IF I'M WRONG, WE SHOULD BE FINE.

We like this mgn't — and they seem to like their stock.

**Shareholder:** With so much of the fund in that one holding, how comfortable are you that WaMu doesn't have any ticking time bombs? I don't have anything specific, but I keep reading about how a lot of financial institutions have loaded up on one carry trade — i.e. borrowing short, buying long and pocketing the difference.

Then there's the issue of derivatives. Fannie Mae, Freddie Mac, and others are all implicated daily in the Wall Street Journal and by regulators. I'd just be curious how you've satisfied yourself on that front.

**Nygren:** For starters, to some extent, there's a black box there that we can't see inside of. And I guess there is always the potential that there is something bad in there that you don't know about.

So why do we sleep at night despite the large positions we have in Washington Mutual? Well, it starts with our confidence in Kerry Killinger as CEO. Kerry has a very long-term wealth building attitude. I don't think he has the personality type to try to engage in transactions that would help him short term, and hurt his long-term value.

He does have most of his personal assets invested in Washington Mutual's stock. And we have not in any way seen a large-scale move by Washington Mutual executives to pull out of the stock and thereby save their own capital, which, I think, would be the case if there were grounds for concern. If there were a problem inside the black box, I think we would be seeing a lot more insider selling.

We like their openness....

**Nygren:** Washington Mutual is more open than almost any other financial institution when it comes to allowing regulators access into their trading room and to their books. Even for unscheduled exams, most of the regulatory agencies comment that they have the freedom to go to Washington Mutual whenever they want and look at whatever they want. Again, I don't think that would be consistent with a problem inside the black box....

Even if we're wrong, our downside is covered and more.

**Nygren:** So I wish I could tell you that we are certain there's not a problem there. Obviously, we can't get to that level of certainty. However, I think we've taken the steps that are reasonable to comfort ourselves that this is not an above-average risk company.

**Shareholder:** Is it fair to say that of all the discussions and all the questions you've ever had about Washington Mutual, that this might be the one area where there's a scintilla of doubt in your mind?

**Nygren:** I wouldn't say that. I really do not worry about this issue. However, in part, that's because on the valuation side, as I said, we think the retail bank *alone* is worth more than the current stock price.

But when you say, "Given the limits to what disclosure is, is it possible that there's something there you don't know about?", I can't say, "No, that's not possible." It's truly something I *don't* worry about, but I don't know how to deflect the fears of people who don't have the confidence in the people that we do....

WE STILL TRUST WAMU'S MGM'T,  
BUT BETTER YET, WE DON'T HAVE TO.

WaMu mgn't could'a/should'a been more candid....

**Shareholder:** I listened very carefully to your comments on Washington Mutual. And I have no doubt whatsoever that you perfectly have a handle on everything as far as the business value of the company. But I am a little bit perplexed at your reaction as far as management. And I'd like to hear a little more of a tangible explanation of why you still give credibility to these people. You mentioned that you want them to communicate better. Isn't that a bit of an understatement considering that not long ago, their CEO was quoted as saying these interest rates would have no effect on their earnings? And then a few months later, when everybody and his brother knew what was going on with interest rates, they predict a huge, huge miss....

How in the world was Washington Mutual caught with their pants down?

**Nygren:** For starters, let me give you WaMu CEO Kerry Killinger's comments on interest-rate sensitivity. He's always said that they didn't believe a parallel shift in the yield curve in either direction would have a significant effect on their earnings.

Unspoken was that they were really just talking about their net interest margin. They weren't talking about changes that may be likely but not certain in the mortgage origination market based on interest rate changes. So we thought they were using their hedging operation to hedge their mortgage banking business, not the mortgage servicing segment of their banking business. And that had us believing that some of their earnings these last couple of years were structural — or long term in nature — as opposed to cyclical relative to the mortgage boom.

Again, I think they could've and should've been more candid about exactly what was included in those projections.

Killinger didn't lie, but he allowed us to get misled.

**Shareholder:** Don't you think it was a bit misleading to come out with that statement? To me, it was like a general overview of the company whereby, in effect, they were saying, "Based on what's going on, we don't foresee any problems." So I interpreted it as misleading the investing public. Do you think I misinterpreted what he said?

**Nygren:** I think we *all* misinterpreted what he said. While the words he said were factual, the implication that

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

it gave to all of us was that lots of variables other than just an interest rate shift had been included in his comment — that, in effect, he thought the company was relatively immune to interest rate moves.

And I believe that was implied — but again, not specifically stated. So I interpret it as he didn't lie to us, but he allowed us to come to our own conclusions.

In WaMu's retail banking franchise we trust.

**Nygren:** Why do I have the comfort level here when other companies where we feel management hasn't been candid have caused us to sell the stock? I think one of the biggest reasons is the numbers I was talking about of the franchise value in retail banking.

And none of that depends on believing anything we hear from management. WaMu's book value number is an audited number. And the deposit number is not only audited, but it has lots of banking regulators looking at it. And that figure has to tie to a number of other numbers throughout the Federal Reserve system. So I don't think that those are fakable numbers.

And its value doesn't depend on mgt's representations.

**Shareholder:** We've all learned the past few years how auditors can be fooled. I'm also a CPA. So I know that these auditors rely on what management tells them. And they don't look very far, if they don't have to — trust me on that one — from the other end. They take what management gives them. And if management is giving them numbers that aren't real... So I don't hold a lot of credence in "the auditors' numbers"....

**Nygren:** Again, it's beyond just the audit of a regular corporation. They are numbers that a number of different regulators have to look at and tie with numbers that are not created by WaMu management. So I think there is much better than average outside verification of those numbers.

We can't come up with any reason to believe that WaMu's deposits would deserve a substantially different premium level than other retail banking deposits. We're not relying in our analysis on management's breakdown of how much income is coming from retail banking versus how much is coming from mortgage banking. So before we even get into the other reasons why I haven't given up on this management, the entire thesis of the valuation is based on numbers that have outside verification — which is unusual.

WAMU MGM'T IS VOTING WITH ITS MONEY  
— AND DOING WHAT NEEDS TO BE DONE.

WaMu's management understands the mistake they made.

**Nygren:** But in addition, management continues to have most of its personal net worth invested in the stock. It has a 20-year history of growth in the retail banking area. And as to the question of why they had results very different than others in the mortgage banking business, I think because of the way WaMu built this business, and because so much of it was acquired so recently, that management took a prudent course to hedging their acquisition value

that was probably not reassessed as it should have been after they had succeeded in growth on the origination side.

I think management *realizes* they made that mistake. And after we get to a more normal spread between mortgage rates and Treasury bonds — which got to a very small spread in the second quarter — I think it is likely that you'd see management reassessing the need for such a large financial hedge.

However, am I disappointed and frustrated with 'em? You bet....

WaMu mgt is already doing what should be done.

**Shareholder:** Harris Associates is one of the largest institutional holders of WaMu. One of the first value funds I invested in was the Mutual Series funds of Michael Price. And when Michael Price was in the same position as you — when he saw a company like WaMu that had great value, but he felt management was not recognizing the value — he *did* something to kind of right things. And it worked. Would you consider doing something like that?

**Nygren:** As I said, the course that management is on is trying to fix the mortgage banking business. And we believe that the steps they are taking to fix that business should lower their expense structure, and should make

PORTFOLIO REPORTS estimates the following were Oakmark Select Fund's largest equity purchases during the 3 months ended 9/30/04:

1. GAP INC

that business more valuable than it would be in a distressed sale today. They are continuing to spend the money to grow the retail banking deposit franchise. And they are using their capital to repurchase shares.

If we decided we wanted to try to do something here and replace management, we would give them exactly the same agenda of what we thought needed to be done to grow value as what management is doing today. So I just don't see anything to be *gained* by us doing that.

And WaMu's value is growing nicely while we wait...

**Nygren:** And given how rapidly the takeover value of the company would be growing if they succeed at this fix and if they continue growing deposits 10% a year while they shrink the equity base somewhat, I think it would be *foolish* to sell the mortgage banking business today.

**Shareholder:** Okay. Well, I trust you — I just don't trust *them*.... [Shareholder laughs.]

We're activists from time to time, but only by necessity.

**Nygren:** As to becoming more like Michael Price, I hope you all remember that we're not unwilling to *do* that when we believe that we have made a mistake in judging management and we think there's a different course that they could be on that'd be necessary to maximize the value of the company. We're *very* willing to get our hands dirty.

For example, we were very involved in the change at Dun & Bradstreet — which resulted in two holdings in the Select Fund and one in the Oakmark Fund that have had exceptionally good performance over the last four years.

(continued on next page)



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

[Editor's note: At this year's *Morningstar* conference on June 25th, Nygren shared a panel with Price's successor (and *OID* contributor) David Winters, where he amplified on the subject:

"David's firm is an expert at shareholder activism. But I think there's a danger in the current trend of encouraging people to buy into poorly-managed companies and turn activist — because bad managements can do a lot of damage while you're trying to get them removed."

**Nygren:** And there are a few cases where we've gotten frustrated enough with management that we've just sold the stock. We sold EDS because we weren't comfortable with the story that we were getting from them. And we sold Interpublic Group for that same reason....

But generally, we don't want to be an activist manager. We want to invest with managements we think *are* doing the right thing. And our opinion as of now is that the management at Washington Mutual is continuing on the right path to maximize our long-term value....

WE THINK WAMU HAS A VERY VALUABLE FRANCHISE  
AND THAT ITS MANAGEMENT IS ON THE RIGHT TRACK.

WaMu's problems shouldn't hurt its retail bank's value.

**Shareholder:** From a takeover perspective, do you feel that the fundamentals of WaMu are still pretty good so that it'd be an attractive candidate for other banks?

**Nygren:** I *absolutely* believe that's true. Clearly, I would much rather have been discussing on this call why Washington Mutual got a 30% premium for their deposit base in an acquisition than an earnings shortfall.

I think management is taking the sensible course of action of *not* pursuing a takeover today, and instead focussing on growing the very valuable basic banking business, and fixing the problem that they've got in mortgage banking. But I don't see any reason why the problems they had with declining mortgage originations and the financial hedge in mortgage banking would have any spillover whatsoever into the value of their retail bank.

We think WaMu has a very valuable franchise....

**Nygren:** We find the acquisitions of Charter, FleetBoston, and Bank One — each at a higher premium to its deposits than the one before it — very encouraging when we look at the retail bank side of WaMu, which has one of the fastest growing deposit franchises around.

And even though WaMu's customer tends to be a more middle-income customer than some of those other banks, the fees its customers generate are just as good. So I think it is a very valuable franchise.

And we don't care whether we get paid now or later.

**Nygren:** And whether WaMu's value comes out while it's a public company after it's done the rest of the geographic expansion and they get a higher multiple than they've got today, or whether it's achieved through an acquisition, I obviously don't know. And to some extent, I

don't care. As long as its value keeps going up each year, I'm comfortable with the path that they're on.

We think WaMu is very good at rolling out new branches.

**Shareholder:** Would you say that the retail initiative, like the one in Chicago, is being done well?

**Nygren:** I'd say that Chicago has not been one of their better markets. However, away from Chicago, the success that the company claims — and we believe them — has been *very* strong. The stores generally achieve profitability very rapidly. It's relatively low cost to roll out. And the growth that they're seeing in checking and savings accounts has to be attributed to their successful retail roll-out....

**Shareholder:** Do you think there's anything to the reports that the board's getting a little restless with Killinger?

**Nygren:** I don't have any insight on that....

BUT WE DO WISH WAMU HAD BEEN MORE CANDID.  
LOTS OF THINGS ARE GOING RIGHT THERE NOW.

We understand what WaMu management was doing....

**Nygren:** Any time there's an earnings disappointment in a company, you're stuck with that difficult analysis where you say, "Did they not know this? Did they not understand their own business enough to know that this was a risk? Or did they know it, and did they misrepresent it to us?" And neither way are you really comfortable with the answer.

I think the Washington Mutual situation kind of goes down the middle of that road — where I think management *did* understand the risk they were taking. They were letting more income from the mortgage boom drop to their bottom line than they were explicitly telling us. They were using those gains to offset the unusually high costs that they had from their retail banking roll-out.

And they thought that if that continued maybe six or nine months longer than it actually did, then they would have a chance to rely more on the natural business hedge of their loan origination capability, which has been strongly built up during the last several years. In that case, they would have created a nice, smooth earnings progression — and they would never have had to talk much about the unusual costs or the unusual gains that were coming through the income statement.

We don't think they outright lied to us. They couldn't....

**Nygren:** Mind you, we were disappointed that they hadn't been more candid about what the risks were if the mortgage refinancing boom ended when it did. However, having gone back and looked at things, we don't think they outright lied to us. We don't think they did something that was a stupid risk to their business value.

And we don't need to rely on what management tells us about the assets that are in their bank. It's looked at by so many outside agencies that it's not even possible that they could be making up those numbers. So there's so much external confirmation of the good news in the better parts of the business in Washington Mutual that it gave us pause, but it wasn't enough for us to say that this is something that we're extremely troubled by.

And probably most important, all the management at WaMu still has most of their own net worth in the stock.

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

There was no large outpouring of insider sales prior to the announcement last quarter....

Some things are going right — like their spreads....

**Shareholder:** So it sounds like you're somewhere between ticked, but not completely ballistic as of yet — maybe somewhere in the middle.

**Nygren:** That's right. And I would say — as I put in the Select Fund report — I'm comforted that some things seem to be going right at Washington Mutual this quarter. For example, they claim that they're ahead of plan on the cost savings side in their mortgage banking business. And WaMu's real problem at the end of the second quarter was that their spreads were at historically very low levels. That basis risk of where mortgages end versus where Treasuries end is something that WaMu has a lot of exposure to from one quarter to the next. And the spreads between Treasuries and mortgages have now returned closer to a normal level.

Frankly, it looks like more of a timing issue.

**Nygren:** And I can see their point when they argue what difference does it make how much of those gains and losses run through the income statement in any given quarter — because over any lengthier period of time, it does offset. In fact, as WaMu's mortgage spreads get more into a normal range, I think we'll see them take off some of their hedge and rely more on the natural business hedge of their strong mortgage origination business offsetting their strong servicing business.

AND WAMU'S MORTGAGE BANKING SIDE  
COULD BE WORTH ANOTHER \$10-15/SHARE.

WaMu emulates Countrywide in mortgage banking....

**Shareholder:** Would you please describe how Washington Mutual's earnings and stock price have behaved versus Countrywide over time?

**Nygren:** There are a lot of similarities between Countrywide and the mortgage banking side of WaMu. Countrywide has done it much better than WaMu has.

[Editor's note: Interestingly, despite doing what Nygren describes as "a better job" in mortgage banking, Countrywide had a big shortfall in earnings recently, too.]

(continued in next column)

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**Nygren:** And I think WaMu has been trying to imitate Countrywide, and to combine a number of different investments in the mortgage area to create something like what Countrywide already has. When they talk about their cost-cutting goals, their target at WaMu is always to do at least as well as what Countrywide's been able to achieve.

WaMu's mortgage banking biz could be worth \$10-15/sh.

**Nygren:** If it were valued similarly to Countrywide's, Washington Mutual's mortgage banking business would probably be worth \$10-15 per Washington Mutual share. Mind you, right now, it's not earning money. So if WaMu can cut costs and match Countrywide's efficiency, that part of the business that isn't contributing to earnings today could be worth \$10-15 per share.

But again, the part of WaMu that we really like is the retail bank.... That's the part of the business that we think is worth more than the stock price. And meanwhile, it's growing at a double-digit annual rate.

Then, if they can fix the mortgage business, that would be a very nice bonus. And that would clean up a lot of the earnings volatility that's been frustrating to deal with for the last couple of years.

FINANCIAL RISK AT CITI, FREDDIE AND WAMU?  
THERE'S NOT MUCH TO SPEAK OF, REALLY.

At Citi, your protection is sheer size....

**Shareholder:** When I think about your success, I think a lot of it involves avoiding the really big losers. However, in these big financials — like Citi and Fannie — how much of their businesses are basically black boxes? How do you figure out how risky they are?

**Nygren:** ...Even though there's a lot we don't know about various hedges inside the financial institutions, I'm not sure that makes them a lot more of a black box than things that go on inside industrial companies.

I think at Citi, part of the answer to your question is that its sheer size, global diversification, and diversification across financial services industries gives them such a broad exposure to the global economy that it would be hard for a hedge in any one of those areas to have the kind of effect that the mortgage servicing hedge had on WaMu.

At Fannie Mae, the issue is political risk.

**Nygren:** We think Fannie Mae's a great growth vehicle because it's a play on the amount of mortgage dollars outstanding in the U.S. They don't benefit as much from mortgage refinancings as the mortgage banking companies do. Yes, they do a lot of interest rate hedging. But again, I don't believe there is the same type of risk there.

As a substitute, though, we've got much higher *political risk* — and potential that people with an agenda other than long-term maximization of business value have the ability to make some changes in how Fannie Mae is operated. And I think that's one of the reasons that we can't target an exit multiple on Fannie Mae that would be as high and as reflective of the franchise value as we would put on something like a Washington Mutual retail bank....

How we get comfort with our holdings' derivatives risk....

**Shareholder:** Regarding your financial holdings, and

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

trying to quantify their derivatives exposure in case we got into a negative episode, I guess your answer is that it's a survival of the fittest — that the larger institutions probably won't have as many problems?

**Nygren:** We don't see every derivatives contract the banks have. What we *do* see is what their policy is toward the credit of the counterparties. And in both Citigroup and Washington Mutual, what we have read about that derivative exposure and the high credit quality on average of that portfolio gives us some comfort with it.

DIMON SEES A LOT OF OPPORTUNITY AT JPMORGAN.  
AND WE THINK HE'S RIGHT — AND RIGHT FOR THE JOB.

There's a lot of opportunity for Dimon at JPMorgan....

**Shareholder:** Based on your comments in your Oakmark letter, I take it that you like Jamie Dimon.

**Nygren:** We do.... We've got a lot of respect for the job that he did at Bank One, and think there's a lot of opportunity for improvement on the cost side at a merged JPMorgan/Bank One.

**Shareholder:** Yeah. I think he's *very* bright. And maybe a very bright guy like him is just what the doctor ordered to add tremendous value to JPMorgan Chase. I've always admired him greatly.

I think Jamie's got a chip on his shoulder — which is good.

**Nygren:** In our quarterly report, I mentioned that our chief investment officer, Bob Levy, has said that he likes people who enjoy athletics because it shows their competitive spirit. However, he'd rather hire someone who was *cut* from a team than who was the *star* of the team because they still have something to prove.

Well, I think Jamie's got a chip on his shoulder and wants to prove something.

**Shareholder:** That's okay.

**Nygren:** Yeah, that's *better* than okay.

**Shareholder:** I think he's a *very*, very bright guy. And it was Sandy Weill's loss. I guess it was a mistake when he was let go there. I think he's going to add a lot of value to JPMorgan Chase....

**Nygren:** I agree with you.

And Dimon just reiterated what he hopes to achieve....

**Nygren:** And incidentally, our analyst was at the Chicago Economic Club last night when Jamie addressed the club. And he said, in response to a question, that if he can achieve what he thinks he can, five years from now the stock should be \$100.

I know that's repeating a quote that he made at the time of the merger, but I think it's encouraging that after this many months have passed, having gotten inside JPMorgan, apparently nothing has changed his mind about what the potential is there....

I'M STILL COMFORTABLE WITH JANUS.  
AND I THINK MGMT'S TAKING THE RIGHT STEPS.

Redemptions have been worse, but mgm't's gotten better.

**Shareholder:** I just wanted to ask you about a couple of other financial services companies. In particular, you own Janus in the Select portfolio. There's been a lot of things going on there in Denver recently. So I was wondering if you could comment on the steps that they've taken in terms of changes at the firm — including the new people that have come on board. Also, is the outflow of the redemptions you've seen at the firm more or less than you expected? And, finally, could you give us a sense of your future outlook and whether or not it still represents a good value?

**Nygren:** I would say that the redemptions that we've seen at Janus have been slightly more than we would've expected in an environment where mutual funds in general were getting money in and the stock market environment was healthy. So that part has been a disappointment.

Offsetting that, we're very pleased with the management changes. I've had the opportunity to meet with [President/CIO] Gary Black and the new CEO. I think Gary is the right sort of personality to be a leader and to help with Janus' turnaround. Our opinion has been that there continue to be a lot of good people at Janus and a strong investment culture. I think they have been in need of a leader like Gary. And I think he will do well there.

And our investment thesis on Janus remains sound.

**Nygren:** I'm still comfortable with the Janus holding. I think management is taking the right steps. And I think it's unfortunate, obviously, that they got caught up in the timing scandal. But basically, our original thesis there has played out — that among the names of fund companies who were caught up in the scandal, their name would not be included in the more offensive infractions, and that they would get the problem behind them and move forward more quickly than some of the other fund companies.

WE CONTINUE TO BE BELIEVERS IN H&R BLOCK.  
WE THINK IT'S GOT A GOOD FUTURE AHEAD OF IT.

Customer count at H&R Block's tax biz continues to fall.

**Shareholder:** Could you briefly touch on another financial services company, H&R Block, which looks like it's been under some pressure due to some issues regarding their business. Are you concerned about that?

**Nygren:** Although its income was as high as had been expected and hoped for, H&R Block reported that the tax season number of customers coming through their offices was down slightly versus last year — and last year was down a bit versus the year before that. It's the first time they've had two years of back-to-back customer declines.

They attribute it to some frustration that their advertising toward more middle-income customers — as opposed to the lower-income customers who frequent Block — had not been as effective as they had hoped. And they've also been impacted by increased competition from Jackson Hewitt and Liberty Tax, who seem to have done an

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

effective job of putting up offices close to H&R Block's most successful offices and kind of living off the runoff traffic as potential H&R Block customers chose not to wait at H&R Block, but rather to get immediate service at the other two.

But HRB is solving the problem and improving otherwise.

**Nygren:** I believe that H&R Block is pursuing a very reasonable strategy of trying to increase the number of branches in order to improve their branch density so customers won't have those wait problems. They thereby hope to eliminate the opportunity for their competition to pick off their customers.

With H&R Block, as with Washington Mutual, we're very pleased with how management has been redeploying their cash flow. H&R Block's tax business is a great cash generator. And they've been using that money to repurchase shares and strengthen their basic brand.

Also, I've been getting more comfortable with their mortgage business. And as that grows as a share of their total income, there's been increasing concern by some that their mortgage business isn't as good as the tax business. And while I would agree with that, I think that some of that segment's profit growth has come from structural improvements in running their mortgage operation, as opposed to just participating in a mortgage boom.

So H&R Block continues to be a very large holding — and we think it's got a good future ahead of it....

TOYS "R" US HAS BEEN A MIXED SUCCESS —  
BECAUSE ITS DOWNSIDE OFFERED US UPSIDE.

At Toys "R" Us, there's been good news and bad news....

**Shareholder:** Bill, could you give us your latest on your view of Toys "R" Us?

**Nygren:** Sure. Toys "R" Us during the last quarter, as you're probably aware, announced that they are considering alternatives for their retail toy business that include the potential sale of the company.

If we look back to when we first bought Toys "R" Us four years ago, we believed they'd be able to succeed in turning around the toy business, and make a very successful specialty retailer out of it. Unfortunately, we have been proven wrong on that assumption.

Fortunately, that wasn't the only underpinning of our purchase of Toys "R" Us. We also felt that Babies "R" Us was a very successful chain. And that's continued to do *extremely* well and grown faster than we originally expected.

A logical outcome could be in the low to mid-\$20s.

**Nygren:** We also thought the value of the real estate underneath the toy stores gave us a pretty good backstop just in case we were wrong about their eventual ability to compete with the likes of Wal-Mart. And as we look at the real estate value underneath the toy stores, we think a logical outcome of real estate value for the toy business, plus a specialty retailer multiple on Babies "R" Us plus a lower multiple on the international toy business together gets us a number up into the low to mid \$20s. And perhaps

a real estate expert can get a higher number than that — because, frankly, I think our real estate assumptions are somewhat conservative.

[Editor's note: For whatever it might be worth, we suspect that Nygren is right about his numbers being somewhat conservative. Our own back-of-the-envelope guesstimate of value is in the mid-to-high \$20s — although we're probably double counting their real estate assets to one degree or another. (Plus, we *know* that we're suffering from a severe case of incentive-caused bias....)]

Rich or poor, it's good to have money assets.

**Nygren:** So I would view Toys "R" Us as kind of a mixed success. It shows the value of having a good Plan B — a downside that's supported by something other than the view of how successful the business might be. And I'm pleased that our assessment of the real estate that initially gave us comfort on Toys "R" Us, has proven to be valid — although we're disappointed, obviously, that we thought they could succeed in specialty toy retailing, and it doesn't look like they will.

Their after-Christmas-sale this year may be a doozy.

**Nygren:** So our guess is after the Christmas season, they will evaluate whether offers for the toy stores make it worth selling them *en masse* to someone else, or they end up closing some of the stores and selling off some of their real estate — like what Eddie Lampert is doing with Kmart now. Either way, I'm comfortable that John Eyster's goals are very similar to our goals as outside shareholders. And I have a lot of confidence he'll decide to do the right thing....

WHY DO WE LIKE VIACOM?  
IT'S SPELLED C-A-B-L-E.

Why we never bought Viacom in the past....

**Shareholder:** You and the other usual suspects, as you call them, have had a lot of investments in both the content and distribution sides of media. And Viacom is not a name I've seen a lot of in your portfolios or those of the other usual suspects. So I'm kind of wondering if you can address what your reluctance to own it may have been in the past, and what got you comfortable with it now.

**Nygren:** Viacom, in case anybody doesn't know, is one of the leading entertainment conglomerates — with large positions in cable television networks, as well as radio and broadcast television and Paramount Studios.

Our reluctance to owning Viacom in the past has been that our favorite assets in the media area have been cable networks. And Viacom, through its diversification, had less exposure there than did the other names that we've owned — like Liberty Media and, I think, even Time Warner.

Today, much more of Viacom is cable related.

**Nygren:** Also, four years ago, Viacom's stock was selling in the mid-\$70s. And cable networks probably accounted for 20% or so of its EBITDA. Today, with the stock down in the mid-\$30s, cable networks represent around *half* of the earnings stream of the company. And we're much more comfortable with the growth prospects for cable networks than we are for either radio or broadcast TV.

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

So as the price has come down and the share of the earnings coming from cable networks has grown, we've gotten more comfortable with Viacom.

And I think the list of names that they have on the cable side is a very strong one. Their MTV network suite of channels — including VH1, the Comedy Channel and Showtime, among others — is a strong one. I think that they've done a good job managing them.

With cable, we think there's a lot to like.

**Nygren:** And what we like about cable networks is that the number of people they're available to grows almost every year — and the percentage of TV viewing that is done on cable versus broadcast grows almost every year. And there is still a gap between what an advertiser's willing to pay for a cable eyeball relative to a broadcast eyeball. And we think that gap will continue to close.

So they're growing subscription fees as the number of viewers grows. They're growing advertising as cable's share of TV viewing grows. And they have great cash-flow-generating characteristics because the networks don't require much reinvestment in infrastructure.

Viacom's cable assets are ones distributors need to have.

**Shareholder:** Aren't the cable companies trying to pick up content assets? I wonder if Viacom is a little light on distribution assets?

**Nygren:** Well, I don't think everyone shares the point of view that content assets need distribution assets. If your goal is to start up new programming, you do have an advantage if you have some guaranteed distribution. But for strong demand-pull networks like those that Viacom has, I don't think their value changes much whether they're tied to a distributor or not. They're the kind of networks that you need to have as a distributor — whether you're cable or satellite or if eventually that moves more toward internet. The brand value is at the cable channel level.

But there's need to have networks and then there's ESPN....

**Shareholder:** Are they up there with the ESPN level of franchise value?

**Nygren:** I think MTV is probably close to that. But as you know, we've got a good size position in Disney. And the primary asset there is now the ESPN suite of channels. We think it's a fantastic brand. So we own that one, too....

[Editor's note: Exactly what Longleaf's Mason Hawkins and Staley Cates have said in the past, and reiterated again just recently (see page 26).]

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I WANT TO AVOID ENGAGING IN GROUPTHINK  
NO MATTER HOW IMPRESSIVE THE GROUP.

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Ben Graham conference reminded me of what's important.

**Shareholder:** You spoke at two conferences earlier this year — the *Morningstar* conference in June and the

Ben Graham conference in New York back in May. And the Ben Graham conference had other speakers such as Seth Klarman, Bill Ruane and Walter Schloss — who have compounded capital at very high rates of return for longer periods of time than you have. What did you take away from that conference — especially from Schloss who did it on more of a quantitative basis, and didn't put a lot of credence in managements.

**Nygren:** The event I spoke at was a New York Society of Security Analysts' meeting that was a tribute to Benjamin Graham — kind of celebrating the book that Jason Zweig wrote to be a companion or update to Graham's *The Intelligent Investor*. There were a lot of great long-term investors at that event.

On the positive side, the takeaway when you see some of these people — who range in age from younger than I am to much older than my father — is their ability to apply discipline to a financial investment program over a long number of years, and just how powerful that can be, and how meaningless it can make the news flow that we hear on a day-to-day basis. You hear these people talking about an investment philosophy they developed — some of them going back 50 years in time — and how it evolved.

And it makes you realize that whether the Fed moves interest rates by 25 or 50 basis points — which seems to be the only thing you hear on CNBC — in the long run, it really makes zero difference to someone's ability to succeed or fail as an investor.

But I don't want to engage in groupthink even with them.

**Nygren:** On the negative side, I thought it was interesting that most people I met at that conference were negative on the market right now. And for some of them, that negativity goes back to the time that net-net working capital stocks were no longer available; for some of them it goes back to when book value stocks weren't available; for some of them, it's that you can't find many stocks now at a single digit P/E multiple.

For me, I think it highlighted the danger of drawing a line in the sand versus a single statistical criterion of valuation, and declaring a market overpriced or underpriced based on that single criterion.

And I think after having attended that conference, that's a risk I will be even more careful with. I mean, we think our strength is bottom-up analysis, not top down. And yet, there are people there who allowed a top-down thought process to affect their market view that then overrode their thoughts on individual companies. And getting a chance to see that first hand, hopefully, makes me less likely to make that mistake.

—OID

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## DAVID DREMAN, HERITAGE VALUE EQUITY FUND

"Financial stocks continue to represent our largest sector weighting at approximately 33% of the fund's net assets as of fiscal year end. A large portion of our exposure to financials is in bank stocks. Washington Mutual and Bank of America are the largest bank positions, and we continue to like their prospects. It has been a difficult year for Washington Mutual, as they have announced shortfalls in earnings because of poor hedging results in the mortgage business. Over the years, Washington Mutual's been an aggressive acquirer of smaller thrifts — and integration problems finally caught up with them. While we were disappointed with the negative earnings surprise, the stock has still provided a small gain year-to-date. Over the next several quarters, Washington Mutual should sort out its integration issues — and we expect them to earn better than \$4 during 2005. With the stock currently trading at around \$39, Washington Mutual trades at a P/E of less than 10 and yields better than 4.5%. The fact that Washington Mutual has held up so well in the face of the recent bad news is testament to the inherent value the market places in the franchise it has created.

"Tobacco stocks continue to remain a large part of the overall fund portfolio (approximately 15% of net assets). All of the tobacco-related holdings posted positive returns for the fund's fiscal year. The big news in tobacco stocks is that the Federal trial in Washington, DC got underway in September. The case has been outstanding since the Clinton Presidency, and the trial is focused on alleged violations of the RICO (Racketeer Influenced and Corrupt Organization) Act. The RICO Act was passed to make it easier to prosecute organized crime, and has never been used against legitimate businesses operating in the U.S. Needless to say, we believe the case has little merit. The notion that a business that pays 70% of its gross profit to governments is somehow a criminal enterprise seems somewhat farfetched. Also, to prove its case, prosecutors have to show an ongoing conspiracy exists. Given the changes in practices the tobacco companies agreed to when they settled with the states in the late '90s, we see little chance of such an outcome.

"Looking ahead, we believe that the end of this case will significantly lift the valuation of tobacco stocks. Altria (formerly Philip Morris and the fund's second largest holding) is likely to pursue a break-up of the company if its stock price does not experience significant appreciation. Our sum-of-the-parts evaluation places an \$80 target on the stock price, which means better than 50% upside from current prices. If our analysis is correct, we would expect to pare back positions in Altria as our price targets are achieved."

Annual Letter to Shareholders — December 6, 2004

Dear Subscriber,

We could have easily filled this entire edition with cautionary remarks from our contributors that make our stomachs queasy and our knees shake. Perhaps we even *should* have. Some of the most successful investors around — including Berkshire Hathaway's Warren Buffett and Charlie Munger, Leucadia National's Ian Cumming and Joe Steinberg, Century Management's Arnie Van Den Berg, Jim Brilliant, et al., Longleaf Funds' Mason Hawkins, Staley Cates, et al. and FPA Capital's Bob Rodriguez — are holding record or near-record levels of cash.

So between what our contributors have been saying and doing, and the unusual difficulty of finding ideas that we're excited to share with you, it seems clear to us that slam dunk bargains are *very* few and *very* far between.

In that case, what's a poor bargain hunter to do? Well, we would suggest the same old mantra — i.e., to disregard Mr. Market altogether and look for companies that you'd be excited to own, that are selling at prices that you're excited to be paying. However, for reasons we hope to bring you in more detail in our next edition, we believe that both logic and valuations today dictate the importance of erring on the side of caution and quality.

Speaking of the importance of focusing on quality, that seems to be exactly what Oakmark Select's Bill Nygren is doing. Although we don't believe that he would describe very many of the stocks he's been buying as dirt cheap, most of them do appear to offer well-above-average quality at a relatively ordinary price.

And it looks to us like most of the managers featured in this edition — including Tom Gayner of Markel Gayner and Davis Advisors' Chris Davis — are, for the most part, doing the same.

Next edition, besides better laying out the challenges, we hope to shine a spotlight on another oasis of value within the bargain-scarce environment which seems to prevail today. Meanwhile, perhaps today more than ever, patience is golden. So keep the faith. And who knows? Just when you least expect it, cash may again become king.

Until next edition,

  
Your Editor

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