

Outstanding Investor Digest

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

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Volume XXI Number 3

May 20, 2008

ARTHUR D. CLARKE & CO'S ARTHUR D. CLARKE
"HERE'S MY LIST OF CAUSES THAT CONSTITUTE
THE GREAT SUBPRIME LOLLAPALOOZA OF 2007."

In addition to posting excellent returns for his clients over the last 20 years — earning 14.8% net of expenses for the ADC & Co. Composite versus 11.8% for the S&P 500 — Arthur D. Clarke has provided a consistently insightful commentary with his annual report. And this year is no exception. We're pleased to share with you Clarke's

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CLIPPER FUND'S CHRIS DAVIS
KEN FEINBERG & CHARLES CAVANAUGH
"THERE'S A HUGE DISCONNECT IN PRICING FINANCIALS.
IT'S THE BIGGEST ARBITRAGE WE'VE EVER SEEN."

Filling a large pair of shoes is not exactly new to Chris Davis. After all, when he assumed the helm of his father Shelby Davis' flagship New York Venture Fund in 1997, it had one of the best and longest records on Wall Street, with a compound annual return of over 14% for a 28-year period. But pedigree can only take you so far. When Chris Davis and partner Ken Feinberg were selected to manage Clipper, they had put up excellent numbers of their own —

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FAIRFAX FINANCIAL'S
V. PREM WATSA
"WE ARE WORRIED ABOUT A 1-IN-50 OR 1-IN-100 YEAR EVENT,
BUT WE'D LIKE TO THINK WE CAN HANDLE IT."

Fairfax Financial's long-term record of compounding book value per share under the leadership of Chairman Prem Watsa is nothing short of amazing — 26% versus 11.8% for the S&P 500 for the 22 years ended 12/31/07. And Hamblin Watsa Investment Counsel's equity returns are no less impressive — returning 25.9%, 18.5%, and 19.5% versus 12.8%, 5.9%, and 10.4% for the S&P for the 5, 10, and 15 years, respectively, through 12/31/07.

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DREMAN VALUE MGM'T'S DAVID DREMAN
"THE MAJOR BANKS HAVE MADE MAJOR MISTAKES.
BUT THEY'LL RECOVER — AS WILL THEIR EARNINGS."

David Dreman is perhaps best known as a columnist and author of books on investor psychology, and how a contrarian mindset, coupled with buying low multiple stocks, is the best way to combat "the madness of crowds." But the proof is in the pudding. For the 20+ years since inception on March 18, 1988 through March 31, 2008, the DWS Dreman High Return Equity Fund had a compound annual return of 12.7% versus 10.7% for the S&P 500.

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ARTHUR D. CLARKE & CO'S
ARTHUR D. CLARKE
(cont'd from page 1)

thoughts on the causes and consequences of what he terms the "great subprime lollapalooza of 2007."

ANNUAL REPORT COMMENTARY — MARCH 12, 2008

A summation of causes brought about the perfect storm....

The market finally took note of subprime lending mid year and didn't like what it saw. To borrow Charlie Munger's term, we had a "lollapalooza". In the current vernacular, we would call it a "perfect storm", but Charlie's description captures an important aspect: there was no one cause but, rather, a summation of causes, which together became additive. Such perfect alignments are hard to see: we generally focus on individual causes, which taken by themselves may not seem alarming. But together: *Wow*.

Here is my list of causes that constitute the Great Subprime Lollapalooza of 2007, in no particular order:

Investors wanting higher returns were willing to cut corners.

(1) With the demise of the dot.com market, real estate became the new Siren Song of quick wealth for those eager to make money fast and easily.

Endowments and pension funds across the country and, indeed, around the world were frantically in search of "yield" in a low interest rate environment: they wanted higher returns — and were willing to cut corners. Forgotten, or never learned, was Warren's folksy wisdom that what you want most in a spouse is *low expectations*.

GSEs were pressured to push money into subprime loans.

(2) Owning a home is part of the American Dream. Washington helped promote this dream. Congress jumped at the vulnerability of Freddie Mac and then Fannie Mae when they were found to have made accounting errors. To avoid tougher regulatory oversight, they were pressured to put substance in the Community Reinvestment Act passed in 1977. The result was that they pushed money into real estate loans that they had previously prudently avoided. They called them, you guessed it: "subprime".

At the same time the Bush Administration salivated at the opportunity to clip the wings of the GSEs and to privatize the mortgage industry, all the while turning a blind eye to the inevitable abuses. Washington's complicity in the mess has not been fully appreciated — but expect them to trip all over themselves trying to ride like heroes to the rescue.

Loans were designed to trigger a refi — and another fee....

(3) Lenders devised a system that paid high commissions for agents to sell subprime (and thus higher interest) loans to people — whether they needed a subprime loan or qualified for a prime loan. Thus, with those incentives, agents steered many people to subprime.

(4) And they added "teaser" rates. Not in the usual sense, like six months zero interest. These were designed to rise after a while and trigger a refinance — and another fee. Unwitting buyers went along because real estate values only went up, right?, so buyers assumed that they'd refinance in a year or two, take money out — and, yes, as was reported in one case, pay off the loan on the white Lexus.

And Greenspan failed to act on the lending abuses....

(5) No small amount of blame has to be placed at the feet of the revered Alan Greenspan. He not only kept interest rates too low aiding the dot.com bubble, he did it in *spades* with the real estate bubble.

He rationalized the irrational exuberance he saw around him. He also — and this may be more serious — failed to act on the lending abuses of which he was well aware, perhaps distracted by writing his revisionist memoirs.

Even endowments and pension funds took on leverage....

(6) Low interest rates led a variety of hedge funds and off-balance sheet entities to leverage the purchase of securities that consisted of pools of mortgages. (Endowments and pension funds circumvented their restrictions against leveraging by investing in these highly leveraged vehicles.)

Last summer, this behavior was revealed as the classic danger of funding illiquid long-term securities with liquid — but ephemeral — short-term funding, which evaporated almost over night. As Warren put it, the tide ran out, and we soon saw who was swimming naked....

Once again, diversification was a fig leaf for ignorance.

(7) Until last summer, the real estate markets were considered to be local — there was no national market. That is, prices might soar or soften in one market, but they would [do the opposite] in another.

Thus, it was believed you would have a sure thing if you owned a geographically diversified basket of mortgages, as in mortgage-backed securities. It was another example of diversification as a fig leaf for ignorance.

The rating agencies have lost serious reputational value.

(8) The rating agencies, Standard & Poor's, Moody's, and Fitch, deserve a fair share of blame. Perhaps charitably, they believed the previous item — that all real estate markets are local — and that, therefore, a geographically diversified portfolio of mortgages deserved AAA ratings.

Perhaps they enjoyed the fees a little too much, which were much higher — and more profitable — than the fees on municipal and corporate securities. Not surprisingly, the fees and ratings were commensurate: the securitizers bought what they got. Whatever their motives, they have lost serious reputational value. Their moats have been greatly diminished.

Then, accountants & regulators added fuel to the fire....

(9) The accountants and regulators don't get off without a scratch. While they may not have caused the bubble, they clearly contributed to its rapid deflation by requiring that mark-to-market rules apply to highly illiquid securities. Mark to market has its use: your monthly statements and quarterly reports are marked to market. Our holdings are liquid, trading usually many times a day. By marking to market, we are less likely to fool ourselves that all is well when it might not be.

But would we find it useful if every morning we rose to find the value of our house, which we do not intend to leave, marked to market? And is it meaningful if that price is derived from fire sale conditions that a sensible, non-coerced individual would ignore? Probably not.

(continued on next page)

ARTHUR D. CLARKE & CO'S
ARTHUR D. CLARKE
(cont'd from preceding page)

Finally, there was the "irrational exuberance" element....

(10) To the above, we have to add a psychological element. The fact that it is present, at least lurking, in all markets doesn't qualify it to be ignored. It operates at two levels: the psychology of the individual and the psychology of the aggregate of these individuals. We, ourselves, have done a pretty good job of keeping our heads level, while the market careens from extreme to extreme with barely a breather in between. Not long ago, it was dot.com/high tech. [Today,] it's commodities.

Our job is to keep a level head to the point of stubbornness. As Ben Graham put it, you are right because your thinking is right, not because others agree with you. Or as Nietzsche put it: "Beware the person who agrees with you."

But what appears to be irrational may, in fact, be rational.

Of course, what appears to be irrational behavior, may, in fact, be rational. This was brought home to me years ago when I lived on the 35th floor in a high rise in Chicago overlooking the Museum of Science and Industry. During peak visitation, the parking lot would become congested. Cars would back up because the lead driver was waiting for someone to back out. It seemed irrational to me because I could see that there were several open spaces further down. One day as I idly watched, it dawned on me that the waiting driver couldn't see what I saw. We live with imperfect information and do the best we can. But it may look stupid to others.

The caution to me is not to let apparent irrationality cauterize further scrutiny — you have to probe until you understand why people acted the way they did. I suspect many of the players of the current mess in all honesty thought they were acting reasonably. And maybe they were.

WE MOST LIKELY HAVEN'T SEEN
THE END OF THE FINANCIAL DISTRESS.

Jamie Dimon builds fortress banks for difficult times....

We own in varying amounts shares in JPMorganChase, M&T, and Wachovia.

We received JPM when it bought Bank One, and WB when it purchased Golden West. The key to both Bank One and JPM was and is the CEO, Jamie Dimon. Over the years I have come to admire him as a focused, owner-oriented manager who really understands his business — and is candid talking about it. He emphasized at Bank One and now at JPM what he calls building a fortress bank so that

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in difficult times, which will occur, his bank can be an acquirer and not the acquired.

He was trained by Sandy Weill, but he clearly took lessons from Warren. The proof is in the pudding. JPM had minimal exposure last summer to subprime — and reported losses are so far within expected cyclical range. And its stock was only down 7% last year.

Buffett said that M&T was a no brainer — and we agree....

M&T is a well run regional bank headquartered in Buffalo, NY. Over the years, it has expanded out of its base throughout New York and the mid-Atlantic. At each stage, the CEO, Robert Wilmers, has acted like the owner he is. Years ago, Berkshire bought an issue of preferred stock, which has since been converted to common. When asked once about the purchase, Buffett replied that it was a no brainer. BRK owns 6% of M&T.

M&T has not been involved in the subprime mess. But when they encountered problems with so-called Alt-A loans, which are a class between prime and subprime, M&T immediately wrote down the loans and placed them, now cheap, in its portfolio. The market had for some while accorded M&T shares a premium price because of its quality. They gave up some of that premium last year, declining 31%.

Wachovia is a "portfolio lender" that eats its own cooking.

Both GDW and Wachovia are what Herb Sandler called "portfolio lenders", that is, they retain in their portfolio the loans they issue. That's the equivalent of eating your own cooking, an act of faith that has become increasingly rare in the mortgage lending business. GDW's mortgage business now makes up about two thirds of WB's mortgage book. The same people are still running the show.

GDW never issued subprime loans; they did not issue the step-up loans designed to trigger a refinance and another round of fees; they did not buy loans from the many mortgage companies that made their fees by originating loans and selling them off — and because they were making a long-term commitment to hold the loans to maturity, they were conservative lenders. They used their own in-house appraisers, and the average loan to value of the house is about 70%. Also, their home equity loans are primarily first-lien loans made to existing bank customers. Although WB's non-performing loans have risen, they haven't risen to anywhere near the levels of competitors....

From the beginning, the market didn't like Wachovia's purchase of GDW, and this has weighed on the stock price. WB was down 30% last year. Insiders, however, have been unusually heavy buyers of WB shares.

How much deleveraging is still ahead is unknown....

We most likely haven't seen the end of the financial distress. How much deleveraging of balance sheets — personal as well as business — is still ahead is unknown. My concern is that the Fed is laying the groundwork for a bout of inflation by succumbing to election-year political pressure to stave off a recession, whatever it takes.

But the world will not come to an end, and we have plenty of fire power working for us. We should come through this fine and may be better off for it. In the meantime, I spend my time looking for younger Herb and Marion Sanders who are eager to make money with principles.

—OID

CLIPPER FUND'S CHRIS DAVIS
KEN FEINBERG & CHARLES CAVANAUGH
(cont'd from page 1)

performance that was further validated by their being named *Morningstar's* Domestic Equity Manager of the Year for 2005. And their long-term record has continued to shine. Davis New York Venture Fund has returned 6.4% on average for the 10-year period ended 4/30/08, versus 3.9% for the S&P 500. Clipper's short-term results, however, have been less than stellar. Since the departure of Jim Gipson and Michael Sandler at the end of 2005, Clipper's returned 2.1% on average versus 6.5% for the S&P for the 2-1/3 years ended 4/30/08.

At this year's Clipper Fund annual meeting, held March 19th in Beverly Hills, Davis fielded shareholder questions about Clipper's rough patch with characteristic candor and self-deprecating humor, showing once again that the apple hasn't fallen far from the tree. Davis covered ground on a wide variety of topics, including the current crisis in financials, and opportunities that may be arising therefrom. Given the long history of Davis Advisors' focus on financials, we thought this a particularly opportune time to bring you the third generation of accumulated wisdom.

To follow are excerpts from comments made at the Clipper Fund annual meeting by Chris Davis and analyst Charles Cavanaugh — as well as, for additional perspective, excerpts from comments made by Ken Feinberg in Clipper's 2008 Portfolio Update. We hope that you find them as timely and interesting as we do.

THE LAST FIVE YEARS, CLIPPER HAS BEEN
SORT OF THE LABRADOODLE FROM HELL.

This is not a one (or two) man show. On the contrary....

Chris Davis: Welcome, everybody. I'm Chris Davis — and this is my colleague, Charles Cavanaugh. Lest you think Ken [Feinberg] had plastic surgery and got 10 or 15 years younger, he had something come up in his family and couldn't be here. And we both wanted Charles to come in his place for two reasons:

One, if I sat up here alone, it conveys the impression that this is a one-man — or even when Ken's here, a two-man — operation. And we work with a terrific team of analysts. There are 12 of us. And I particularly get a lot of credit that's owed to others in the organization. Charles has worked with us for almost six years — and he's just first class in every way. And I thought that if you ask hard questions that I can't answer, I can defer them to him....

Grandma doesn't want any excuses about our performance.

Davis: I thought I'd briefly look at our results, try to give you a little insight into the portfolio — and some changes in it — talk a little bit about what's happening in the world of financial stocks and credit and capital markets, and then just touch on our outlook. And this will be very quick, because the real purpose of this is to take your questions.

I'll start with our trailing results. I'm going to talk a lot about long-term goals and long-term perspective. But you know, I went dancing with my grandmother last weekend. She's 101 — and she was dancing to "Blue Suede Shoes". She's also a large shareholder of Clipper and she was asking me about it.

And she said, "Well, don't forget: the long-term is a lot of short-terms put together." So she didn't want me to make excuses — and she's right.

The five-year results at Clipper are an abomination....

Davis: What I want to try to do is put the results in some context. You know, our compensation packages for the portfolio managers and analysts — as Charles, as a member of the research team, knows — are tied by and large to our five-year results. And for it to fully vest, we have to have beaten the market after fees — and we have to be in the top quartile relative to competitors. So that's how we measure ourselves.

Now, when you look at the five-year results at Clipper, they are an abomination — they are *terrible*. But in a sense, there's no single person to blame. Our predecessor — who ran a firm and a fund that I admired throughout my career — went through an uncharacteristically bad three years in a row just before he left. And the result was Clipper trailed the market by 6% a year for the last three years that his team was running it....

During those same three years, our results were about 3% ahead of the market per year. So we had a relatively good three-year stretch — he had a relatively bad three-year stretch — and the switch happened just in time for us to go into the tank. And in the two years since then, we've trailed the market by about 4% a year.

Clipper shareholders got the worst of both managers....

Davis: The trouble is that if you'd had either one of us for five years, the results probably would've been satisfactory. And we can look at our own five-year results and say that — even though we don't think that they're anything to write home about — they were satisfactory, certainly relative to the market and to competitors.

I don't know what Jim [Gipson]'s team's record would have been in the last two years. But knowing his long-term record, I'd expect they would've been very good, particularly coming off such a bad three-year patch. So in a sense, we've taken the worst of both worlds.

This has been sort of the labradoodle from hell....

Davis: I don't know if anybody knows about these dogs called labradoodles. But the theory of a labradoodle is that you breed a poodle and a labrador — and you'll get the intelligence of the poodle, and it won't shed, and you'll get the nice disposition of the labrador. And I've always questioned why that's the presumption. Why isn't it the case that you could get a very snappy, irritable, dumb dog that sheds? [Audience laughs.] There's a presumption that you'll only get the good traits.

Well, this has been sort of the labradoodle from hell, in the sense we've got the worst stretch from two different managers. And for that, we don't make an excuse — and we apologize — but we want to give that context. In another three years, the five-year results will be, for better or worse, all ours.

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CLIPPER FUND'S CHRIS DAVIS
KEN FEINBERG & CHARLES CAVANAUGH
(cont'd from preceding page)

But our total return since our firm was entrusted with the management has been about zero. And over that two years and three months, the cumulative return of the market was about 12% — or about 4.5% compound during that period. So our returns were well below — on both an absolute and a relative basis — what our goals are and what our compensation plans are tied to.

BUT CLIPPER BEING MORE CONCENTRATED & SMALLER
SHOULD WORK TO OUR ADVANTAGE OVER TIME.

We initially failed to take advantage of Clipper's smaller size.

Davis: Turning to the portfolio: I think in many ways, our approach is consistent with Clipper's history in that it's eclectic, it's opportunistic, and it's concentrated.

The eclectic nature was predictable, and the concentrated nature was predictable. But in our first year managing Clipper, one of the things we did not take advantage of was its relatively small size. We'd never intended Clipper to be hugely different from what we do with our larger funds, except that it would be more concentrated. And I think after a year, we realized that we had not taken advantage of Clipper's relatively small size.

Oaktree is an example of where we can be opportunistic.

Davis: And particularly in this environment, that's let us be much more opportunistic. I'll use Oaktree as an example. Many of you may know Oaktree. Howard Marks is its chairman, and we've read his memos for maybe eight years. It's a high-grade operation.... But the company wasn't public.

When the company came public in a very quirky, strange, low-key way, well, that was interesting to us. We know the business, we know the people, we admire the culture, and we had followed it for a long time just as admiring investors — but we hadn't been able to own it. Well, if we weren't running Clipper, we probably wouldn't be able to own it, in the sense that Clipper, as a vehicle, allowed us to buy a position that could be meaningful in what would otherwise be a relatively small company.

And that should work to our advantage over time....

Davis: So what you've seen is some relatively large holdings in some relatively small companies. And I'll touch base on some others if you have questions. Besides Oaktree, I'd highlight RHJ, a strange Belgian holding company — I'll give you the peculiar background of that investment later — and Redwood Trust, a small real estate/mortgage operation that we've recently purchased that's up in San Francisco and that Charles and I were just visiting yesterday. And we'll be with Oaktree this afternoon.

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Those are positions that we can't own in size for our other funds. The companies themselves are too small. And we hope that over time, this will help Clipper. The one thing I would *not* have expected — and I would not expect over time — would be for Clipper to do worse than our other funds, because it's more concentrated, and it's able to be more opportunistic. But it *has* done worse. But I think the ability to have relatively larger positions in smaller companies is something that should be helpful over time.

Limiting your focus to regional markets is anachronistic.

Davis: Another characteristic of Clipper that's somewhat different than in the past is it has a relatively larger percentage in international companies — or what I'd say are companies whose securities are listed outside of the U.S.

Around 1993, my dad and I were at a research conference that was sponsored by a little firm called Adams Harkness & Hill. I doubt you would know them out here. It was a New England research boutique that was focused on companies in New England. Well, there were lots of these sorts of boutiques in the Southeast, the Midwest, the oil patch, and so on.

And my father said, "You know, this is an anachronism — because while it used to make sense that you could have an advantage studying companies in one region, it no longer makes sense. If you're studying an insurance company in the Midwest, for example, and you don't have a national perspective, what you'll find is that you're disadvantaged on two fronts:

"The first is you will misassess the company's growth prospects if you don't know how well it's competing outside of its Midwestern market. And second, you'll misassess its competitive threats if you don't go to Washington and study Geico and see how it might be advantaged."

Nor does it make sense to limit yourself to one country.

Davis: Well, the analogy he was trying to make was that the same is true of investors that divide themselves by geography — thinking they're a U.S. investor or a European investor or an Asian investor. He said the fact is that all companies, by and large, compete in a global landscape. And it won't make sense to limit your research to companies based on where their stocks are trading.

How can one person study Anheuser-Busch and another study Heineken? Or one person study Merck and another person study Roche, or Sanofi or Takeda? How can one person study ConocoPhillips and somebody else study BP, Royal Dutch Shell, Petrobras or PetroChina? These companies all compete in a global landscape.

So you'll probably see more non-U.S. companies in Clipper.

Davis: So starting in the mid-'90s, we reoriented our research around that premise. And the result is that oftentimes there's a company that doesn't happen to have a U.S. listing, but that will have, in our view, a more attractive valuation in terms of risk and reward than a company that happens to be listed here. Forty percent of the earnings of the S&P 500 are now from overseas. So it doesn't even make sense to think of the S&P 500 as a domestic index.

So what you've seen in Clipper — and I expect will continue to see — are more non-U.S. companies in there.

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CLIPPER FUND'S CHRIS DAVIS
KEN FEINBERG & CHARLES CAVANAUGH
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For example, we have some Japanese nonlife insurance companies: Millea, which is just a new name for what used to be called Tokio Marine & Fire — the largest insurance company in Japan — and NipponKoa, also a Japanese nonlife insurer....

So international holdings are a change that reflect a long evolution that I expect will continue.

**"FIRST COME THE INNOVATORS, THEN THE IMITATORS
— AND THEN COME THE SWARMING INCOMPETENTS."**

It seems a little different, but it's always the same.

Davis: The next point I want to touch on is financials and the current environment in the credit and capital markets. You know, Charles and I had breakfast this morning with Charlie Munger, who is a hero and mentor and somebody we've admired a long time. And he said, "You know, in a funny way, it's always the same. It seems a little different, but it's always the same."

And what he meant is that as you look at what's happened in the credit markets today, the particulars are different but the *pattern* is the same. The old Spanish saying is: "What wise men do in the beginning, fools do in the end." Well, that sort of gets at it. Bill Ruane, who was one of the great managers of the last 40 years, had a great expression. He said: "First come the innovators, then come the imitators — and then come the swarming incompetents."

First, you get great returns — and capital starts flowing in.

Davis: Well, that pattern goes back to the South Sea Bubble or Tulip Mania. It's a simple sort of four-stage pattern, right? And as I describe this pattern, you can think of Drexel Burnham and high-yield bonds in the '80s; you can think of S&Ls and commercial real estate in the early '90s; you can think of the quant strategies and global arbitrage and Long-Term Capital in the mid-'90s; and you can think of the recent tech, internet, and NASDAQ bubble. Now, we've got a fifth bubble. And this pattern applies to all of them.

First, there's an asset class that produces great returns for a long period of time. Second, as these returns get noticed, capital starts flowing into the asset class. And that capital flow is usually accelerated by intermediaries that charge high commissions or high fees.

Then you get more leverage & lower quality — and collapse.

Davis: The third stage is that the participants feel justified in adding or increasing leverage. And banks are happy to lend — because the past returns justify more leverage. At the same time, the definition of the asset class usually broadens — and that, in effect, lowers quality standards. So you get more leverage and lower quality. And then you get to the final stage, which is collapse.

And as I say, you'd see it whether it was Long-Term Capital, Bank of New England, Drexel, Enron, Global Crossing, or WorldCom — or what we're now seeing with the collapse of Bear Stearns. Every one is different in its peculiarities, and is different in its magnitude. And this

current one is a large magnitude. But the pattern, as Charlie said, is always the same....

The four most expensive words in investing....

Davis: You know, my grandfather used to say that the four most expensive words in investing are: "This time it's different." And usually you hear those at market tops. You hear them as a justification for why we're on a plateau of permanent prosperity, and why things won't collapse. But you also hear them near bottoms. You hear, "No, this time is different. This time the system is going to collapse. This one is much worse."

So I just want to give you some numbers to think about — because I think there's an enormous durability and resilience in the economy over a long period of time. I think that it absorbed crises in the past — and I think that the durability and the resilience will show through here. I don't know when it will be. Charles and I just met with a terrific investor in San Francisco. And he said his feeling was that this was going to be a *long* bottom, not a snapback — and that may well be.

The people that get killed got in late and levered the most....

Davis: But here's a number to think about to try to give you some context around what we've seen in mortgages: The appraised value of residential real estate in this country is about \$21 trillion. The total mortgages outstanding are \$10 trillion. Now, I know this is not evenly distributed and there are people that own their house outright. But there's an enormous amount of equity in the houses relative to the amount of mortgages outstanding.

Think of that \$10 trillion of mortgages, and then think about the fact that when the tech bubble burst in '01-'02, the S&P 500 lost about \$6 trillion. There were \$6 trillion of losses in the S&P. And there's going to be a lot of losses in real estate. And just like in all of these bubbles, the people that get killed are generally the people that got in late and levered the most.

And so if I had to guess, I'd guess that we'll probably give up — just as we did in the stock market — four or five years of appreciation in houses. And it'll vary by market and so on. But when I look at the net equity relative to debt — and when I look at what makes people toss back their keys and walk away — I think that it will be absorbable.

We're in a period of incredible pessimism — and opportunity.

Davis: What's striking to me is that we're in a period of such incredible pessimism. I wrote in the annual report about the issue of *Business Week* that I read as I was writing the annual report. It had a melting house on the cover. And if you went through the table of contents, it was so striking: wireless growth is slowing, the end of free trade, bone cancer in women. I mean it was just one awful story after another.

And it brought to mind Buffett's comment that he wants to do business in times of pessimism — not because he likes pessimism, but because he likes the prices it produces.

Financials are trading at 5-7 times normalized earnings.

Davis: I have no idea where the bottom will be. And they say the only people who buy at bottoms and sell at tops are liars. But I know that the stock market has been flat for over eight years — so P/Es have come *way* down.

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CLIPPER FUND'S CHRIS DAVIS
KEN FEINBERG & CHARLES CAVANAUGH
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Global multinational leaders are trading at 14 or 15 times earnings. Lots of financial companies are trading at mid to slightly-above-mid single digit multiples on what we think are going to be normalized earnings.

We have embarrassed ourselves in Ambac. And we'll be glad to talk about that — [chuckling] not glad to, but willing to. And we've made a much larger investment in Merrill Lynch during this time. And these investments are not based on trying to call the bottom, but are based on what we think the value of these institutions will be over a long period of time.

And we're experiencing Clipper's results along with you.

Davis: I'll end by saying that we eat our own cooking. We are large shareholders in Clipper. And several months ago, we put another \$5 million of our own money in. So we're not pleased with the results. And we're experiencing them along with you.

But we are pleased with the quality of what we own, and the ability to be opportunistic and concentrated in this way, and with the idea that we're buying businesses in times of pessimism....

IT'S KEY THAT THE CEO BE THE CHIEF RISK OFFICER —
AND WE'RE COMFORTABLE MERRILL PASSES THAT TEST.

In buying Merrill, one big factor was new management....

Shareholder: When you were doing the research that culminated in buying Merrill Lynch, you probably looked at some of their peers, like Bear Stearns. So what did you see in Merrill that you didn't see in Bear Stearns?

And it's been a few years since Hank Greenberg left AIG. Where do you think we are today at AIG?

Davis: Well, I'm going to let Charles speak quite a bit on Merrill. Charles plays an important role at our firm, particularly in the financial sector, in terms of making exactly those sorts of comparisons — because two companies can look identical on a P/E basis or a price-to-book basis, and have very different mixes in their earnings, in their franchise, and in their leverage.

I'd only say that to me, these were the big factors in a time of uncertainty for buying Merrill: One, you obviously had a change in management. And that's very important in times of turmoil in the sense that it's very hard for the existing management to own up to the problems that developed under their watch. Things tend to get buried. So you had somebody new whose incentive system was tied to "let's get everything out and mark it as low as possible" — and who had the competency and credibility to do so.

And Merrill's ability to raise capital was important, as well.

Davis: But more importantly, if the world continued to get a lot worse, I wanted to be in a franchise that could raise more money. And the line we used at the time was that, "the world doesn't really need Bear Stearns."

But Merrill Lynch has an enormous client base on

Main Street all over the country. It has a brand that does matter somewhat. It has great relevance in the world *outside* of Wall Street. And so our feeling was that if we were wrong in our analysis on Merrill and they needed to raise more capital, even if they needed to raise it at \$35, they could do it. And I wasn't sure that anybody would step up to Bear Stearns if they needed to raise more capital.

By the way, if you need to raise capital, let us see the deal.

Davis: We talked to a number of institutions about, "If you were to raise capital, come to us. At least we'd like to see the deal before you go to the Middle East or to Asia." We were just with some of the folks at Dodge & Cox. You know, there's no reason why American investors shouldn't be leading these things. There's liquidity. Why should these returns be going to private equity or overseas?

But Charles, why don't you talk a little bit about how we compare the different financial institutions....

It's key that the CEO is also the Chief Risk Officer....

Charles Cavanaugh: I think the key thing with investment banks is you want to have the Chief Executive Officer be the Chief Risk Officer....

You want that person to have the ability to figure out what the traders are doing. And if there are problems there, they'd be noticed. They wouldn't get the wool pulled over their eyes.

Bear had to keep going to the market for seven-day loans.

Cavanaugh: And I think the second thing we focus on is how a firm is funded. Do they need to go to the market because they are funded a lot with commercial paper — and repo, which is similar to commercial paper? Bear Stearns needed to go to the market again and again, every 30 days. And that kept getting shorter and shorter. And before it went bad, it was seven days. Nobody would do anything with them longer than seven days.

For Merrill Lynch, it was much longer funding. And they had much more in terms of free liquidity they could call upon. So they had much smaller short-term funding requirements. And I think that right there is a key difference — because markets can be irrational for a long time. We certainly didn't predict the downfall of Bear Stearns, but we thought there was much more risk there.

Finally, it was the value of MER's franchise + 2 major assets.

Cavanaugh: The third thing is the value of the franchise, like Chris talked about. Merrill Lynch has 16,000+ brokers — I think Bear Stearns had 550. Merrill has a giant stake in BlackRock and in Bloomberg — and those things are worth something. So if you said, "Okay, the investment banking part and the trading part are worth negative money — they're going to be a drag for a while — then what is the other part worth?"

So it was basically the CEO, funding, and valuation. I think those are the three key things that we saw when we tried to weigh the other investment banks versus Merrill.

The CEO needs to understand the risks they're taking.

Davis: And that was in big part due to Charles' work. I mean, I can say that one of the few things that I'm proud of is I'm proud of what we *haven't* owned, by and large. I'm glad that we didn't own WaMu, we didn't own Countrywide,

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and we didn't own Bear Stearns. And you can bet we looked hard at all of them.

And Charles is exactly right — that the Chief Executive Officer of a leveraged financial company *needs* to be the Chief Risk Officer. They don't need to understand the specifics of every risk, but they need to understand the structure of the risks they're taking. And by and large, our poorest investments — with the exception of Ambac, which I'll come back to — have been ones where the CEO does not pass that test. They become what I would call a "classic value trap."

And we're comfortable that Thain and Dimon pass that test.

Davis: The best example is Citi. I mean, the Chief Risk Officer at Citi reported to the Chief Administrative Officer, who was a lawyer, who then reported to the Chief Executive Officer, who was also a lawyer....

And, we sat there with a stake — not in Clipper, thank God, but in our other funds — just because it always seemed so cheap. But [Merrill Lynch CEO John] Thain and [JPMorgan Chase CEO] Jamie Dimon are two people that we're comfortable pass that test.

Thain can write everything down and blame his predecessor.

Davis: I would say that Thain has an easier job than Jamie partly because of being the new sheriff. So he can write everything down — and put all the blame on his predecessor. And he has an easier, more focused franchise, because of the nature of the retail side of what they do — and because of the big BlackRock and Bloomberg holdings. And he has enormous credibility — so he attracts great people to work with him.

And he also came in after a CEO that was quite unpopular internally.... So there's an enormous morale boost from him coming in. Thain is not a charismatic guy. He's not the guy you'd pick to lead a retail Merrill Lynch brokerage force. But in comparison to his predecessor, he's just beloved. So there's a willingness of people to move forward.

So I think that Jamie has a little bit of a harder hand to play. But I think the Bear Stearns deal was a great example of how they can behave opportunistically, in part because of their credibility.

But current management at AIG doesn't pass that test.

Davis: You asked about AIG. AIG is a great example of a company that passed that test for 30 or 40 years — and doesn't pass it today.

And we just met with [CEO] Martin Sullivan last week. AIG has a \$100 billion of tangible equity, and they earn \$25 billion or so pre-tax. So they can afford to take enormous charges if they need to. But it's my strong conviction that you have a top management team that does not understand the nature of some of the risks that they have. And so what you're left with is the question, are those risks bad enough to disrupt or derail the enterprise?

We've added some to AIG though — but it's been painful....

Davis: And I think going back to Charles' point on

funding, which is equally important, the nature of the insurance enterprise is that they have enormous amounts of cash coming in every day. So we don't think they have the sort of funding issue that — even if the hits are worse than we expect them to be — could put them in a commercial paper spiral like Bear.

So we've added some to AIG. It's been very painful — but I do think there'll be a new management in there. So it's been partly because of the difference in the funding, the franchise and the cash they generate, and then just the sheer scale — the earnings power and the tangible equity.

WE REALLY DON'T KNOW WHAT BEAR IS WORTH —
BUT WITH MERRILL, WE THINK WE DO.

Why did the Fed let Bear go? Maybe Voltaire can explain....

Shareholder: On the Bear Stearns situation, have you done your analysis of what you think it's worth in conjunction with what JPMorgan offered?

Davis: Well, Bear Stearns was worth a lot more *after* the announcements the Fed made an hour after the Bear deal was announced. What's interesting is that if the Fed had made the same announcements an hour *before*, that probably would have stabilized Bear. So why did they, in a sense, let Bear go before they made the announcements about the Fed window and so on?

You know, Voltaire said that, "Every once in a while, you have to hang an admiral to encourage the others." [Audience laughs.] Looking back a few years, I don't know if Arthur Andersen had to go under, but there was a view that maybe that's good to encourage the others.

And there were unnatural, somewhat sordid forces at work.

Davis: I think there was also a strong political will not to show this as a bail-out — although, interestingly, they bailed out the bondholders. [Chuckling] I don't know why stockholders are considered not worth bailing out. But there are a lot of forces at work that aren't directly market forces.

And there were unnatural forces that caused the decline. I mean, these hedge funds would short the stock and then write a letter to their clients saying, "We're going to move our prime brokerage from Bear Stearns because we think it's very unstable." And people would say, "Oh my God, these hedge funds think it's unstable — we better sell the stock."

So there was a lot of that going on. And I would call it sort of sordid.

We don't know what Bear's worth — so we just stayed away.

Davis: When we first looked at Bear, though, we thought, "They wouldn't have to be that wrong on a mark to wipe out the equity." How much was the leverage? I'd say it was more than 17 to 1, wasn't it?

Cavanaugh: The adjusted leverage was 19 to 1, but the real leverage was almost 33 to 1.

Davis: Yeah. So you had to have some assumption about the asset marks, because you only had that sliver of equity. But I'd say that I have no idea what Bear Stearns is worth. That was one of the reasons we stayed away. We could have a good idea of what the private client business

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at Merrill Lynch is worth. But it's very hard to know at Bear. I think their clearing business is great. There were some very good businesses at Bear.

Cavanaugh: But in terms of what it's worth, we really don't know.

But JPMorgan evidently has some idea....

Cavanaugh: JPMorgan has said that they think that once things cool down, they can have about \$1 billion of earnings coming from it. And they're going to take about a \$6 billion charge. And who knows if that's \$5 or \$7 billion.

Davis: So they think they can get a billion dollars of earnings out plus the asset value of the building and so on. And JPM went up the next day. Merrill went down — because people said, "Well, wait a minute. You guys always tell us it's trading at book. It must be attractive." And Bear sold out for a tiny percentage of book. So people said, "Well, book might not matter." So they sold Merrill. And I think we bought Merrill Lynch that day.

Cavanaugh: Sure. At \$39.

Davis: At \$39. You could see sort of a panic. So we'll see how that goes. Obviously, we bought some at \$48, too.

THIS IS THE BIGGEST ARBITRAGE I'VE EVER SEEN
— AND IT'S GOT TO CLOSE.

There's a huge disconnect between mkt and intrinsic values.

Shareholder: I had a related question about Clipper's financial stocks. With this protracted period of bad news, particularly about asset quality, what things have you done to try to reassess those holdings? And do you concur with some of the reactions the financials have been taking?

Davis: Well, what's interesting is that you've got a huge disconnect — in fact, it's so wide it's almost unprecedented — between what the market says certain asset classes are worth, and what the institutions that do not need to mark them to market think they're worth. And if you think about it, if you generally believe that the markets are fairly efficient, it would be very unusual for an institution to say, "Well, we made this loan — and we think within this basket of loans, 3% or 4% of them will go bad; we think our losses on those will be 50%; so we're going to put up a 2% reserve against this \$100 worth of loans" — and then have the market look at that same pool of loans and price them at 60, implying 40% losses.

But there's a chance that it could get a hell of a lot worse.

Davis: Well, that is the biggest arbitrage I've ever seen. And it's got to close. Now, I'm not sure in what direction it'll close [he laughs] — because it can close either way, right? For the institutions that have made the loans and that are carrying them the way a traditional bank or insurance company might carry risk — based on actuarial values, and based on current and projected experience — it could get a hell of a lot worse.

Or you could say that there's a dislocation in the

market and that the market prices are not reflecting values in an efficient way.

So we've added to companies that've already taken the hits.

Davis: Now, what could cause that? Well, what could cause that could be a buyer's strike. It could be caused by massive selling where people are not discretionary sellers — they're forced sellers. It also could be caused by some manipulation. Obviously, things like the ABX index are subject to that sort of manipulation.

So we have added to companies like Merrill Lynch, because we feel they've, in a sense, taken the big mark to market hits. We have not added to companies, for example, like Wells. These are companies that we do own in Selected American but we don't in Clipper — and it's partly because of that difference. At this point, we have conviction in the accounting of those enterprises. But we

PORTFOLIO REPORTS estimates the following were Davis Advisors' largest equity purchases during the 3 months ended 3/31/08:

1. GENERAL ELECTRIC CO
2. GRUPO TELEVISIA SA GDS
3. MERRILL LYNCH & CO INC
4. CISCO SYSTEMS INC
5. AGILENT TECHNOLOGIES INC
6. VISA INC CL A
7. EBAY INC
8. WHOLE FOODS MARKET INC
9. BED BATH & BEYOND INC
10. AMERICAN INTL GROUP INC

think that they're more vulnerable to bad news than Merrill as that arbitrage starts to close.

We haven't seen home prices drop like this since WWII.

Davis: What would you say on that, Charles?

Cavanaugh: When I look at companies like Wachovia, Wells Fargo, or banks in their entirety, I want to say, well, things aren't normal. Things weren't normal before. They were abnormally good. Charge-offs were nowhere near normal. But what can they get back to? And when we look at valuations, what should they be?

And that's the same thing that I want to think about when looking at home equity losses. They'll be close to what credit card losses will be for JPMorgan and some other companies. But what's more normalized? You want to think about that. And you also want to overlay the fact that we haven't had home price depreciation nationally like we have now since World War II — and some say since the Great Depression.

So you want companies that have fortress balance sheets.

Cavanaugh: So you're going to have some things that are really big outliers — some Bear Stearns-type events. And you want to have companies that can withstand that. You want to have fortress balance sheets. So we want to think about it both ways.

But you certainly want to backtest.... You don't want to be blind and say, "Oh, it's just going to go back to the

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averages, and they're going to be fine." A lot of people have had to raise capital.

WE'RE FINDING BARGAINS IN MARK-TO-MARKET CO'S,
AS WELL AS IN MISLABELED FINANCIALS.

Merrill is the real archetype for what we're looking for now.

Davis: What I'd say is that as an investment strategy, what we're doing here is we're saying, look, there are companies where there is this divergence between mark-to-market accounting and held-to-maturity accounting — and we're recognizing that some real distortions and dislocations have been created because of what's happening in the markets. So this is not a normal time of efficiency, in the same way it wasn't a normal time a year or two ago when there was an idea that risk premiums were disappearing.

So we're looking for what, in a sense, could turn into offense. What are some holdings where there's an enormous amount of future losses already discounted in the current valuation? Those tend to be the mark-to-market companies — and, obviously, Merrill Lynch is the real archetype.

And Bank of NY Mellon is being tarred with the same brush.

Davis: We've also made investments in companies that because they're considered financials, there's a presumption that they must have these sorts of exposures — but really are in different sorts of businesses. We have a large holding in Bank of New York Mellon, which we view as really more of a processing and asset management company. But I think that its relatively attractive valuation has come about because of it being tarred with the same brush.

But what do you think? Charles did an enormous amount of work on Bank of New York Mellon.

Cavanaugh: I agree. I think that people get very scared about their loan book. And they haven't had losses there in a number of years — and they certainly will have small losses. But people say, "To heck with financials." Bank of New York Mellon is more of a processor, though, which is a business that has a much higher return on equity and a much higher return on invested capital.

[Editor's note: In Clipper's 2008 Portfolio Update, Ken Feinberg elaborated on the case for BK:

Ken Feinberg: Bank of New York Mellon gets about 60% of their profits from the custody business. And the custody business is really sort of a call on the growth of the capital markets. And it's a business where they're number one, that grows over time, and where they've got huge opportunities globally. But it's a *scale* business. You need to be a big player to reinvest in the systems to do the job correctly — hence the recent merger of Bank of New York with Mellon Financial which made them number one.

The other 40% comes from the money management business. And they've got about a trillion dollars in assets spread over money markets, equity funds, bond funds, and some hedge funds — so they're pretty diversified. And they've done a pretty good job over time. So we like the businesses. They tend to grow over time — and they tend

to generate a lot of free cash flow.

The two companies still have to be integrated intelligently.

Feinberg: In terms of management, a fellow named Bob Kelly became the CEO of Mellon almost two years ago. This is a good example of a company with pretty good businesses that just tended to be undermanaged — run more for senior management and less for shareholders. So a lot of tough decisions might not have been made as quickly or as thoroughly as shareholders might have liked.

Anyway, a new CEO comes in — and he's got a proven track record. Kelly was the CFO for First Union, that then merged with Wachovia. And so he helped Ken Thompson, the current CEO of Wachovia, rejuvenate and reenergize the old First Union by successfully integrating a very big acquisition with Wachovia. And we think he's got the team in place to integrate Bank of New York Mellon. There's always risk when you integrate two big companies. Some people leave, and perhaps you might lose some customers. But you do get a lot of synergies and expense-saves that often makes it all worthwhile. But you still have to integrate the two companies intelligently, successfully and *slowly*.

And we've been able to buy BK at 13 times 2008 earnings.

Feinberg: And then the final thing is the price.... We think we've been able to buy a very large position in Bank of New York Mellon at a very attractive price — about 13 times what we think they're going to earn in 2008. And then there are more expense synergies to come in 2009.

So we like the qualities of the business. We like the scale that they have and their competitive positions. And we *really* like the management. Bob Kelly is a terrific under-promisor, over-deliverer, no-nonsense guy — sort of in the footsteps of Jamie Dimon. He *hates* waste. So we think he's the right steward of our shareholders' capital.]

THERE'S GOING TO BE A LOT OF FORCED SELLING —
AND WE'RE LOOKING FOR OPPORTUNITIES OUT OF THAT.

Some funds are going to be in a forced redemption mode....

Davis: Also, although we don't wish ill on others, sometimes funds become forced sellers which can create opportunity. I mean, the first call a lot of Bear Stearns' hedge fund clients are going to get from JPMorgan is going to be, "It's business as usual — except we're cutting your margin." [Davis and audience laugh.] So there's going to be a lot of forced selling.

And in just the same way, when Long-Term Capital was in a panic mode, everybody was trading against what they knew they owned — because they were forced sellers. That can happen in a mutual fund. You have somebody that owns a lot of stock and they're in a forced redemption mode. They *have* to sell. So we're looking for opportunities out of that.

We want shareholders to know what we own — and why.

Davis: But preventing that is one of the reasons we do these meetings. We want shareholders to know what we own and why we own it — so that they'll be less inclined to panic out. Now, we haven't been very successful with that, considering that we're down to about \$2 billion. But that's all right. What really matters is what we produce in terms

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of investment results over time. Assets in this field take care of themselves.

And that is the reason that we want to have our own money in the funds: we want to make it clear that our fundamental concern isn't whether the fund is \$3 billion or \$6 billion or \$4 billion or \$1.5 billion — what matters is the investment results.

You just never want to be forced to sell...

Davis: But as I was saying, we don't want to end up being forced sellers. This is also why we care about the liquidity of the companies we own.

One of the joys about owning Wal-Mart and Microsoft is that when you need to raise cash, you can raise it very quickly. And we do think a lot about liquidity. And I'd say that Ken, in particular, is often reminding me of that. You know, "How much Oaktree do you want to own? How big do you want that to be relative to assets? Because you never want to be forced to sell." And he's absolutely right. And that is something that we take very seriously....

I KNEW WAY BACK THAT EVEN A LITTLE EXPOSURE
WAS TOO SCARY. BUT SOMEHOW, THIS TIME, I DIDN'T.

Ambac is painful — particularly since I studied it early on.

Shareholder: Can you talk about the municipal bond insurers?

Davis: Yeah, sure. [He laughs.] Well, Charles is here because it was *his* idea. [Audience laughs.] No, Charles has stayed a mile away from these. This is really my doing. And it's really painful, because when I was a starting analyst, I wrote a long research report on MBIA and Ambac — which was spun out of CitiCorp that year.

And I wrote a very negative report — because I said, "These businesses have what appears to be very attractive economics, but how can they have zero losses?" In other words, how can you sell insurance where the expected loss is zero? It flies in the face of common sense. And they did that for a long time.

Investors will pay an irrational price for certainty....

Davis: But what really scared me in the case of MBIA is that they guaranteed a lot of hospital debt. And the line at municipal bond insurers is: municipalities don't go broke. And even if they do, they still owe the money. So when they reconstitute, they owe all the money plus interest back to MBIA or Ambac. So they had wonderful experiences for very long periods of time.

In essence, they were simply in the arbitrage business.

What they realized is that investors — and this is Behavioral Finance 101 — will pay an irrational price for certainty. You know, if I offer you a 90% chance of getting \$1,000 versus a 100% chance of getting \$800, most people will take the 100% chance. Well, that's sort of crazy. But people will pay a premium for certainty.

And what they were doing, by and large, was they were

taking AA bonds that were virtually certain to pay back, and making them AAA. And the amount of interest that investors were willing to give up to have that AAA would more than offset the increase in loss experience from having the AA. So that was the model.

I felt MBIA was too scary — and felt like an idiot for 15 years.

Davis: But this is what scared me about MBIA when I wrote this paper: I said, "You know, hospitals *do* go broke and stay broke." They just shutter the building, and that's that. And I'm doing this from distant memory, but I want to say that if only a small percentage of the hospitals went bad, a big chunk of their equity would disappear. And I remember saying, "That's just too scary." So I passed. That was probably 1992 or '93.

So I studied them at a distance. I admired the management, particularly at MBIA under Jay Brown, but never owned 'em — all the way up. And I kept feeling like an idiot, because they were great businesses for 15 years.

They were a rating agency with a money-back guarantee.

Davis: And then they began to crack. And we have two good analysts that have done a lot of quantitative work on them. And I said, "Well, if nothing else, to help us understand the exposures at JPMorgan and other holdings that we own, let's get to know these guys and really spend time with their actuaries, and spend time with people pricing these risks." And the more time we'd spend there, the more impressed we were with them. In a sense, they were a rating agency with a money-back guarantee.

And we thought, well, they take the subway to work. There's no big egomaniacs. The compensation is modest. And they would just say, "We're in this crazy dislocation where people just assume, because we've got a lot of insured exposure relative to our equity, that we must be a high-risk enterprise."

I thought that Ambac looked like a typical sort of panic.

Davis: Well, let's use Geico as an example. Imagine if you were to add up all of the policy limits of every automobile insurance policy that Geico has outstanding. You would get a number that exceeds their equity by a huge amount. Right? But not all of their cars crash at the same time — and not all the policy limits hit.

That's true of Allstate's homeowner coverage. You know, if every house in the country burned down at the same time — I don't want to make up a number, but if I had to guess, I'd guess it'd certainly be many, many times their equity in their insured risk at face value, at par, or the notional value of the risk that they're insuring.

So I thought, this looks like a typical sort of panic.

I realized a tiny exposure was too much before, but not here.

Davis: And by the way, I think Ambac and MBIA's market share in real-estate-related underwritings had gone from something like a 70% or 80% market share when they peaked in the 2001-2002 time frame down to a 5% market share in 2007.

So they'd done everything that we liked: they'd walked away from volume. They'd said, "This is irrational, we're getting out of this business." But with the hospital business, I realized that a small percentage was still too much — and somehow here, I didn't. I was impressed with their

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thoughtfulness — and the fact that there was this panic....

So having passed on them for 15 years, I waded in....

Davis: And the final thing was, having lost money in all sorts of financials where, as Charles said, we underestimated the importance of liquidity, what I liked at MBIA and Ambac is they had cash coming in every day and no funding needs. So I thought, I've never heard of a company going bankrupt when they're highly liquid. And so, for all those reasons, I thought it was a good bet.

And on top of that, just like in hurricane insurance, right after the hurricane, demand for the insurance — and the rates — are going through the roof, the regulatory environment tends to be more benign, and your irrational competitors are out of business. So that's usually a good time to invest. And here these things were trading at a fraction of book.

So having passed on them for 15 years, I waded in — earlier in our other funds, later in Clipper. And, well, we've gone through what we've gone through — and I sure don't look too smart....

THERE'S A POSSIBILITY I'M GOING TO LOOK LIKE AN IDIOT,
BUT I'M NOT PREPARED TO CALL THIS A MISTAKE YET.

We came in after it was clear what they had done wrong.

Shareholder: But aren't you forgetting something in your analysis? I had a nephew who used to work for Ambac. And the fees that they were making on the CDO's, the CBO's, the SIV's were just obscene. The banks were doing the same — and they were obscene.

So what brought Ambac and FGIC and that other outfit down was their moving away from their prime business. Why didn't you smell that?

Davis: Well, we came in *after* it was clear that that's what they had done wrong. In other words, when we made the investment, it was already clear that it was the CDO and the CDO-squared business and so on that were the specific issues that were killing them — but that the municipal business was still strong.

Our question was, how bad would the CDO losses be?

Davis: So our question then was, how bad will it be? We knew that that business was going to disappear. So that business was not going to be a factor in the future. The question was, how *bad* would the losses be for the years that they were in it — and at the same time, how *good* was the traditional municipal business?

There are lots of examples of investments that are successful based on the company doing something very stupid — and there's disarray and panic around that — but they're able to recover and never do that again....

And AES and Williams are two examples to keep in mind....

Davis: So the history isn't written — and this is what I mean. When you have a dislocation, think about AES and Williams Energy. Now, Enron did lots of terrible things and went under. But AES and Williams both traded under

\$1 a share — only a couple of years ago. And one's in the \$20s and I think one's in the mid-\$30s now....

Now, if you'd bought that business at \$15 and it went to under \$1, you'd spend a lot of time saying, "What did we do wrong? We were idiots. Why didn't we see this risk?" But the funny thing is, it was really a dislocation in market perception that drove AES and Williams down to under \$1 — and buying either one at \$10 or \$15 was very rational in both cases, and profitable, even though they each fell more than 95% in the interim.

But there's a possibility that I'm going to look like an idiot.

Davis: I do not think that will necessarily be the case here. Our Ambac cost basis is \$16. And I'm not prepared to say that that won't prove out. But I'm certainly prepared to say there's a significant possibility that I'm going to look like an idiot on it.

We didn't go in, though, not knowing that they had this massive CDO exposure. We went in saying that with a reasonable range of loss scenarios — allowing, by the way, for a 30% nationwide devaluation in real estate prices — they would still be able to withstand that, and that they'd still reserved enough to absorb that.

The lesson in CDOs — they were often insuring the rating.

Davis: Another lesson in these is that when they were insuring a municipality, they were insuring cash flow. When they were insuring a CDO or CDO-squared, they were often insuring the rating. In other words, they had to make certain payments if the instrument got downgraded.

Well, the cash flows for the instrument may be the same. And the rating can change because of pressures on the rating agencies and the rating agencies trying to cover themselves. And I think that has certainly been the case. That was another thing that we missed. We kept focusing on: what is the cash flow in these instruments? In this CDO, if 30% of the CDO goes bad, they're still okay. But if the CDO — if the instruments — were downgraded, the cash flow patterns could change. And that's what we missed. In essence, they were insuring the rating.

And if Ken was here, he would say he's prepared to write it off. He's prepared to say that it was wrong. I've been stubborn — and it was *entirely* my decision.

But like Charlie, I'm not prepared to call this a mistake yet.

Davis: But another example that I recall had to do with Berkshire's investment in U.S. Gypsum, USG Corp. And I think they made the investment at around \$10. And it went down to about \$1 or \$1.50?

Cavanaugh: It was well down. I think it was \$3, but regardless...

Davis: But it went down 70% or 80% from what they had paid for it. And it may have been at the Wesco meeting where somebody said, "Charlie, you guys have generally done a good job, but can you explain what happened here?" And Charlie said something like, "Well, I'm not prepared to call that a mistake yet. But we don't look too smart."

And then, USG peaked at something like \$85. So 18 months later, it went from \$2 to \$85.... So buying it at \$10 was brilliant, even though it was marked down 80% in between. But I'm not trying to make a comparison here — Ambac ain't going to \$100.

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KEN FEINBERG & CHARLES CAVANAUGH
(cont'd from preceding page)

And Marty's report on Ambac and MBIA is worth reading...

Davis: But I do recommend a much more articulate description of these that was written in Marty Whitman's current annual report for Third Avenue Value Fund. Marty is an old credit guy who I've admired and known a long time. And he's a very large shareholder — maybe one of the largest shareholders — of both. And he's also been buying the credit default swaps and the trust preferreds. You know, he's in his 70s — so he's seen a lot. And his description is worth reading.

[Editor's note: We couldn't agree more. We find Whitman's letters and books to be essential reading.]

Davis: But I have not had the nerve to buy more. And Ken says he may lock me out of the office if I do. [Audience laughs.]

The big disadvantage of size really has been publicity...

Davis: We got a lot of publicity for buying MBIA and Ambac because we bought more than 5% of the companies. And that's the big disadvantage of size, by the way. The big disadvantage of size really hasn't been liquidity for us. It's been publicity — because we bought these. But they were 6/10ths of 1% of our firm's assets. So 99.4% of our investments were not in Ambac or MBIA.

And we put maybe 7 times the money we put in Ambac or MBIA into Merrill Lynch. In Clipper, Ambac is 7/10ths of 1%. And I would guess today that Merrill Lynch is probably 5%.

BUFFETT'S ENTRANCE INTO THE MARKET WAS REASSURING — BUT IT ALSO DEPRESSED ME.

Buffett's entrance meant you had a fierce new competitor.

Shareholder: Did Warren Buffett's entrance into the market have any influence?

Davis: Yeah, it depressed me [Davis and audience laugh.] In one way it reassured me, because it did reinforce the fact that this is a hard market and that there is irrationally good pricing — because Warren doesn't take risk lightly. But it depressed me because it meant that you had a fierce competitor who had enormous credibility with the regulators. Let's just say I was glad I owned Berkshire. That was my hedge.

(continued in next column)

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Our interests and BKHT interests were somewhat different.

Davis: You know, I worked hard with a group of people to try to come up with a rational plan to avoid what was happening in the municipal auction market. And this was not because I'm a public servant — it's just because I have a vested interest. And I *told* the regulators I had a vested interest.

But our interests and the interests of the Ambac shareholders — or JPMorgan shareholders for that matter — were probably somewhat different than the interests of Berkshire shareholders. And so, yeah, I'd say it validated that we were looking in the right area. But it depressed me because I thought that makes it a significantly harder fight.

And Buffett drives a really hard bargain...

Shareholder: Did it surprise you?

Davis: No. What would've surprised me — there were rumors about Berkshire getting involved in Bear Stearns. I thought that was a very low probability. And it would have surprised me if they had bought either Ambac or MBIA. I don't think they like people to have a pen other than Ajit that can commit so much capital.

But it wouldn't have surprised me if he had done a reinsurance deal with them. And of course, he *offered* a big reinsurance deal to them which was basically, "Pay me 150% of the premium that you've been paid on your municipal bond exposure, and I'll reinsure it only provided you've gone broke in the interim." [Audience laughs.] And they said, "Well, thank you very much, but no thanks."

So it didn't surprise me that he offered to do reinsurance on these.

The CDO business would really increase Buffett's reading.

Davis: But I don't see him getting into the CDO business and all of that.

Cavanaugh: He'd have to read too many documents.

Davis: Yeah. If he were to read all of the documents that underlie the original securities and then the first tranche, I think he said it's something like two million pages you'd really have to read to actually have read what each security was.

But the fault on Ambac is definitely mine. Charles played no part and Ken didn't either — except to try and talk me out of it.

MILLEA & NIPPONKOA TRADE AT ROUGHLY
75% OF EQUITY — AND THE EQUITY IS GOOD.

The old Millea was a big source of my grandfather's success.

Shareholder: Do you want to talk a little bit about Millea and RHJ, and to what extent macro considerations have factored into those decisions?

Davis: Well, those are two different ones. I'll talk about Millea and NipponKoa together. They're both Japanese nonlife insurers.

Interestingly, one of the big sources of my grandfather's success was that he was the largest foreign shareholder of Tokio Marine & Fire. He bought it in 1960 — and sold it in

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the early 1990s, I think. And we've essentially been out of Japan since then.

Millea and NipponKoa are trading at roughly 75% of equity.

Davis: What started to strike me from a macro point of view was how many "net nets" there were in Japan — how many companies were trading below cash liquidating value. You'd had a bear market there for 18 years.

And I started looking at the nonlife companies, because by and large — and this applies to both of them — they're trading at roughly 75% of equity. And the equity is *good*. They don't have long-tail reserve issues. They don't have asbestos or things like that that would make you think, "Oh, the book value is not the book value."

I see a 14% ROE over time on their investments alone....

Davis: Let's say that Millea has roughly \$3 of investments for every \$1 of equity. So that means we have roughly \$4 of assets for each \$1 of equity that *we* put up, because we're buying at 75% of book. Half of those investments are in bonds. So we need to have some view about what Japanese bond returns will be over a long period of time. But let's just call it 2%, okay? So now I've got a 4% return on my equity just from the bonds.

Then you've got \$2 in Japanese stocks. Now, I don't have a broad macro view about Japanese stocks except that as I look at the number of net nets, I look at valuations — and I look at an 18-year bear market — I think they probably aren't grossly *overvalued*. So if I were to continue down this track, let's just assume a 5% return on Japanese stocks. Well, I've got \$2 of Japanese stocks for each \$1 I put up. So I get a 10% return on my equity plus the 4% from bonds. That's a 14% return on my equity over time using 2% and 5% return assumptions. Now, I could use 3% for bonds and 4% for stocks and get exactly the same thing.

A company like this wouldn't trade below book value here.

[Editor's note: In Clipper's 2008 Portfolio Update, Chris Davis further elaborated on the pluses for Millea:

Davis: Millea is an absolute leader in its market that trades below book value with enormous investment leverage and has generated an underwriting profit every year except for one in the last 10 years. A company like that here would not trade below book value.

But it's in an area in a part of the world that's less understood and has underperformed for long enough that here you have a company that 10 or 15 years ago, everybody would've thought of as global leader, like Deutsche Bank or Hong Kong Shanghai Bank or Chase Manhattan Bank. Tokio Marine and Fire was enormously well known. But now with a new name after a long bear market, it's out of the spotlight....]

But they're grossly overcapitalized — and it'll never change.

Davis: But although Millea's had an underwriting profit most years, they only have 75¢ of premium for each \$1 of equity. So what that means is that even though they're generating an underlying profit, it doesn't contribute a lot. But it also means that they're *grossly* overcapitalized.

So it is true — although it will never happen — that these companies could dividend out almost the entire market cap of their companies as a special dividend and still maintain the same level of underwriting that they're doing now. Now, that will never happen — the regulators won't let it happen, nor will the culture, etc.

That they're buying reinsurance from Ajit isn't a good sign.

Davis: But one of the things that got me excited is I met the new president of Millea in Omaha — he was attending the Berkshire meeting. And I thought, "Oh, this is *great* — because he's going to learn about capital allocation." I was surprised to see him there.

Well, it ends up that he was there as a big customer — which is a bad sign, because they do not need to buy a lot of reinsurance. The fact that they *do* buy reinsurance and that they buy it from Ajit means that they're probably not getting a bargain. So it ended up *not* being a good sign.

And I'd say that every month that's gone by, I have mixed feelings — because I think their aspiration is to get to a 7% ROE by 2012. And I say, "By 2012? Are you *crazy*?" But that's their *goal*.

So Millea and NipponKoa could be classic value traps....

Davis: Now, at NipponKoa, we have a large active shareholder in [Longleaf Funds'] Mason Hawkins. But in the last 12 months, both the companies put through poison pills and anti-takeover provisions — a lot of Japanese companies did. And that's been a big setback.

[Editor's note: In Longleaf Partners International Fund's 1st quarter shareholder letter, Mason Hawkins, Staley Cates and Andrew McDermott shared their thoughts on both companies, as well as on the recent selloff in Japanese equities: "We prefer today's Japanese opportunity set to those offered the last two times Japan dropped off investors' maps in 1998 and 2003. Today's valuations are similar, but returns on capital are higher, attitudes towards M&A have improved, dividend payouts are increasing, and share repurchases are accelerating. This activity extends to the portfolio, where Millea, Daiwa, and NipponKoa have all been significant repurchasers. Opportunities exist for improvement, but the fund's Japanese companies enter this downturn with stable businesses and strong balance sheets in a capital-starved world. Most important, valuations discount Armageddon.... Today, the Nikkei trades at about 13 times earnings."]

Davis: But I think they'll work out fine. And I think, in some ways, they are a peculiar type of diversification in the portfolio. But they could be classic value traps. It's just amazing to have almost a regulated underwriting profit and have a company trading at 75% of book with so many assets.

But we'll suffer through it — and we think they'll work out.

Davis: Now, I'm afraid I'll open the paper tomorrow and find out that they have a lot of CDO-squareds. And I've gone through it with them: "No, we don't. Definitely not." You go through the documents — through the disclosure — and there's nothing in there to indicate that they do. But somehow, it wouldn't surprise me. [Audience laughs.]

So we'll suffer through it. And right now, of course, they're in a downdraft because the return on stocks has been negative, so that pushes the book down. But again,

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over time, if there's *some* positive return on stocks and bonds, with a 4-to-1 leverage relative to the price we paid, we think things will work out.

A FUND INVESTING IN DISTRESSED EUROPEAN FIN'LS
AT A 20% DISCOUNT WITH NO MANAGEMENT FEE.

RHJ is around 80% of net book — with roughly half in cash.

Davis: RHJ was created by Tim Collins and Ripplewood — which is one of the most successful private equity operations of the last 15 years — to distribute in a tax-efficient way companies that had been bought in Japan and taken private. They bought these companies, they did very well — and they took them public. And they put them in this holding company so that the institutional investors could then simply choose to liquidate the holding company rather than [the separately-traded equities.]

And those equities, some of which are not so great — like car parts stocks — represent about half of book value. But they're at very depressed valuations. And then you've got roughly half in cash. And you're buying it at roughly 80% of net book.

RHJ's looking for bargains in distressed European financials.

Davis: Tim is the chairman. He brought in a guy named Lenny Fischer as CEO, who was, for what it's worth, the youngest-ever member of the supervisory board of one of the major German banks — Dresdner Bank — when he was 29. He went on and ran Winterthur, and then a big operation at Credit Suisse. And he was a CEO candidate at Credit Suisse, but he got passed over.

And he came to work on this peculiar little thing to try to look for opportunities in the disarray that's going to happen, and is happening, in European financials — such as the German Landesbanks.

So I thought, look, if Lenny and Tim Collins came into my office and said, "We're raising a private equity fund to invest in distressed European financials — and we'll let you come in at a 20% discount and there's no management fee..." And by the way, do you know how they compensated Lenny? He got \$1 or \$2 million worth of stock. Tim Collins gave him the stock personally. It wasn't new stock issued — he just transferred stock from his name into Fischer's.

And there's been enormous selling pressure in RHJ....

Davis: So Collins has got an unbelievable long record. And there's enormous selling pressure on this thing because the institutions that invested say, "We don't want to own some Belgian holding company stub. We just want out."

So it is a little bit of a blank slate in terms of what it will be. But obviously, I'm betting that it will work out well over time. But it will not look anything like it looks now in two years. It may look a lot worse. [He chuckles.] But chances are it will have a European financial institution in there in some form or another. And it may be a much larger company because they can do a rights offering in conjunction with something like that....

WE'VE SPENT A LOT OF TIME LOOKING AT GENERICS,
BUT WE HAVEN'T DISTINGUISHED OURSELVES THERE.

We're looking hard at generics — as well as pharmas....

Shareholder: In the past, Ken [Feinberg] has talked about pharmaceutical stocks. And his opinion was that generics were the future and the way to go. Can you talk a little bit about generics?

Davis: Ken's done a great job buying CVS/Caremark. We owned it in the big funds, but we didn't buy it in Clipper. And the reason we didn't buy it is that it had already gone up a lot. So we thought, "Well, we'll get a better chance." And it's a good example of a company we never really put in our top 20 — and the more it went up, the *less* inclined we were to put it in our top 20. But it's been a terrific investment.

We've spent a lot of time looking at generics. We've actually just had somebody back from India who was visiting some of the companies over there. We're also looking hard at pharmaceuticals. Johnson & Johnson is interesting to think about. If you get a 7% or 8% earnings yield on Johnson & Johnson and you compare that to a TIP — and you assume that Johnson & Johnson is inflation-protected, because they can price for inflation, they don't have a huge raw materials component, and they wouldn't have huge resistance to passing on inflationary costs — that is sort of interesting to me.

We just haven't distinguished ourselves on generics though.

Davis: So we've spent a lot of time on Pfizer and Merck, and on the drug stores. But we just have not distinguished ourselves. It's been discouraging. And that's been true for a decade.

Now, before I retire — in hopefully 30 years or so — we will get it right. We know it's important. And the reason it's important is because healthcare spending as a percentage of U.S. GDP or gross global production is going to be larger.

And I'd guess that will also be true of media spending, technology spending, and a lot of these areas. So you want to be in the pools that grow as a percentage of that pie.

But generics are an obvious trend, so we keep working on it.

Davis: So it's very important that we get it right. And we keep working on it. And in a funny way, Agilent in some ways is a global healthcare investment, because it has a huge biology test and measurement business. But generics are an obvious trend.

[Editor's note: Ken Feinberg elaborated on the size of that trend: "To give you a number, just between 2005 and 2010, there is about \$50 to \$60 billion of branded pills that are going off patent that will become generics. And generics really are a win-win for everybody. It's great for the government if they're the payer, because they pay a much, much lower price per pill. It's great for the customer, because they also tend to benefit by paying a lower price per pill. It's also, surprisingly, great for the drug stores. They actually make more money per pill every time a generic is sold versus a branded pill. So we think it's sort of a win-win-win."]

Davis: And as I say, Ken got it right in CVS/Caremark. But it was before Clipper. And then as it went up, we kept

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saying, "Maybe we'll get a better chance at a better price."

Ken feels that the scandals at UnitedHealth are transitory.

Shareholder: Could you talk a little about UnitedHealth Group? I'm sure I'm throwing you under the bus here a little bit. There are a lot of headlines right now, a lot of talk about what's going on with medical cost ratios. Could you give us your investment thesis on the company?

Davis: I can talk a little bit about the investment thesis, but UnitedHealth is really driven by Ken. You know, when there's political uncertainty, everything goes down. And then we try to rationally focus on, how do low-cost producers do in that sort of world?

I think the valuation on UnitedHealth combined with the scandals, and how difficult it is to compete with them, are the big tenets that draw Ken to UnitedHealth. He feels that the scandals are transitory. We can get through that. And he feels that the competitive advantages are significant in terms of trying to compete with them.

And the regulatory risk would hurt competitors a lot more.

Davis: And when he looks at regulatory risk, his view has generally been that there are few regulations that wouldn't hurt the competitors a lot more. And they're too important to dislocate.

And you also want to participate in healthcare inflation. It's a little bit like the ad agencies in a different era. The ad agencies were a wonderful way to participate in the growth of consumer products. As TV stations raised prices, they could just pass that through and advertisers paid more. They just got a piece of that inflation going through their system.

So I can't speak on it more knowledgeably than that. It's one of the few names that's really been solely his focus.

HARLEY-DAVIDSON IS THE ONLY BRAND IN THE WORLD
THAT PEOPLE TATTOO ON THEIR BODY.

It's an open question whether Harley can be a global brand.

Shareholder: With the market being in a dislocation, where are you guys seeing other opportunities besides financials? What's jumping off the page?...

Davis: Well, Harley-Davidson is a name that we own that has performed badly. We see a dislocation in Harley because it's a consumer product that some people believe is slightly sub-prime — or the financing aspects of their business are sub-prime in nature. On the other hand, it's the only brand in the world that people tattoo on their body. I mean, it is an *incredibly* powerful brand that way.

But there are lots of reasons to believe that Harley is going to have very tough sledding for a while. And a very important question that we have researched but have not definitively decided is whether or not it's capable of being a global brand. It hasn't been — but that doesn't mean it can't be.

And Budweiser hasn't played outside the U.S yet either.

Davis: There are very few iconic American brands that have such low market share outside the U.S. The only two that really jump out are Anheuser-Busch — Budweiser — and Harley-Davidson.... I mean, if you think about MTV, Levis, McDonald's, Coke, Pepsi, Colgate, Marlboro, or Avon, they tend to play well globally. But Budweiser hasn't — yet. That doesn't mean it can't. It's the third largest selling beer in Ireland, right?

Cavanaugh: Yeah, they love it in Ireland.

Davis: Oh, have you been doing due diligence over there? [Audience laughs.]

Cavanaugh: [Laughing] No, no, no.

Davis: Johnny Walker is a global brand. But Budweiser hasn't been.

Now, there are all sorts of peculiarities. The beer market is a strange market. Heineken's been a more successful global brand, but it's not a single brand. Heineken is a value brand in the Netherlands, and it's a premium brand in the U.S. They're masterful at positioning. But I'd say Harley is sort of peculiar that way....

SOME TECH COMPANIES HAVE CHARACTERISTICS
SIMILAR TO GLOBAL CONSUMER PRODUCTS COMPANIES.

Tech is no longer made up of tiny, fly-by-night companies.

Davis: I don't know if anything else jumps off the page. I think that there is a presumption in technology — and I'd say Berkshire is part of the reason for this — where a whole group of investors will say, "We don't invest in technology. We don't understand it." And I think when technology was a tiny percentage of the economy and you had fly-by-night operations that came and went, that made sense.

But over our history, we've made a lot of money in tech companies. We've also had some lulus the other way. But in aggregate, of our top-10 contributors over the last 10 years, I think there were two technology companies: Texas Instruments — and maybe IBM....

I've visited technology companies my whole career....

Davis: So I visit tech companies three or four times a year — and I have my whole career. But the only ones we own so far are Agilent and Microsoft.

Agilent is the old test and measurement company that came out of Hewlett Packard. It's got a high-quality CEO, wonderful global franchises, huge market share, good margins, and very sensible management that buys in a lot of stock. They sold their headquarters building for a fortune and moved into a very low overhead R&D center. And they sold 20%+ of their revenue, a semiconductor test equipment business that the CEO had run, because he said that that's turned into a commodity business. So it's very rational.

Some are now like the best global franchises, only cheaper.

Davis: And I'm continuing to look for opportunities there because I do think there are tech companies that have characteristics that are similar to the global consumer products companies. But because they're considered technology, they sometimes trade at much lower multiples. And we don't own Cisco or Hewlett in Clipper, but those are

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two I'd put on that list — and maybe Texas Instruments, too.

We don't own SAP, but that's a company I've followed for years. Talk about a beautiful franchise — and I don't use that word loosely. It's a franchise in the sense that you have very high substitution costs, you have customers that spend more with you every year that wouldn't consider switching — or that *can't* consider switching. You have very, very long lead times.

So there could be opportunity in tech — because as I said, they may be the new global growth companies. They may earn their way into the Procter & Gamble universe. And they're trading 5 multiple points cheaper — and they're global....

THERE'S A STUBBORNNESS THAT CAN SET IN
WHEN YOU REFUSE TO DEAL WITH LOSERS.

Inflows fund new ideas by selling a little of everything else.

Shareholder: As the assets in the fund draw down due to redemptions, are you finding yourself having to sell companies you'd really rather keep?

Davis: That's one of the things we were just talking about this morning. You know, Berkshire, in a sense, has had inflows every year because of the growth in their float.... So what that means is that every year that they didn't buy Coca-Cola, they sold Coca-Cola. Coke became a smaller percentage of their assets as new money came in and didn't go into Coke.

Well, that's true with a mutual fund, too. If we have inflows and we use those inflows to buy a new name or add to a single name, we've funded that purchase in effect by selling a little of every other holding.

Redemptions make your sell discipline more important....

Davis: As you get into a period of redemptions, your sell discipline becomes more important — because if you think about inflows, your sell discipline has really been that you've been selling a little *pro rata* of every position.

But are we being forced to sell things that we would otherwise not want to sell? Well, I think we always have the choice of selling a little of everything to fund a redemption. In other words, if we like the company weightings the way they are, we should be able to do something like that in a tax-efficient way, given that we have some unrealized losses in the portfolio.

It's very hard psychologically to sell in a falling market....

Davis: If we instead choose to sell an individual company, well, yes, I would say that if we hadn't had the redemption, we might not have sold that company. But that's not very rational — because the redemption shouldn't be what triggers the decision of what we want the portfolio to look like. The portfolio should be structured in a way that we think is optimal whether money is coming in, going out, or it's a closed pool. That's the ideal structure.

But I would say that in reality, yeah, selling is hard. And it's particularly hard in a falling market because, although it's more tax efficient, it's very tough psychologically to sell something at \$30 that you paid \$36 for — especially if it was only a few months ago.

A stubbornness can set in when dealing with losers.

Davis: But it's something we've talked a lot about — because there's a stubbornness that can set in when you refuse to make those decisions. And redemptions can be very useful for helping you focus on that.

You know, why on earth don't we own more Merrill? Or we bought Millea on a very rational basis in terms of its long-term prospects. But when we bought Millea, my guess (and I don't know this for sure) is that Merrill was probably at \$65 or \$70, or maybe even higher — maybe \$75. So would I sell Millea today down 15% to buy Merrill Lynch down 50%? And the answer is, probably.

Our turnover will generally be driven by price changes.

Davis: Now, that creates a peculiar situation because you say, "Well, you bought Millea at X, and you're selling at 0.7X or 0.8X just six months later. Are you short-term guys?" And the answer is, "Well, no. Valuations change dramatically, and we have to have the discipline to look through our portfolio and make those decisions."

We're long-term investors, but our turnover will generally be driven by price changes in the portfolio, as well as fund inflows or fund outflows....

Psychologically, having a little cash helps you a lot....

Shareholder: If you'd had a larger cash position, wouldn't that have helped you in this kind of evaluation?

Davis: It definitely would have. You know, there's a big interest in market neutral strategies. And I have a peculiar bias against them — because I think, "Why would I want to be market neutral if markets go up over time?" Now, you have to have that presumption — that five years, 10 years or 20 years from now, [the market will be higher than it is today.] And if you accept that, then what you're doing is you're trying to time that: "Well, we're in a more overvalued range or more undervalued range."

When Ken was here last year, we said that it would be very unlikely that we'd ever have more than 5% to 7% cash. Mathematically, 5% to 7% cash doesn't help you all that much in a bad market. But psychologically, it helps a lot — because you come to work thinking about what's cheap today that I can add to, rather than, what do I have to sell.

But there was a cost to raising 30% cash in 1975....

Davis: So I think that of *course* in hindsight, 100% cash would've been better. But I wouldn't want you to think that a lesson we've learned is to generally have more cash.

New York Venture, at one point in its history, was 30% cash. Would anybody want to guess what year that was?

Shareholder: 1974.

Davis: '75. They had already taken the hits in '73 and '74. And in 1975, they couldn't *take* it any more. I mean, they had redemptions every day. And every decision they had made in the previous two years had been wrong. Anything they bought was like a falling knife.

And they finally said, "You know, there's so much to

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CLIPPER FUND'S CHRIS DAVIS
KEN FEINBERG & CHARLES CAVANAUGH
(cont'd from preceding page)

worry about: the world is getting worse, interest rates are going up, inflation's going up, unemployment's going up, oil prices are going up — it's just more prudent to have cash." And so they raised 30% cash — and the market went up 37% that year. They went up 23%. [He laughs.]

So I would think it is likely over time that we'll have realistically between 2% and 5% cash. We've been closer to zero, and that's been more a function of just constantly having redemptions. And we're working hard to keep that at 2%. But the 2% will not materially impact results. It won't save us in hard times.

WHEN OPPORTUNITIES ARE THE GREATEST,
IT'S VERY HARD TO SUMMON THE COURAGE TO INVEST.

We look at the return on cash vs. the return of co's we own.

Davis: But Jim Gipson ran with a lot of cash — which makes his results over time even better because, in a sense, he had to *overcome* that. But over time, the cash was an extra cost to overcome for the benefit that when the world went to ruin, he had an opportunity to invest more. But that is something that will be unlikely for us to do — because our feeling is we always look at the return on cash versus the return of companies that we already own....

So I wish we'd had a lot of cash going into this downturn. But I wouldn't want to give you the impression that it's likely, therefore, that we'll have a lot more cash in the future.

I always use what we call the "desert island test"....

Shareholder: What Jim Gipson said when I asked him about this is, "If there aren't good values out there, then we're going to cash." And he'd scrutinize the market to see if there was something to buy. But if he didn't feel comfortable buying some equities, then he'd be in cash.

Davis: I can't speak to Jim specifically. But the hard thing for me is, if you're 80% in equities, and your view of why you have 20% cash is, "I can't find any good values" — what's the 80%? So I just haven't been able to get comfortable with that. I always use what we call the "desert island test" — which is, if I was going away for five years, what would I do?

And then I use the cautionary tale of my father in 1975 and just say that we have not distinguished ourselves in being able to raise cash and then bring it down at the right times — in particular, because at the times that the opportunities are the greatest to invest, it's going to be very hard to summon the courage to invest.

Managements generally tend to buy high....

Davis: And I'll give you the best example of this, which is in stock repurchase plans at corporations. A stock repurchase plan is far more rational than a dividend — and it's more rational in an ideal world because the company has inside information about what their business is worth. The management of an enterprise *ought* to have some view of what it's worth. If they do, they therefore ought to have some view of when the stock price is well

below what they think of as the intrinsic value — and to be able to buy in shares then which would be very good for shareholders (and to buy in fewer shares if they thought it was well above). That's the way it ought to work.

But it *doesn't* work like that. If you look at stock repurchase plans, by and large, the dollar-weighted price paid by companies when they repurchase their shares is higher than the average trading price of that stock. In other words, they buy more when it's high and they buy less when it's low.

If I had 20% in cash, I'd wonder about the other 80%....

Davis: Well, if you think about how boards and managements work, when the stock is low, it's because everybody's nervous. They're nervous about the business, and they're nervous about the economy. And so they say, "We don't need to buy in a lot of stock here. It's an uncertain environment — so let's be careful." When the economy is doing great and the business is doing great, they tend to buy in a lot more shares because everybody feels things are going well. Well, the result is that they're buying in at a higher price. So I worry that I'd do the same thing with cash levels at the fund — that at the bottoms when the opportunities were the greatest, I'm not convinced that I would run that cash down.

But again, going back to if I raised cash because I couldn't find anything to buy, I'd be suspicious about why then do I own what I own — which is always the vast majority of the fund, even if I raised 20% cash.

So there are investors that I admire that have done it very successfully. But I wouldn't want to shape that expectation....

BUFFETT'S FIVE REASONS WHY MOST ACTIVE
MONEY MANAGERS UNDERPERFORM THE INDEXES.

Temperamentally, it's better for most to be in index funds.

Shareholder: I've got Jack Bogle's book on investing. And what Bogle says is that 95% of mutual funds don't beat the S&P 500. So why shouldn't someone invest in an S&P 500 index fund — rather than with Clipper or another actively managed fund?

Davis: I think that most people would do better in an index fund — and not necessarily because of the results, but also because of their behavior. If you're in an active fund, you're going to underperform for some period of time. And the temperament of most individual investors is that when they go through three lousy years, they want out. So they switch into a fund that's done great over the last three years — and their returns end up worse.

If they were in an index fund, their behavior would have been better because they never would have underperformed. So I do think temperamentally, it's better for many people to be in index funds.

In investing, group decision-making doesn't work....

Davis: Now, do I think, therefore, that beating an index fund is a high hurdle? Well, in the center of our research department, we have a letter that Buffett wrote in 1965 hanging on the wall. And in this letter, he speculates

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CLIPPER FUND'S CHRIS DAVIS
KEN FEINBERG & CHARLES CAVANAUGH
(cont'd from preceding page)

about why it's the case that active money managers underperform the index. And he says it's certainly not a lack of integrity or intellect or talent or commitment. But yet, he says, it is the case that they've underperformed. Why? And he listed these five reasons:

Number one was group decision-making. Earlier, we talked about Dodge & Cox. They are a glorious exception, and I admire them greatly.... But they *are* the exception. And I agree with Warren that group decision-making in investing, by and large, doesn't work.... So that's the first reason that he speculated.

There's a tendency to want to look like everybody else....

Davis: Then the second was that there is a tendency to conform your portfolio and your policies to what other large, well-regarded institutions are doing. So you end up wanting to look more like them.

[Editor's note: As Jean-Marie Eveillard has put it, "It's warmer inside the herd."]

Davis: That partly goes back to the nature of the investment business. If you're in the money-raising business, you don't want to look stupid. You don't want to stray too much. So that's why it's important that you have your own money in the funds that you manage, so that you have a counterweight to that tendency to want to look like everybody else.

Rewards for being long headline risk don't offset the risks.

Davis: The third is the most important reason, in my view, which is: the asymmetry of risk and reward. In other words, the rewards for straying too far from the path are not enough to offset the risks — and we call it being "long headline risk." There's probably a more elegant way to describe it. But what I mean is that by buying Ambac, we knew we were going to be long headline risk. We knew it was all over the papers. And we knew there was a possibility that it would go to zero.

Now, you can say, "How can you buy something where there's a possibility it'll go zero?" Well, if you bet me \$1,000 on a coin toss and you give me two-to-one odds, I should take that bet. There's a 50% chance though that I'll lose 100% of my investment, right? That's just the math of it. But it's still a rational decision if you only bet a small percentage of your net worth.

Well, being willing to be long headline risk — being willing to buy Tyco when it's in the papers — is very difficult in an organization. And it's even more difficult when you get down to the analyst level. So we really want a culture where that asymmetry doesn't exist. But I think it's very, very widespread.

Money managers just want out before the quarterly report.

Davis: Just look at the funds that want out of these things — and they don't care at what price. It's just, "Get me out before I send out the quarterly report." And you know what? Shareholders will be grateful. They'll be glad you're out. We sold Waste Management during the scandal that they were in some eight or nine years ago. We'd bought

it in the mid \$20s or low \$30s, and I think it went down to \$12. And we probably sold it at \$13 or \$14 — and people were *delighted*.

And then, of course, the stock went back to \$30. So that was a really stupid sell. But nobody ever calls you on it and says, "Hey, that was really dumb." Nobody is mad at the guy that sold AES at \$3. They were just glad it was out of the portfolio. So that asymmetry is very important.

The fourth reason was over-diversification. And the fifth was inertia — that once these things are in place, they're hard to take out.

So we just try to eliminate those negatives....

Davis: So I would say that the reason a lot of active money managers underperform has to do with the structure of the way their firms are set up, the way their compensation plans work, and the way they interact with their investors. And I would add adverse selection in the sense that many good analysts say, "I can make more money starting my own fund." So a lot of companies don't have the ability to compensate at a competitive level.

As I go down that list, I think, "Well, we *shouldn't* fall victim to that. We can deal with concentration, we can deal with headline risk, we can deal with asymmetry, we can deal with looking different, and we can avoid group decisions. And we can try to have a rational compensation strategy." So that eliminates the negatives.

THE OVERARCHING REASON FOR THE OUTPERFORMANCE OF INDEX FUNDS IS IT IMPROVES INVESTOR BEHAVIOR.

We're generally competitive on low turnover and low costs.

Davis: Now, what do index funds do from a portfolio management point of view? Well, they have very low turnover — and they have very low costs. And we're certainly within spitting distance on both of these.

Our fees are about half-a-percent higher, but our turnover is in the range of index fund turnover. A lot of index funds' turnover is 4% to 5% on average — because things go into the index, they come out, and things get taken over. Ours is probably 10% to 20%.

Most of our biggest mistakes were what we sold too early.

Davis: But then you get to stock selection. And the index funds pick stocks with a committee at the McGraw-Hill Corporation that looks at things like the economy and GDP, and weightings and liquidity. And I feel we ought to be able to add value on stock selection through research over that process. So if we can eliminate the risks — or the negative tendencies — of active management, and add value through stock selection while still recognizing that a low turnover approach with low fees works best, we shouldn't have a big disadvantage over time.

And by the way, index funds never sell their winners. Over time, that's probably a good thing. I think value managers sometimes struggle with that. You cut the flowers and water the weeds. If you were to get ten of them here at this table, I think most value managers would say their biggest mistakes were what they sold too early — the great businesses that they owned for the first double, and then they were out and they could have had a really long run with a great company. So we try to learn from that.

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CLIPPER FUND'S CHRIS DAVIS
KEN FEINBERG & CHARLES CAVANAUGH
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But the number one overarching reason that index funds are good for many investors is that they don't jump in and out when managers underperform or outperform.

Headline risk is the biggest risk of size....

Davis: It's funny — people talk about us getting too large as a firm. And we do run a lot of assets. And running more assets is harder partly because of liquidity, but mostly because of headline risk. You know, nobody knows who was the 12th largest holder of Enron, but everybody knows who was the largest. And I could have bought the same position in MBIA if we were running \$5 billion and it wouldn't have hit the papers. But at our size, it hit the papers because we show up as one of the larger shareholders.

And human nature being what it is, you therefore become less inclined to take headline risk — because you're worried more people will know you're stupid if you're wrong. [Audience laughs.] So we try hard to resist that. But that's the biggest risk of size.

And I do think index funds have liquidity issues, too....

Davis: But having said that, it's sort of amazing that roughly 17% of the market is index funds. Well, if you think about more than \$1.5 trillion with 4% turnover all having to buy the same stock on the same day — that's a lot of liquidity issues. I mean, our total firm is probably running \$90 billion with, say, 9% or 10% turnover — and we don't have to buy the same stuff on the same day.

I don't want to be cavalier about it. Larger sums are just generally harder. But I think index funds have that issue, too.

BOGLE SAYS MOST FUNDS UNDERPERFORM BECAUSE OF "COST" AND "TIMING & SELECTION" PENALTIES.

We always want to make more from 10% better results....

Shareholder: I got into about five mutual funds about 10 years ago, of which Clipper was one. And Clipper had typically been the only one that does this sort of a meeting.... And I find it really helpful to be able to get out and see the managers and develop a better confidence level in them than I might have had otherwise. And of course, I need to be developing some more confidence with Clipper. But we know you folks are regarded in the industry as highly competent managers.

Davis: That must baffle you. [Audience laughs.]

You know, we have money in all of our funds. So we always say we want to make more money from 10% better results than 10% more assets — but we also like managing with inflows over time. It makes the funds far more tax-efficient. It means you make more buy decisions than sell decisions. It means your turnover — your frictional costs — are lower. So there are lots of benefits to that, as well....

The "cost" and "timing and selection" penalties loom large.

Davis: You know, Jack Bogle, who is one of my favorite people, has always emphasized that most funds

underperform the index. And the degree of that underperformance is generally the frictional costs of turnover — and fees. And depending on the time period, that gap may be a couple of hundred basis points.

But then he's worked hard to publicize another gap that's larger, which is: what are the returns that actual shareholders in the funds get? And the first penalty he called the "cost penalty" — and the second penalty he called the "timing and selection penalty".

Typically, investors chase what's already worked....

Davis: And Ken and I and our team can work on the first one. We can measure ourselves and ask, do we produce results above the index after costs over time? Then we'll feel we have done our job. But the way we run the firm, and how we communicate with shareholders, can have a big impact on the second goal — because what happens, typically, is that investors chase what's already worked. They put money into what's already gone up because they wish they had owned it. Their neighbors own it — and it sounds smarter if you own it. And that happens with individual stocks. But with individual stocks, the net is a zero-sum game. In other words, for every buyer, there's a seller. So you can't get, in general, people doing better or worse than the market in aggregate.

Now, the exceptions to that are things like management buy-outs, takeovers and IPOs. So, in fact, you do have the case that net, all investors probably do somewhat worse because more money — more product — is leaked into the market at high levels through IPOs, and more is sucked out at low levels, etc.

Unlike stocks, fund investors can do a lot worse in aggregate.

Davis: But in mutual funds, the aggregate of all investors can do a lot worse than the funds. And the reason is because the funds' sizes change. Some well-known funds have wonderful 10-year records. But if you dollar-weighted their returns, they have awful records, because they had very small assets when their performance was best. So they had small assets, produced a great record, people poured in — and then they had a terrible period. So the dollar-weighted returns were just awful.

So historically, our boards and management company have felt that part of our objective and mission is to try to close that gap, too — to not just focus on the investment results, but also to focus on client behavior and if there are things that we can do to improve that, and if there are things that we can do to avoid making it worse.

The best way to make it worse is to advertise after you've had a good three years. [Audience laughs.] You have the ad and put in the three-year number, and people say, "Ah! That looks good." You can have commissioned sales — on the load side, people will pay a higher commission for a certain period of time or they'll do golf outings and that sort of thing.

YOU WANT TO STRUCTURE YOUR FIRM
SO THAT YOU RESPECT YOUR CUSTOMERS.

Respecting our clients is a big part of our structure....

Davis: So respecting our clients is a big part of our structure. And this came from Costco — which is one of

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CLIPPER FUND'S CHRIS DAVIS
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(cont'd from preceding page)

our largest positions. Think about the fact that they charge a fee to walk in the store. Well, that seems kind of dumb, because there are a lot of people that would go to Costco if they didn't have to pay a fee, right? Now, it may be because they live paycheck to paycheck, but more often it's because they just can't really do the math. They can't figure out why on earth it could be a good deal to pay \$50 to walk into a store.

And so, I was once talking to a director at Costco about the fee — because even if it's just 5% of the population that won't pay \$50, why not let that 5% into the store and take all of the revenue you make from the \$50 and make it in slightly higher prices?

At the end of the day, you want to respect your customers.

Davis: And this director said, "You idiot." [Audience laughs.] He said, "Think about what the membership does. Think of who it keeps out." First, it keeps out thieves, right? So the shrink — the shoplifting at Costco — is a tiny fraction of what it is at places like Wal-Mart. Now, that's partly because you've got to pay \$50. It's also partly because they have very big stuff. [Audience laughs.] It's sort of hard to steal a cereal box that's so big. And part of it is that they pay their employees better, so you don't have as much employee shrink. But part of it is also that people don't pay \$50 and get their picture taken and get their membership and then go and steal — or to the degree they do, it's a tiny fraction.

You also keep out small tickets. You tend to have people spend more there. So the parking lot and the registers aren't jammed with people that are buying \$6 worth of stuff. And they're still jammed in their stores, but at least they don't have that.

So he said, "At the end of the day, you want to structure your firm so that you respect your customers — because if you don't respect them, pretty soon you'll start taking advantage of them." It's just human nature.

So we try to get customers that we want to work for...

Davis: You know, I think it means a lot to Berkshire that they know a lot of the shareholders personally. It really matters to them that they think about what risks they would take or wouldn't take with their money versus with the life savings of somebody else....

So a big part of what we do — whether it's these meetings or the other things we do — is to try to get customers that we want to work for, and that we have a relationship with, so that it means more.

COSTCO DOESN'T MANAGE FOR QUARTERLY RESULTS
— THEY'RE THINKING IN TERMS OF DECADES.

Costco only makes money on their membership fees....

Shareholder: I'd just quickly point out to you that if you're a reasonably good Costco customer, you get the fee rebated to you at the end of the year.

Davis: Yeah, I know. There are so many things that

are virtuous about Costco.

[Editor's note: Another admirer of Costco (albeit, to his chagrin, mostly from the sidelines) is Warren Buffett. As he said at Berkshire's 2000 annual meeting: "Costco's an *absolutely* fabulous organization. We should have owned a lot of Costco over the years — and I blew it. Charlie was for it, but I blew it...."

Ken Feinberg expanded on the virtues of Costco — which was Clipper Fund's top holding at 3/31/08 — as well as on its significant growth opportunities, in their 2008 Portfolio Update:

Feinberg: Costco is really a great example of what we look for. They generated about \$66 billion of sales — and those sales, historically, have grown about 10% a year. They have 530 stores — with about 375 in the U.S. — and they tend to open about 30 to 32 new stores a year. So their store count grows about 6%.

And what's interesting about Costco is that on that \$66 billion of sales, they make almost no money. Where they make their money is from their membership fees. They've got about 50 million customers. And of those customers, on average, about 28 million pay. The other 22 million are spouses, which are free — and some business add-ons, which pay a lower amount. But generally, there are about 28 million Costco customers that are willing to pay a little bit more than \$50, on average, per year just for the privilege of getting into a Costco store.

But their customers keep coming back and renewing....

Feinberg: And their renewal rate has been remarkably stable at about 87%. So customers like it, they're willing to keep going back, and they're happy. And they know they get great value — because Costco prides themselves on never being underpriced by their biggest competitor, which is Sam's Club, a subsidiary of Wal-Mart.

And the culture and the management are incredibly customer-oriented — and they think long term. They have a rule that they will not mark up a product more than 15% from the cost that their buyers pay to get that product — no matter how good a deal the buyers get and no matter how much a customer really would be willing to pay for that product. And so, customers know on that \$66 billion of sales, they're getting great value.

It has a self-fulfilling business model that's a virtuous circle.

Feinberg: That is really a self-fulfilling type business model. It's really a virtuous circle. Customers love 'em. They know they get the best value. Managers really are not trying to manage for quarterly results or even annual results. They're thinking in terms of *decades*. And that's why they've been successful for 15 or 20 years.

And we think they're still in the early-to-mid innings of their potential growth, and that they can double their store counts from 530 up to maybe 1,100. They also have a big presence in Canada, they've been growing in Asia, they've been growing in the U.K., and they have a good presence in Mexico. So that's our kind of durable business in the sense that the business model is so difficult for others to come in and compete against and make any money. We hope we do very well with Costco.]

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FAIRFAX FINANCIAL'S
V. PREM WATSA
(cont'd from page 1)

Those results are due in no small part to the influence of Ben Graham, whose classic book *Security Analysis* Watsa first read upon getting a job as an investment analyst at the Confederation Life Insurance Co. in 1974. Before reading Graham, Watsa said in a speech last May, he'd spent a lot of time studying alpha and beta. After: "I never talked about efficient markets again." And in 2006, Watsa repaid the debt owed to Graham, and to the school where he earned his MBA, by endowing the Ben Graham Centre for Value Investing at the Richard Ivey School of Business, one of only three such centers in the world.

At a time when risk, in all its forms, is being so dramatically repriced, we thought who better than Watsa, whose firm has distinguished itself for over 20 years on both the underwriting and investing side, to speak to whether or not we are indeed at the beginning of a 50 or 100 year storm. To follow are excerpts from Watsa and associate Brian Bradstreet's comments at Fairfax's annual meeting held in Toronto on April 16, 2008. We hope you find them as interesting as we do.

FOR FINANCIAL MARKETS, THERE'S A RISK
OF THIS BEING A 1-IN-50 OR 1-IN-100 YEAR EVENT.

A year ago, there was no risk premium & nowhere to hide.

V. Prem Watsa: Last year, we showed you — and we've been talking about this for a few years — that there was no premium for risk. There was no premium a year ago — and no place to hide in the U.S. stock market, corporate bond market, or real estate. Then, with structured products, people thought structure would eliminate risk. One famous structure was the "ninja" loans — no income, no job, no assets. [Audience laughs.] And they gave you a loan — no problem....

A year ago, hedge funds and private equity could do no wrong — and almost all worldwide stock markets were at record highs. And the correlations, we thought, were approaching 100%.

Today, spreads are widening and deleveraging has begun.

Watsa: But that has changed, of course. Today, we think there are three things happening quite clearly:

(1) Risk is being repriced. You've got to be paid for taking risk. That means, if your credit rating is not high, or if you're in mortgages, you're getting big spreads. That's happened already — and it continues....

(2) Deleveraging has begun in size. So when you see Carlyle Capital going bankrupt or Bear Stearns suddenly within a few days of going bankrupt — or you see banks taking big hits — all of that is suggesting to you that deleveraging has begun and risk is being repriced.

Usually, banks run into problems after a recession....

Watsa: Finally, (3) the U.S. economy and U.S. stock markets have begun to decline. That means a recession is coming — and now it's only a question of how long it will

last and how deep it will be. And the stock markets are perhaps reflecting that.

Now, when we look at all this, this will be the first time in 50 or 60 years — at least in our thinking — where you had problems even *before* the recession has hit. Usually, banks and others have problems *after* you have a recession. We're now having problems prior to the recession. That's why we think there is risk for the financial markets of this being a 1-in-50 or 1-in-100 year event....

[Editor's note: George Soros, for one, feels we may be in the midst of just such an event, calling it the most serious crisis of his lifetime. In an interview on *The News Hour* on May 13th, he went on to say that the housing bubble, far from being a one-off event attributable to inflated real estate prices, will instead trigger the pricking of a "super bubble" in the extension of credit and increasing use of leverage that's been going on for over 25 years. And because of that, he felt that while the liquidity crisis is now being brought under control by the government, the true fallout to the economy has yet to be felt.]

THERE'VE ONLY BEEN TWO IN THE LAST 100 YEARS:
THE 1929 CRASH AND THE JAPANESE BEAR MARKET.

The tech bubble is the only bubble that hasn't reversed....

Watsa: The first big risk is just U.S. stock valuations. We compared them to nominal GDP. It's something we've looked at for a long time. And they are still high.

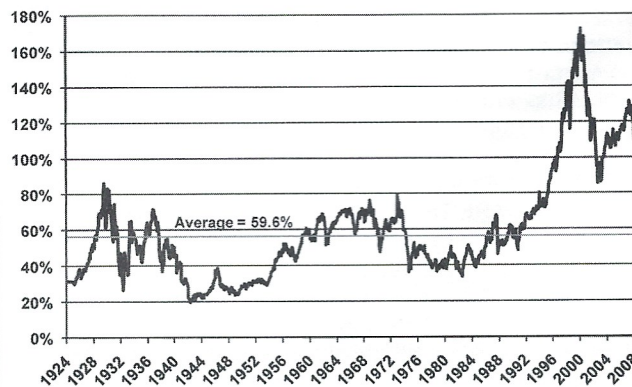
Jeremy Grantham, who manages over \$100 billion for Grantham, Mayo, makes the point that he's studied 28 bubbles — and the 1999-2000 bubble is the only bubble that hasn't reversed. [See **CHART 1.**] It was about to reverse itself in 2003, but it turned and went up. And now it's coming down.

And you can just look at that versus past history. Of course, there are more companies today that are in the stock market. And so there are many reasons why you might say that there is a bias to these charts. But we think that it does point to significant overvaluation, particularly when you consider the fact that pre-tax margins for U.S.

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CHART 1

U.S. Stock Valuations Remain Elevated
Stock Market Capitalization as a % of Nominal GDP*



Source: Ned Davis Research Inc.

*Monthly

**FAIRFAX FINANCIAL'S
V. PREM WATSA**
(cont'd from preceding page)

companies are at record highs — for 2007, in particular — and they might come down. So that's one risk.

The Japanese bear market was a 1-in-50/100 year event....

Watsa: When you look at a 1-in-50 or 1-in-100 year event, that's a 1% to 2% chance, right? So it's very small probability, but high severity. And in our mind, there have only been two big ones in the last 100 years: the Japanese bear market [starting in 1989] and the 1929-1933 period.

If you look at what happened in Japan, you really had two drops of 50%. First it went down from 40,000 to 20,000. And then just when you thought, "Okay, they've handled it," it went from 20,000 to 10,000. So you can see that the Japanese market went from 40,000 in 1989 to below 10,000 in 2004. [See **CHART 2**.]

And interest rates went down from 8% to 0.5%. It was very significant. And almost no company's stock price went up during that time period — a very tough environment. It was a 1-in-50, 1-in-100 year event in our minds.

[Editor's note: In his March 7, 2008 shareholder letter, **Watsa** said: "With the Federal Reserve dropping the Fed Funds rate down to 3% from 5.25%, we might be witnessing a repeat in the U.S. of the Japanese experience. In spite of record low interest rates and record high fiscal deficits, Japan went through years of mild deflation. The feelings at the time in Japan were that they were different and would not allow stock prices and land prices to fall — not dissimilar to the sentiment currently prevailing in the U.S."]

The other event was the stock market crash of 1929....

Watsa: And the stock market crash of 1929 was the second 1-in-50, 1-in-100 year event — and it's quite interesting. You all know that the stock market went down 90% between 1929 and 1932.... But it is quite interesting to really study this time period because you find that tax rates were increased to 63%. And tariffs were increased by

a Republican president — not by the Democrats.

And the deficits, [as **Hamblin Watsa** portfolio manager] **Brian Bradstreet** showed me, were huge during this time period, the supply of bonds was very significant, and you had a foreign exchange crisis — so short-term interest rates had to be increased. And so in 1931-'32, you didn't have a lot of time to make decisions. You had to do it quickly. And at the time, most people thought it was the right thing to do — raise rates and flood the market with U.S. Treasuries. And long U.S. Treasuries were probably one of the few places where you didn't lose money in that time period....

Although commodities are up, we don't see wage inflation.

Watsa: Here are long-term U.S. Treasury rates [**CHART 3**] just to show you what they've done. But in the perspective of time, we don't think inflation is the problem in a global market. I see commodity prices going up. But because wage inflation hasn't taken place in the U.S. or in many parts of the world, we still think U.S. rates can come down, particularly when we look at this chart. We monitor that, of course, very carefully.

The opportunity in high-yield is still ahead of us....

Watsa: Here's what's happening in the marketplace. These are high yields versus Treasuries — and the spreads are widening significantly. [See **CHART 4**.] We can, of course, buy these high yield bonds. We haven't bought them yet in any significant way, but we think the opportunity could be very significant — and we continue to look at them.

IF HOUSE PRICES DROP 20% ON AVERAGE,
A TON OF PEOPLE WILL BE UPSIDE-DOWN.

Even if house prices drop 30%, it's still 40% above the norm.

Watsa: This is the U.S. Real Housing Price Index — and it's really a very fine chart that goes back to 1890. [See **CHART 5**.] Robert Shiller and Van Hoisington — the Hoisington guys are some of the best bond managers we've come across — have put this slide together.

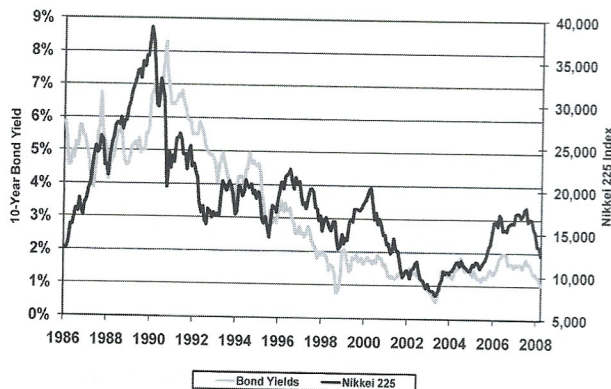
And what it shows are real U.S. house prices — adjusted for the consumer price index. So you can see where we've gone in house prices compared to the past. Until these guys produced this index, you couldn't figure it

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CHART 2

Can Japan's Experience Be Repeated in the U.S.?

Nikkei 225 Index vs. Japanese 10-Year Gov't Bond Yields*

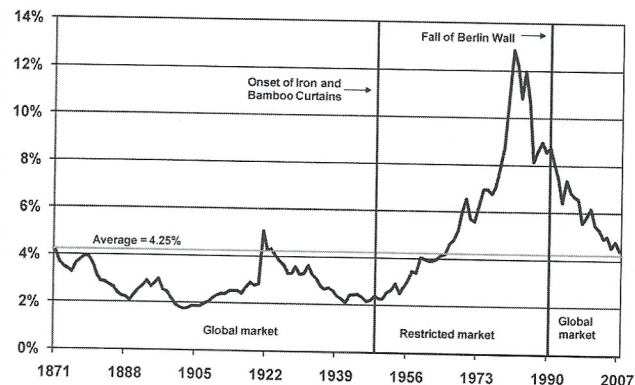


Source: Ned Davis Research Inc.

*Monthly

CHART 3

Long Term U.S. Treasury Rate



Source: Hoisington Investment Management

**FAIRFAX FINANCIAL'S
V. PREM WATSA**
(cont'd from preceding page)

out. And I'm sure that you can quibble with the index, but you can see how far we've gone above the norm — and that even if residential house prices drop by 30%, it's still 40% above the norm.

The simple fact is that housing supply exceeds demand....

Watsa: And in the U.S., approximately 35% of all households have no mortgages — so 65% have mortgages. And the average equity in that 65% who have mortgages is 20%. So the value of the loan is 80% and they have equity of 20%. So if house prices go down 20% on average, a ton of people will be upside-down in their mortgages — meaning that their mortgages will be in excess of the value of their houses. And there are over four million houses in the U.S. today that are for sale. So this is a significant problem.

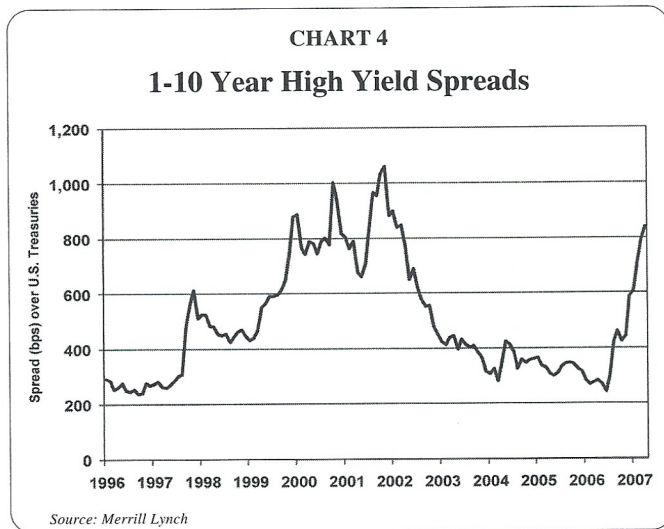
And you've got the Federal Reserve and lots of people trying to help and do all sorts of things. But the fact is... supply exceeds demand. And prices went way above where they should be — and on their way down, that creates havoc if you've got mortgages. And the same idea applies to automobiles [and credit cards]....

The number of non-performing assets can rise very quickly.

Watsa: Grant's [had a chart profiling] two savings and loan companies, FirstFed Financial and Downey Savings. And it showed that the number of non-performing assets was very, very small [from 1999 through 2005]. And then when the problems hit [in 2006-2007], the number just took off. It went from less than 1% to about 10% in the case of Downey, and 6% in the case of FirstFed.

I remember we invested in Bangkok Bank in Thailand. And Bangkok Bank was the best bank in Thailand. Then they went into the Asian crisis, and 40% of all their loans were non-performing — 40%, just like that. And they survived — they're still in business — but just barely.

There were all sorts of rights issues, all sorts of capital had to be raised, they sold stuff left, right and center, and the bank is totally different from what it was. Prior to that, it was the #1 quality bank in Thailand.



The ABS/MBS market is twice the supply of Treasuries....

Watsa: I highlight for you the fact that mortgage-backed and asset-backed securities are very huge in the U.S. They're probably huge in many parts of the world, but those are not easy-to-get statistics.

[Both the Treasury market and the mortgage-backed/asset-backed market were about \$3.5 trillion back in 1997.] The Treasury bond market is now about \$4.5 trillion. But the mortgage-backed/asset-backed market has grown to around \$9.5 trillion. So if people want to shift from that \$9.5 trillion and get into something that's safer, there's half the amount of Treasuries available today.

Too many houses/cars were built, and credit cards issued.

Watsa: This chart shows the asset-backed market. [See **CHART 6.**] This is where you had moral hazard. The asset-backed market was where you took your mortgages, automobile debt, or credit card debt, and you put it into a trust and sold it so that you never had to worry about it. And you can see what happened. Now, year-to-date [through March, 2008], it's almost disappeared. And if that doesn't come back — and it's highly unlikely that it'll all come back — the idea of getting mortgages or automobile loans and all of that on an easy basis is gone.

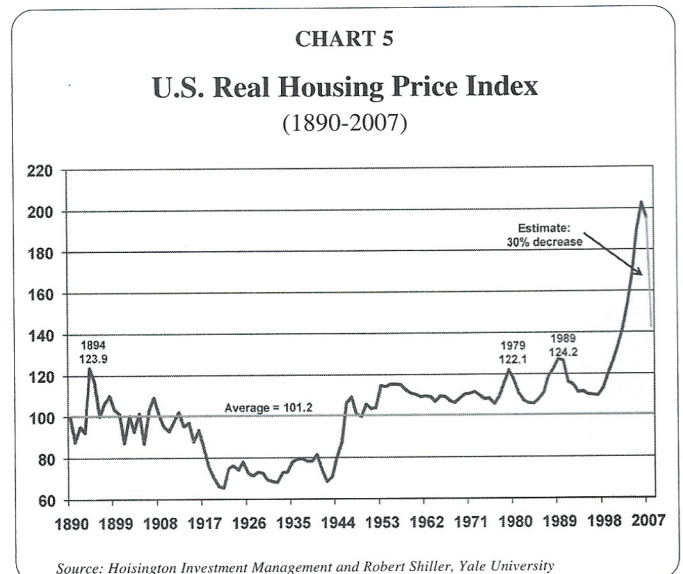
But the effect of the asset-backed is that too many houses were built, too many cars were built, and too many credit cards were issued — everyone got up to five or six credit cards. And too many leveraged buyout loans took place. All of that has to reverse itself. And it will — and all will be well — but we have to go through that process first. So the asset-backed market has collapsed.

WE ARE CONSERVATIVELY POSITIONED BECAUSE
WE THINK THE OPPORTUNITIES ARE AHEAD OF US.

A 10% ABS/bond price drop wipes out 23% of P&C capital.

Watsa: Now, how does all of this affect us? [These statistics are for] the U.S. P&C insurance industry from a publication put out by Dowling & Partners. So it's not the whole industry, but it's a significant part of it. Treasuries

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(cont'd from preceding page)

are only 11% of the total portfolio of the P&C industry in this sample of large companies. But corporate bonds are 30%, and mortgage-backed/asset backed are 20%. So corporate bonds and MBS/ABS are about 50% of the composite portfolio — and most importantly, 230% of equity.

That means any time you have a 10% drop in the market in those two categories, 23% of the capital gets wiped out (pre-tax) of the P&C insurance industry. So as I told you, the cycle's not going to change unless significant capital in the property/casualty industry disappears — as would occur in the case of a catastrophe like Katrina, or reinsurance failures. But this is another reason that might change the cycle. So it's something to watch.

We think opportunities will come our way the next few years.

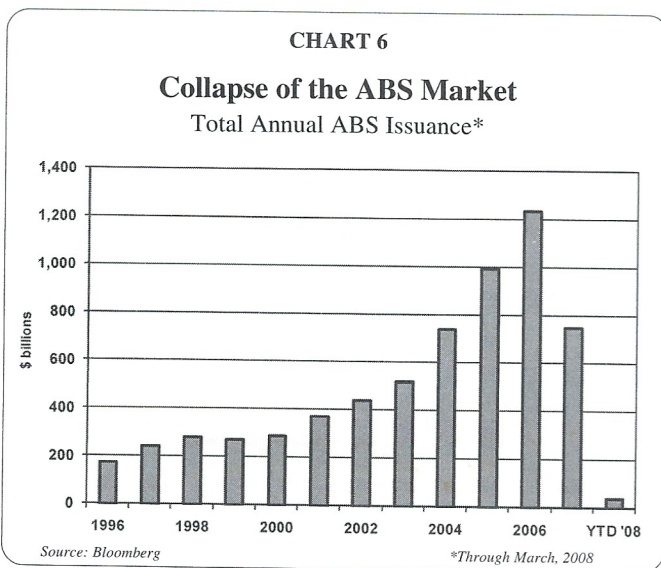
Watsa: Today, we are conservatively positioned. We've got 74% in government bonds and cash — and we've got no mortgage-backed or asset-backed securities. Our equity portfolios are hedged, so there's only 3% net exposure. The "other investments" (5%) are CDS [credit default swaps] — and corporate bonds are only 4%.

And we don't like the fact that we have these government bonds and cash. But we like it today, because we think the opportunities are ahead of us. We think opportunities will come our way the next few years to invest this money and make a return for our shareholders. But right now, we're not reaching for yield.

**WE ARE WORRIED ABOUT A 1-IN-50/100 YEAR EVENT
— BUT WE'D LIKE TO THINK WE CAN HANDLE IT.**

We're well positioned with our cash, bonds, and concern...

Shareholder: If I understand you correctly, you're concerned about how bad things could become, but take comfort in how well positioned you are because of your



cash and bonds.

Watsa: That's correct — our cash, our bonds, and our concern. Our thinking is very simply that if this recession that we're going into is like any that we've had in the last 50 years, then this is a really good time to be buying — this is a good time to be aggressive.

But if it's the 1-in-50 or 1-in-100 year event that we worry about, then, of course, you might be too early. So we are focused on worrying about that — but we'd like to think we can handle that type of concern.

[Editor's note: Watsa said in his March 7, 2008 letter to shareholders, "Recently, we came across an interesting observation by the man who provided the intellectual underpinnings of 'long term value investing' and to whom we are ever indebted. Ben Graham made the point that only 1 in 100 of the investors who were invested in the stock market in 1925 survived the crash of 1929–1932. If you didn't see the risks in 1925 (very hard to do), it was very unlikely that you survived the crash. We think Ben's observation may be relevant to what we have experienced in the past five years."]

Irrespective of the rating, people will gravitate to Treasuries.

Shareholder: Yesterday in the *Journal*, they talked about the possibility that at some point, the U.S. government might have to go in and back either Fannie or Freddie — or both — due to the crisis in the housing area. And if that were to happen, it's possible that the U.S. might lose its AAA rating. Is that the type of 1-in-50 or 1-in-100 event that you're talking about?

Watsa: One of the ratings agencies said yesterday that if Fannie and Freddie debt is guaranteed by the U.S. government — it isn't today, but most people assume that it will be — the U.S. government could lose its AAA rating...

But our thinking is that irrespective of the rating, people will eventually gravitate towards the safest credit in the world, Treasuries, because ultimately they're backed by the people of the United States.

Every day, you're seeing a company come in to raise capital.

Watsa: But we'll just have to watch how we go through these next few years. Every day for the last six months has been: Washington Mutual takes a big hit, Citigroup's taking a big hit. UBS has lost its capital for all practical purposes — they've had \$40 billion in write-offs. Merrill Lynch has taken a big hit — and they say they'll take another hit.

So every day, you're seeing a company come in to raise capital. We haven't seen this type of thing for 20-30 years — or even 40-50 years. Every day, there's something new that's coming in. So you just have to be careful — and worry about it.

Prolonged periods of prosperity lead to instability...

Watsa: And we haven't had a recession to speak of for 20 long years. We had a small one in 2001. But this might be a long one, because there's a lot of excess credit... For example, Citigroup has a balance sheet in excess of \$2.2 trillion — and it's got \$100 billion of equity. The Federal Reserve's balance sheet is \$900 billion, of which half is already spoken for. And Deutsche Bank has got a balance sheet of a couple of trillion on \$40-\$50 billion of

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FAIRFAX FINANCIAL'S
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(cont'd from preceding page)

equity. So it's just so *huge*.

You know, I quote Hyman Minsky, who makes the point that it's only during a long period of stability that you could've gotten this much leverage. There's no way anyone would have levered their balance sheet that much unless you had a long period of stability....

[Editor's note: Watsa elaborated on Minsky's theory in his March 7, 2008 shareholder letter: "Hyman Minsky, the father of the Financial Instability Hypothesis, said that history shows that 'stability causes instability'. Prolonged periods of prosperity lead to leveraged financial structures that cause instability. We are witnessing the aftereffects of the longest economic recovery (more than 20 years) in the U.S. with the shortest recession (2001). Regression to the mean has begun — but only just begun."]

Watsa: That's where we are today. And it just seems to us that deleveraging will take some time. But I might add that's an opinion — and it can change. But it's an opinion that we have. And we continue to follow that through.

MORTGAGE POOLS ARE VERY TOUGH TO ANALYZE —
AND WE DON'T TAKE COMFORT IN THEIR DIVERSIFICATION.

Mortgage-backed security pools are very difficult to evaluate.

Shareholder: As the mortgage-backed securities are sold in the future — presumably at quite distressed values — do you envision a point where you can then enter into the market at quite a discounted value? Or is that just something that's too hard to read?

Watsa: That's a very good question. We look at it. But our thinking is that it's *such* a tough market to value. You know, it's not just one mortgage. You have tons of mortgages in different cities and different places. So it's *very* difficult to evaluate.

Brian, why don't you take a crack at it?

Brian Bradstreet: I think that's a very tough question to answer, as Prem said. It's just that our strength as an investment team is our ability to analyze individual situations. That's what we excel at. That's what we've been trained to do over many years....

We just don't take a lot of comfort in pooled diversification.

Bradstreet: One of the problems in dealing with

(continued in next column)

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these large pools of assets is it's really difficult to get a good handle on what you own. Most investors are quite comfortable relying on the diversification that that implies — many, many names within a pool of assets. But that's something we just don't take a lot of comfort in....

Now having said that, if prices get so distressed — if they went down far enough — I'm sure we'd start to have a look at some of them. But I don't think we're anywhere close to that on some of the things that we've seen so far. The real distress is in these CDOs where you've got very low-rated securities that have been tranching up to look like they're AAA. And we just don't agree with that at all. So we're not interested in getting involved in that right now.

We never delegate a credit decision to rating agencies....

Bradstreet: But we'll see how things play out with the economy going forward. So I guess we're not saying no — but we're saying it's not our real strength. And unless

PORTFOLIO REPORTS estimates the following were Fairfax Financial's largest equity purchases during the 3 months ended 3/31/08:

1. LEVEL 3 COMMUNICATIONS INC
2. JOHNSON & JOHNSON
3. STEWART ENTERPRISES INC
4. KING PHARMACEUTICALS INC
5. RYANAIR HLDGS PLC ADR
6. NAM TAI ELECTRONICS
7. BROWN & BROWN INC
8. USG CORP
9. DELL INC
10. OFFICE DEPOT INC

there's a tremendous opportunity, I doubt that we'd get seriously involved.

Watsa: One of the points that Brian makes is that we *never* delegate a credit decision to rating agencies or others. We do it ourselves. So it's a very important difference, because you'll see other companies that say they've got AAA and AA securities. We like to analyze them and understand them. And again, we find that the mortgage pools are very tough to analyze.

One other area we've found tough to evaluate....

Shareholder: I noticed that Warren Buffett has seen the problems at MBIA and Ambac as an opportunity to get into municipal bond insurance. Have you considered that?

Watsa: Well, you have to have very good ratings for that — and Warren has terrific ratings. But we don't really understand that business well enough. We have a tough enough time understanding our own business. So we are not in that game.

LENDERS USED TO WORRY ABOUT EACH INDIVIDUAL LOAN
— UNTIL THEY WERE ABLE TO PACKAGE THEM OUT.

Pooling loans into tranches is proving to be a bad idea....

Shareholder: A very similar dynamic is playing out in the U.S. CMBS market that happened in the RMBS market,

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FAIRFAX FINANCIAL'S
V. PREM WATSA
(cont'd from preceding page)

that you were very prescient on and participated in.

Watsa: You mean commercial mortgages.

Shareholder: Yes. And the CMBS index is anticipating and pricing in 1-in-100 historical loss ratios — but yet fundamentals are still very strong. I'd be very interested in hearing what you think is going to happen there.

Watsa: In terms of commercial mortgages, there are not a huge amount of buildings that have been built. But you saw what happened in New York where the fellow who bought the General Motors building bid at a yield of 2.5%.

And the idea that you can tranche loans — mortgages, automobile loans, leveraged loans, credit card loans — and then split them and lay them off on the market is proving to be a bad idea. That's proving to be an idea where there's moral hazard — and the losses are going to be significant.

Pooling loans meant that you didn't have to worry anymore.

Watsa: As an example, if you were an auto dealer and you had a bad experience on 0.5% of the loans that you lent, that was because you watched every customer that came in. But after this idea of tranching and putting the loans in an asset-backed trust happened — and the rating agencies gave them AAA and AA ratings — you could care less....

The problem now is you're no longer focused [on each individual loan.] You lend money to every single person who comes in to buy a car because you package it out. So the 0.5% loss experience that you had is no longer relevant in the future. And in a recession, we'll find out how bad it really is. And it could be *really* bad with big losses. But it might not be, depending on the recession. I'm just saying that you can't look at the past experience and say that's what it's going to be in the future, because there's been a huge change. You had been worried in the past — and then you didn't care.

People are now back to being worried again. There's a credit crunch in the U.S. that's spreading across the world, where people don't want to lend for mortgages or cars....

Shareholder: So Prem, do you have credit default swaps in the commercial real estate market?

Watsa: No — just through banks, but not direct commercial real estate.

WE ARE VERY MUCH INTO OVERSTOCK.COM —
AND WE *REALLY* LIKE JOHNSON & JOHNSON.

We're still very much into Overstock....

Shareholder: Are you still in Overstock?

(continued in next column)

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Watsa: Yes, we are. We've shown our position, as required under securities rules. And we are very much into Overstock.

[Editor's note: As of 12/31/07, Fairfax owned 15.9% of the shares outstanding of Overstock.com.]

Shareholder: But then you've talked about positions that you no longer have, and are glad to have gotten out of.

Watsa: Well, we tell you in our annual report every year the significant common stock positions that we've sold. We buy common stocks in the main for 3 to 5 years. And sometimes, if we're really lucky and they've doubled in a year or two, we might think of lightening up or selling it all. But quite often, it's 3 to 5 years.

JNJ has the best long-term track record we've come across.

Watsa: But that reminds me that we identified one company in the annual report that we *really* like — that we're going to hold for a *long* period of time — and that's Johnson & Johnson, where we have the better part of \$400 million in one stock.

[Editor's note: In his March 7, 2008 letter to shareholders, Watsa enthused: "Johnson & Johnson has perhaps the best long-term track record we have come across. They have compounded sales and earnings for the last 100 years in excess of 10% per year. The growth prospects for their products on a worldwide basis are unlimited. And we own 5.9 million shares at a cost of \$62.29 per share with a market value of \$370 million."]

Watsa: But in the main, except as required by securities rules, we only tell you our stock positions after we sell them.

We think Torstar, CanWest, and Abitibi are 50¢ dollars....

Shareholder: With your 18%-19% interest in CanWest and Torstar — and now in the newsprint industry with Abitibi — could you just speak to your obvious confidence over the long term in the media sector.

Watsa: Well, we're value investors — and we take a long-term view. We buy things when we think we can get \$1 for 50¢. And we feel that we're getting \$1 for 50¢ in Torstar, CanWest, and Abitibi-Bowater.

But we have to be patient. You have to take the long-term view. And there are concerns. The reason Torstar's gone down 30%, and CanWest has gone down at least that — and Abitibi-Bowater has *really* gone down: it's down 90% — is because there are concerns. And Roger Lacey and our investment committee analyze all the concerns — and then we see if it's discounted. And if it's discounted, then we take a position in it.

Media shy? Well, if you can't beat 'em....

Watsa: The fact that we own 20% is not that we're activists or anything. It just happens to be a position that we have. We're not diversified over 50 names, but we like to have about 20-25 names across many industries.

So it's not that we think the media industry is going to do extremely well — although someone did say to me that we've been referred to as "media shy", and maybe this is one way of getting [back at them.] If you can't beat 'em... [Watsa and audience laugh.]

But for the record, it's just an investment.

—OID

DREMAN VALUE MANAGEMENT'S
DAVID DREMAN
(cont'd from page 1)

Given the current environment where investor sentiment has swung so strongly to pessimism, we were all ears when we heard Dreman was giving a talk entitled "Overreaction, Panic and Value Investing." And we weren't disappointed. To follow are excerpts from his prepared comments, as well as answers to attendee questions, on what causes bubbles to form, how they inevitably burst and create panics, why he feels we are in the midst of a classic panic, and what areas he thinks may best weather the storm and create future returns.

The event took place in New York on April 8, 2008 as part of the Investment Strategy Series at the 92nd Street Y, created and moderated by Claire Benenson. We trust you'll find these excerpts as timely and interesting as we do.

INVESTORS ARE NOT OMNISCIENTLY RATIONAL.
IT'S EMOTION THAT CREATES BUBBLES & PANICS.

We now have 40 years of data on investor psychology.

David Dreman: I thought I'd talk about overreaction, panic and how it ties into value investing. Value investing has a lot of psychology to it. Although it sounds very matter of fact, and very staid, in actuality, it's not. The economists call it "behavioral finance" because they don't like — and have never liked — the word "psychology". This goes against their basic premise that people are totally rational.

In any case, the question is, why are we looking at behavioral finance? Well, statistics have been out for 40 years, and the truth is that although our money managers are intelligent — probably the best-trained in market history — and have the finest information at their fingertips, they don't outperform the market over time. The facts are that according to John Bogle, over 90% of money managers underperform the market in a 10-year period. And over 95% underperform over a 15-year period....

Conventional theory assumes all investors are rational.

Dreman: And the reason — as we've written about and as a lot of other research now shows — is that current investment theory doesn't teach them to account for powerful psychological forces that influence their decisions and often result in consistent and predictable errors....

Conventional financial theory assumes that all investors are rational — that we're all almost automatons, we're omnisciently rational, we do everything precisely, and that emotion never affects us — or so the books tell us. [He laughs.] In reality, emotion often leads to irrational investment decisions and creates panics and bubbles. And behavioral finance explains them better than conventional theory, because conventional theory fails to recognize and possibly take advantage of the psychological mistakes of both professional and individual investors, while behavioral finance does....

One of our investment errors is that we're overly optimistic.

Dreman: For example, one of the investment errors

that we make that has a psychological basis is the fact that people are usually pretty optimistic. And money managers and analysts — and I guess I'd have to be included in that group — are *over-optimistic* a lot of the time.

We did a study entitled "Seventeen Years of Over-Optimism." And in that study, we simply looked at the forecasts of analysts and economists — each one made by IBES, which is a major earnings forecaster — against the earnings for the S&P for that year. And IBES did it pretty scientifically. They had groups of analysts that followed every company in the S&P — and the groups would range from, say, 7 for consensus estimates at the bottom, to as many as 35 or 40 for a Microsoft, Cisco, or General Electric.

Analysts were just a tad too optimistic — about 188% so....

Dreman: What we found was that from 1982-1997, the S&P earnings actually grew 7.9% per year. The average analyst estimates said earnings would grow 21.8% (if you take the average of all those numbers) during that period. So their forecasts were 188% above the actual earnings.

Now, economists being dour people on average — [chuckling] I hope there are no economists present — looked for earnings to go up, too, but not quite as much. They estimated that earnings would go up only 17.2%. So they were only 130% too optimistic....

BUBBLES & PANICS WILL TAKE STOCKS WELL ABOVE — AND WELL BELOW — THEIR TRUE NET WORTH.

Bubbles and panics have been around forever....

Dreman: But since we're in the middle of a panic — in my thinking, anyway — what I want to do is go over some of the overreactions and panics we've seen, and examine what happens during them.... One of the interesting things is that bubbles and panics have been around forever. One of the best recorded was the South Sea Bubble back in 1720. The South Sea Company went up from £129 to about £1,050 in about nine months. So it went up 713% — and then broke 88%.

Now, there've been numerous bubbles in this country — most of them since World War II. And in each case, the losses have been greater than the South Sea Bubble. In the gambling mania, for example, Resorts International went up 1,428% — twice the South Sea Bubble's peak increase — and then went down 85%.

And when it comes to bubbles, investors are getting worse.

Dreman: In the Internet Bubble of 1997 to 2001, Qualcomm went up about 8,000%, and Yahoo went up 19,000%. So when you put that together, that's something like 12-14 times as high as the South Sea Bubble. It's just an enormous difference.

So despite the training we receive in graduate school and all of the online information we have, are we getting any better at avoiding bubbles or at trying to figure out where prices should be? The answer is, no. In spite of all the modern techniques and advanced statistical tools that we have today, we don't do any better. In fact, we're actually doing much *worse*.

Why? Because we decide based on emotion, not cognition.

Dreman: And the question is *why* are we doing so

(continued on next page)

DREMAN VALUE MANAGEMENT'S
DAVID DREMAN
(cont'd from preceding page)

badly? I think one of the major reasons is a psychological factor called "affect" — that's a very strong influence. Affect is actually one of the major psychological influences on investor decision-making. It's been around in psychology, but it's only been brought into finance in the last 10 years or so. What affect states — and it works either alone or in tandem with other psychological forces — is that if we have strong likes, dislikes, opinions or feelings, they can influence our judgement about ideas, personality types, stocks, or industries — and pretty significantly at times.

Affect is emotional — it's not cognitive. And emotions can lead us much further from the norm than cognitive decisions.

Insensitivity to probability can lead to major overvaluation.

Dreman: There are a number of factors to affect that I think are particularly important for stock investing. One of them is called "insensitivity to probability." This simply says that when consequences have sharp affective meaning, insensitivity to probability can result in small probabilities carrying disproportionately large weight.

What that mouthful really means is that researchers found that if we like something — say, a lottery or gambling in a casino — if the odds are 1 in 10,000, or a *thousand* times worse (1 in 10 million), we believe intuitively that we have an equal chance of winning in either. It doesn't influence our decision at all.

And similarly, in the stock market, if the attraction to a stock is powerful enough, insensitivity to probability can lead to overvaluation as high as 100-fold, which is a possible reason for the enormous disconnects between price and fundamentals in the tech bubble.

And risks seem much higher in out-of-favor stocks....

Dreman: Just a couple of other brief thoughts about affect: Judgement of risk and benefit are negatively correlated. So if large numbers of investors like a stock, they perceive the risk as low. And if you go back to the tech and dot.com bubble in the late '90s, you'll see that analysts wrote numerous reports about Amazon, Cisco, and Yahoo, but very few of them said there was much risk. And conversely, if we *don't* like a stock and it's not doing well, we'll think the risks are much *higher* than they really are. And what that leads to is both the major overvaluation of the favorites during a bubble, as well as the continued outperformance of out-of-favor contrarian stocks....

It might also be a reason for reassessing how we view risk. Many of you probably read *Morningstar* — and the risk is *very* well calculated. It's very precise mathematically. The only problem is that it rarely works. If you look at their five-star funds in the late '90s, they held Amazon,

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Cisco, and Yahoo. So it may have taken out a generation of investors — but it was *precise*. [Audience laughs.]

The further out we look, the more we overlook complexity.

Dreman: There's another aspect of affect that's called "temporal construal." And what that means is the further we look into the future, the more we overlook all the complexities of a company. Say a company's been growing at 50% a year. But will it have a lot of competition, or new products coming in, and so on? We tend to ignore that and just project a straightforward line of growth. But the chances of that rate of growth continuing are very small.

Just as an example, some of you may remember AOL — America Online. In late 1999, a discounted earnings model that we put out showed that to justify its price, AOL would have needed 18 *billion* subscribers — which is only about triple the population of the earth. I imagine investors thought there were zillions of extraterrestrials ready to come in and subscribe to the service on other planets... [Audience laughs.]

When bubbles turn to panics, prices get destroyed....

Dreman: Moving on to panics — we're in the middle of one now with the subprime crisis and the financial crisis. And it's just amazing what has happened in the course of less than 18 months. Take the ABX subprime index, which is pretty well-known. In July of 2006, the subprime index was trading at 100. By the beginning of last month, it was at 10. That is as big a break as the market crash from '29-'32. So we're in a real panic.

And look at what happened to Bear Stearns. Bear went from \$130 back in October of last year down to — I guess the original price was \$2, but it's now just over \$10. In a panic, prices are destroyed.

So bubbles will take stocks up enormous amounts relative to their real net worth — and when they break, they come down to their net worth, and very often, during panics, well below. And I think a good part of it is this affect heuristic.

EARNINGS SURPRISES LEAD TO PREDICTABLE
AND CONSISTENT INVESTMENT ERRORS.

The average earnings estimate is off by 40.8%....

Dreman: So how do we benefit from these things — or from behavioral finance? There are a number of ways. One of the most important is that although we all are taught in graduate school that analysts can precisely fine-tune their earnings estimates, as we saw earlier, it just doesn't happen. Over time, analysts estimates are way off the mark. And when they *are* off the mark and there are earnings surprises, they lead to predictable and consistent investment errors. The results of earnings surprises also work strongly in *favor* of stocks that are out of favor, and very strongly *against* stocks that are in favor.

We put together [data] that goes back to 1973 — which is when they started to computerize earnings estimates — through 2007. Every company followed has a minimum of six earnings estimates, and sometimes they're up to 30 or 40. Well, analysts are looking to fine-tune earnings within a 2%-3% error margin. But what we found is that the average earnings estimate is off by 40.8% in a

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DREMAN VALUE MANAGEMENT'S DAVID DREMAN (cont'd from preceding page)

given year — and the median is off by 36.5%.

That roughly means that if I were looking for earnings of \$1 a share, I'd come up with 60¢ to \$1.40. So it's impossible to fine-tune earnings within that 2%-3% range. There's no precision. And the estimate evidence is enormous — about 1.5 million analysts' consensus estimates. So it's a very major sample.

It's almost easier to try and win the lottery...

Dreman: Just carrying [that data] further, we found that in one quarter, the chances of an analyst having earnings within $\pm 5\%$ of the estimate is only 30%. And then we got nasty. We asked, using the same information, what were the chances of an analyst being within 5% — which is a pretty wide margin — in one year? Well, they're 1 in 125. If we went out 10 quarters, or 2-1/2 years, they're 1 in 170,000. And if we asked what the chances would be for an analyst to be right within 5% on his or her estimates over five years every quarter? They're 1 in 30 billion. So it's almost easier to try and win the lottery. [He laughs.]

But it also says very strongly that we can't really forecast earnings precisely — which means that when we pay these enormous multiples for projected earnings well into the future, the odds are incredibly high that we're going to lose....

Out-of-favor co's w/positive surprises outperform by 7.9%.

Dreman: The last part of this equation is earnings surprises. And what we find — and I mentioned this earlier — is that earnings surprises help out-of-favor stocks because they're not expected to have positive surprises. If they have

(continued in next column)

CHART 1

CUMULATIVE RETURNS FOR VALUE AND GROWTH STRATEGIES

(Compustat Largest 1500 companies: 1970 - 2006)

Strategy*	Annual Return	Growth of \$1 million
Low P/E	16.6%	\$296 million
Low P/BV	16.2%	\$258 million
Low P/CF	15.2%	\$190 million
High Yield	14.3%	\$140 million
Market	12.7%	\$82 million
High P/E	9.5%	\$29 million
High P/BV	8.8%	\$23 million
High P/CF	8.8%	\$22 million
Low Yield	9.4%	\$28 million

*Highest 20% and lowest 20% by strategy.

Source: Dreman Value Management, LLC © 2008

positive surprises, out-of-favor stocks will go up 7.9% above market in the year. That doesn't sound like much, but given that stocks increased by 10% a year on average over the long term, that's a 79% above-market performance. When favorite stocks have positive surprises, they're up only 15% above market.

But the real killer for a lot of people who buy stocks with great growth prospects is the *negative* surprises. With negative surprises, stocks that are out of favor aren't affected much. People only expect the worst from them — so if there's a negative surprise, the market doesn't really react much. They're down less than 1%. However, if a favorite stock has a negative surprise, it's down 8.2% — so it underperforms the market by 82%, on average. And this is a big sample of 1,500 companies between 1973 and 2006. So again, that evidence is particularly significant given that stocks return 10% over time.

PREDICTING EARNINGS IS ALMOST IMPOSSIBLE, BUT THAT CAN BE USED TO YOUR ADVANTAGE.

It turns out growth stocks don't give you better appreciation.

Dreman: One of the things we do in trying to put a practical philosophy together is to look at these statistics very carefully. And as we've seen, predicting earnings is almost impossible to do over time. But there are ways to get around this. We've done these studies ourselves since the late 1970s. And there have been dozens of academic studies that have arrived at the same conclusion. And one of the facts that comes out very clearly from these studies is that if you buy out-of-favor stocks — like the lowest 20% of P/E stocks in the Compustat 1500 — you achieve well-above-average results over time.

One interesting thought is that you buy growth stocks because they're supposed to give you better appreciation. Unfortunately, the statistics don't show that. For the out-of-favor stocks, the appreciation is 11.9% during this 1970-2007 period. Appreciation for favorites — the highest 20% of P/E stocks — is 7.8%. So appreciation works in favor of the unloved and unwanted.

Then when you get to dividends, of course, you expect higher yields from unloved stocks. And that adds up to a total return which is *much* higher. So if you bought the out-of-favor stocks, you'd have a 16.7% total return against a 9.3% return for the favorite stocks.

All of these different out-of-favor strategies outperformed.

Dreman: And what we did is look at various out-of-favor stocks using different measures — low P/E, low price to book, low price to cash flow, and high yield. Conversely, the favorite stocks are high P/E, high price to cash flow, high price to book, and low yield. And what we find is that the out-of-favor stocks do significantly better. (See CHART 1)

This is basically for an institutional presentation — so I apologize. But if somebody had \$1 million in 1970, it would've grown to \$296 million over this period of time. And all of these different out-of-favor strategies outperformed the market, which would've grown to \$82 million.

A contrarian strategy really harnesses earnings surprises.

Dreman: Now, every one of the favorite stock groups

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does worse — high P/E, high price to book, and so on. And the differences are really very substantial over this 37 year period. Low P/E outperforms high P/E by something like 10 to 1. And low price to book outperforms high price to book by about 10 to 1. So the difference is *enormous*. That 3%-4% annual outperformance really grows a lot as a result of compounding.

So we can harness these behavioral forces by using a contrarian or low P/E strategy. They really harness the earnings surprises. And if somebody can stick to the discipline — which is actually very hard because of other behavioral finance factors — it really does work *very* well.

And the Dow's been up 37% a year on average after a crisis.

Dreman: Then lastly, we always hear in a crisis, as we're hearing today, that these are new, totally uncharted waters — that nothing like this has ever happened before, and because of this, we have no way of knowing how to react. So what we did is look at the 12 panics and recoveries since World War II — and in every one, the results worked out well.

We started with the Berlin blockade, when we were on the verge of nuclear war with the Soviets, we go through the '73-'74 stock market crash, the '87 crash, the Russian bond default in '98, and then the high-tech/dot.com crash. And what we found in each case was that after the markets hit their lows, they were up 36.6% a year on average afterwards — and there wasn't one year that was negative. Two years after the crash, the market, judged by the Dow, was up 53% on average.

So staying on the sidelines has always been bad advice....

Dreman: Now, nobody's going to hit the low or even come close — at least I haven't ever been able to do it. But even if you're 20% or 30% off, there are still enormous profits to be earned in a crisis. The thing to do is to *buy* good companies — not sell them. A lot of experts will say — you'll hear it on CNBC, and you'll read it in a lot of the market columns — "Stay on the sidelines for awhile. Don't do anything yet." Well, that's always proven to be bad advice from what we've been able to find looking at the past.

I'm not saying invest everything at a single moment in time. I'm saying that we are in a liquidity crunch — and it might even be worse than the one in the '30s — but we've

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got the tools to get out of it. The Fed was behind the curve for a long time, but it's ahead of the curve now. So I think we'll get through this one, too. And I believe many investors will probably look back and say, "Why didn't I just buy good companies this time?" Well, hopefully, some of us will have done that....

THE MAJOR BANKS HAVE MADE MAJOR MISTAKES.
BUT THEY'LL RECOVER — AS WILL THEIR EARNINGS.

Today's ugliest ducklings are obviously the financials....

Moderator: If someone came to invest with you today, where would you put the money? What are the unloved, ugly ducklings?

Dreman: Well, the ugliest of the ugly ducklings are obviously the financial stocks. But there are many financial stocks I wouldn't touch. Many of the REITs are highly leveraged. The leverage used to be 30 to 1. And they all borrowed very short. So they were caught. And there still may be more of that.

The major banks though would be an area that I'd look at — because I think the Fed is already starting to help them out. They have to, in a sense, because the banks have run out of money. If they hold on to their mortgages, which they don't want to sell in a panic, and they hold on to their private equity, which they also have a lot of — something like \$150 billion — they can't lend much money.

So I think between the Fed helping the banks and some congressional legislation on mortgages, some of these problems will go away — probably in the next few months.

Among the banks, we like Bank of America & Wachovia.

Moderator: I see that Warren Buffett's in Wells Fargo. Do you like that one?

Dreman: Well, Wells Fargo is very safe. It's a very good bank. We also like Bank of America, which is down very sharply — it's probably down 40%. Wachovia is down 50%. They've made major mistakes, but they'll recover. And they'll have pretty major earnings power in the next few years.

We worry the smaller regionals have yet to face the music.

Attendee: What about some regional banks like Fifth Third or National City — or the second tier down from the major banks you were talking about before?

Dreman: You really have to pick and choose and see which ones have problems. I like Fifth Third. We don't own it yet, but we have been looking at it. They may also take over another regional in the next month or two. So Fifth Third is a very solid bank.

I think one of the things we're a little frightened of is that some of the smaller regionals may have problems that we're unaware of, because they may have more of the CDO's and other fallout from the subprime crisis that hasn't really been realized just yet. But I think some of those mid-size banks probably are very good values.

Citi still has its name — and an incredibly good franchise.

Attendee: What are your feelings about Citigroup —

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and would you buy it and hold it for the future?

Dreman: Well, obviously, they made some major mistakes. But the Comptroller of the Currency said some years ago that none of the 20 top banks in the U.S. would be allowed to fail. And I think they're even more intertwined than they were back then.

So my thought is that Citi will take its losses. Its earnings will be very lackluster, if it has any at all, this year — and possibly even next year. But it has a name and an incredibly good franchise. And I think that it's probably a good value at this point.

I'll have a lot to say about WaMu in the coming weeks....

Attendee: Washington Mutual just did a very dilutive share issuance. I'm curious if you felt that was a necessary evil to raise capital.

Dreman: Unfortunately, I'm not allowed to speak about that at this point — because of legal restrictions. But I'll probably speak a *lot* about it in two weeks. [Dreman and the audience laugh.]

Attendee: Fair enough.

You don't want to buy co's that have no ability to come back.

Attendee: It seems like the past six months or so have been somewhat frustrating for value investors because some of the financial stocks that a lot of well-known value investors were attracted to that seemed cheap a year ago have just gotten cheaper and cheaper. And some, like Bear and Countrywide, have basically just disappeared.

So how do you know when to get out at some point no matter how cheap something seems?

Dreman: What we're seeing now in this financial crisis is very different than the normal bear market for value investing. With a Bear Stearns or some of the others — Washington Mutual would be another case where the stock has dropped dramatically — you have to really be very careful that you're not buying into stocks that have no ability to come back.

But if you buy quality banks, you should do well over time.

Dreman: But we had a banking crisis back in the early '90s. A lot of S&Ls — and even a lot of major banks — went under. But if you looked at the capital ratios of most of the major banks, even though they had huge losses, their capital was strong — tier one capital was probably 6%-7%. And although history never exactly repeats itself, what happened was that the good banks back then came back strongly and many doubled within a year. The bank index was at 0.5 times book, and it went back to 1 times book. And within 10 years, banks like Bank of America were up 10-fold.

So I'd really buy quality here — and if you do, I think you should do very well over time. But I wouldn't venture out into REITs or other areas that are more dangerous.

Something like Thornburg would be too risky for us....

Moderator: One of the major mutual funds put money into Thornburg Mortgage. Is that too risky?

Dreman: It would be for me. Actually, we had looked at it. We owned a very small position — and fortunately sold it off back in June at something like \$23. And it's around \$1 or so today.

Again, that's a case where they were borrowing short, which means the banks can call their loans at any point. And at the height, they had 35 times the mortgages relative to their capital. So that's something that would be too risky for us.

THE GSE'S DIDN'T SEE THE LIQUIDITY CRISIS COMING.
BUT THE FED ERRED IN CURBING THEIR MANDATE.

There was a bad management factor — particularly at FRE.

Attendee: Fannie Mae and Freddie Mac are two companies you've written a lot about over the past year. Do you feel let down by management at these companies — or do you think it was more bad luck or bad politics that caused them to experience the declines that they've had?

Dreman: I think there are a number of factors here. There's no question there was a bad management factor — particularly with Freddie Mac. They were buying their stock at \$60. So I think you can say that they didn't recognize the liquidity crisis for what it was for a long time.

Then the Federal Reserve — whether it was on its own or through political pressure — was trying to curb their mandate. And by doing this, they were certainly one of the major causes of the liquidity crisis, because Fannie Mae and Freddie Mac had very high standards for underwriting mortgages — much better than the rest of the industry.

So there was a lot of bad publicity there. Also, I think the mortgage crisis is more severe than anybody had thought. But having said all that, I think they both probably still have a fair amount of upside over time.

A lot of the crisis was due to an absolute lack of regulation.

Attendee: What's your best sense of what future government regulation will be?

Dreman: I think there definitely should be more enforcement. A lot of the housing crisis — at least the subprime and the other mortgage crisis — was caused because of an absolute lack of regulation. Many people just didn't know what they were buying. They didn't know that they were getting "teaser rates" at 2.5% — and that they'd then have to pay 8% or 10%.

So I think there should be, and probably *will* be, some major legislation in this area.

The Fed really has no choice but to reliquify the economy.

Attendee: What is your feeling on the debt markets now that municipal bonds, Fannie Mae and Freddie Mac, and high-quality corporate debt have taken a beating?

Dreman: I think that right now, there is virtually no liquidity in parts of the debt markets. Even in some of the Freddie and Fannie smaller preferred issues, the dealers are not making markets. So you're frozen out of buying or selling. It's a situation that I don't think any of us have ever seen before.

And my thought is that the Fed has to reliquify the economy in order to get markets going again. And Congress is probably not far behind in trying to do this. So I think

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that the current situation can't continue — because if it does, what might be a mild recession could become a very major recession, because the banks simply won't have the money to lend to good companies.

I wouldn't expect much from the bond insurers....

Attendee: Do you see any value in the bond insurers?

Dreman: We went short the bond insurers very early last year. Well, we actually bought puts when they were sitting in the \$60s and the \$80s — and now they're down to \$11 or \$12. We bought one-year puts that are up six-fold.

But it looks like they have a very hard road. They could be bailed out if the government bails out some of the subprime level mortgages. Otherwise, it's going to be very difficult for them. I don't think they'll go under. But I don't think I'd expect much at this point.

WE LIKE THE ABOVE-AVERAGE RETAILERS.
AND SOME HEALTHCARE STOCKS HAVE BEEN OVERSOLD.

We like above-average growers when they get very cheap.

Moderator: What other areas look unloved to you that are worth buying?

Dreman: In a period like this, some of the really good growth retailers get knocked down sharply. For example, Lowe's is down. It used to be a 12%-to-15%-a-year grower — and probably will be again. And it's down around 12 or 13 times earnings. Now, earnings are down this year, so the multiple is probably a little bit higher than that. But over time, people will buy home furnishings again. They'll buy homes again. So the housing markets might have a couple of rocky years, but it will come back.

Another one I like is Staples, which has come down pretty significantly. It was a 20%-a-year grower — and would be in normal times — and it's come down from a P/E of 25 to about 15 at this point. So although we like value, we do like growth stocks when we can get them very cheaply.

We think fears about healthcare legislation are overblown.

Moderator: Do you like any of the drug or healthcare companies?

Dreman: We do. Actually, there's a lot of worry with the healthcare companies like UnitedHealth and Aetna — and they've dropped pretty significantly. There are worries that if a Democrat wins the election — which is quite possible at this point in time — there will be immediate legislation that impacts their profits significantly over time. But we think that's probably really an overreaction. So we like the industry in general....

A couple of the pharmas are rock solid and very cheap....

Moderator: Any other areas?

Dreman: Well, we have positions in a number of other areas. We talked about retailers — and we like a

couple of the pharmaceuticals. Wyeth is a company that we like and own. It's a major position.

We have a position in Pfizer. It hasn't done much for years, but we think that the economics are getting better in that industry. And it will have new products coming on the market in the next couple of years. These companies are rock solid — and they're very cheap.

The leading tech companies aren't growing much right now.

Moderator: What about technology?

Dreman: Technology is not an area that we really like. We've owned technology, but at this point in time, we don't have a major new technology discovery boom. We're pretty much just going along with the technology of the mid 1990's.

Among the leading tech companies, Cisco is growing at 10% a year. Dell is not really growing at all anymore. And Intel has probably had negative growth for a number of years. But we'll like tech again. It's just that there's nothing very exciting there today.

WE LIKE BOTH PHILIP MORRIS INTL AND ALTRIA.
AND WE THINK ALTRIA SHOULD TRADE AT A PREMIUM.

Altria's up 10-fold for us, but we still like both pieces....

Attendee: Could you comment on Philip Morris International as well as the domestic? And if you were to choose, which would you own?

Dreman: You'll probably get a contrarian answer. [He chuckles.] We actually own both — and we've owned them since the dark days. And they've 10-folded for us since the tobacco trials in early 2000.

I would think that Philip Morris International would be a good stock. I have a feeling that Philip Morris Domestic [Altria] might do better. It's slower growth, but it has some very good assets besides tobacco. It's trading at \$23-\$24 now — and it has \$5 a share of assets other than tobacco. It has a high yield, it has 50% of the U.S. market — and its P/E is about the same as the other tobacco companies. So, obviously, we think it should trade at a premium.

I also think their earnings will go up over time due to their other assets and through cost cutting. So Altria might be a somewhat better market mover — although they're both good.

At a 72 P/E, I think the Chinese market is the next bubble.

Attendee: What's your feeling about Asian stocks in general, and Japan in particular?

Dreman: In general, I think the Chinese market is the next bubble. For the average Chinese stock (although it's down some), you're paying something like 72 times earnings — and you're not getting the infrastructure. And by infrastructure, I mean they don't have the code of laws that a lot of the Western companies tend to have. And we saw what happened with Russian stocks back in 1998. Restrictions were put on — and a wave of investors were just wiped out.

Japan's more interesting because it has much better infrastructure. So if a Japanese stock reached a reasonable price, we would certainly look at it....

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And it turns out that great art only returns 7% or so a year.

Attendee: What do you think about putting money into an art fund?

Dreman: We own some art. Art is good over time. Actually, in writing one of my books, I found the prices of some of the Renoirs and Monets back in the 1880s — and through a tortuous route, figured out their value today. And it turns out that art really only returns something like 7% a year in spite of the spectacular prices we see. And we're talking about the really outstanding artists. Most art, really, has no value over time.

WE LIKE OIL IN THE GROUND. SIMPLY PUT,
WE'VE USED MORE THAN WE'VE DISCOVERED.

Relative to the market, oil companies are still very cheap.

Moderator: Are there any other areas that you particularly favor at this point?

Dreman: Well, yes. We've never been gold bugs — although gold is probably interesting — but we do like oil. We like oil in the ground. And we've owned it for four or five years. The basic economics of oil is simply that we've used more oil than we've discovered for the last 25 years. Last year, for example, with all the discoveries — and with all the money devoted to discovering new reserves — we used roughly twice as much oil as we discovered. So although oil could go down a little, I don't think it's going to go down a great deal.

And I think that the oil companies, relative to the market, are still very cheap — and they're flush with cash.

Moderator: Do you like some of the oil service companies as well, or do you only like the drillers?

Dreman: Some people do. I personally like oil in the ground. So I like the domestic companies with major reserves — companies like Apache, Anadarko, and Devon.

Oil sands? I wouldn't load my portfolio with them....

Moderator: Do you follow the oil sands in Canada?

Dreman: I do. Being from Canada, I've followed them for most of my life.

Moderator: How do you feel about them with the price of oil so high now?

Dreman: Well, the problem with the oil sands to me has been that when I was in my 20's — [chuckling] which was 100 years ago — they used to think that they could produce oil at \$5 or \$6 a barrel. Now, it's probably about \$60 a barrel — and there's still not huge production.

I'm not a skeptic, though. But I wouldn't want to have my portfolio loaded with them.

In several commodities, demand is now ahead of supply.

Attendee: What do you think of the agricultural stocks? Are they in some type of a bubble phase — or if

not a bubble, are they overextended?

Dreman: That's a very good question. We looked at them, but we're not buying them. At the same time though, we think that agriculture — and also some of the major mining stocks — are in a different era now.

Through the mid-'90s, the cyclical stocks really had no earnings at all. They might have one or two good years out of 10, and then eight bad ones. But I think we've moved to the point where demand is now ahead of supply. In industrial commodities, we haven't developed a lot of new mines. And when you see wheat hitting \$25 a bushel, something is very different in agriculture.

So I guess our thought is that we'll buy if there are any other setbacks in the mining area. And in agriculture, we'd start looking at the stocks pretty seriously.

Moderator: Would you look at coal, too?

Dreman: Very definitely — coal or iron ore. It's just a

PORTFOLIO REPORTS estimates the following were Dreman Value Management's largest equity purchases during the 3 months ended 3/31/08:

1. CITIGROUP INC
2. KEYCORP
3. FEDEX CORP
4. BHP BILLITON LTD ADR
5. HILB, ROGAL & HOBBS CO
6. BANK OF AMERICA CORP
7. FREDDIE MAC
8. FANNIE MAE
9. SCANSOURCE INC
10. TENNECO INC

matter of what seems to have the most potential. But I think all of these areas are very different than they were even 10 years ago.

Even gold is probably very reasonable here....

Moderator: How do you feel about gold?

Dreman: Well, gold has always adjusted to inflation. If you go back 250 years, a good men's suit would cost an ounce of gold. And one of my partners is a real gold bug, so he says, "Therefore, gold should be at \$2,500 an ounce." [Dreman and audience laugh.]

But in any case, I think we will have more inflation. I think, if anything, the Fed is letting inflation go because of this serious liquidity crisis that they have to solve. If the liquidity crisis weren't here, I think we'd see long-term rates at least 200 basis points higher. So I think gold is probably very reasonable here.

It's very volatile. But I'd certainly buy it when it's had a major dip.

IN A PERIOD OF ABOVE-AVERAGE INFLATION,
DISCOUNTED REAL ESTATE SHOULD OUTPERFORM.

In real estate, you have that leverage....

Attendee: I'd be interested to hear your views on the real estate market — when you think it will bottom, and

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DREMAN VALUE MANAGEMENT'S
DAVID DREMAN
(cont'd from preceding page)

what you think the ramifications are for the economy?

Dreman: Well, you never know where a bottom is. But I would think in the next year or so, there'll be some pretty good bargains there. I think we're headed for a period of well-above-average inflation. So if I were able to buy real estate in a good area at a major discount, I'd probably start to buy in the next few months.

In real estate, you have that leverage — because you only put down 20%. And if there is the kind of inflation that I think there might be in a few years, the values could go up very significantly. You could double or triple your capital over a 5 or 10-year period.

And once every 10-20 years, there's a great opportunity....

Attendee: So over the course of the next five years, you think valuable property will outperform a valuable stock portfolio such as your own?

Dreman: I think once every decade or two, you get an outstanding chance to buy real estate. And I think people who buy real estate in some areas like Palm Beach, Miami, or L.A. — where I've heard they're now selling at 30% discounts — will probably do as well or better because of the leverage in real estate that isn't in the stock market.

Moderator: But Florida is so overbuilt that the inventory has to work down, which will take awhile.

Dreman: Yes. In buying anything like this, you have to give it a four or five-year time span....

Long bonds are too dangerous. In fact, we've shorted them.

Moderator: Would you recommend that investors keep their portfolio of bonds very short because of the possibility of inflation?

Dreman: Well, that's a very good question. I'd keep my portfolio very, very short — because if interest rates rise 1%, a 30-year bond will go down 16%. So it's just too dangerous to be in long-term bonds in a period like this. And actually, we've just started to short 30-year government bonds in one of our hedge funds. So I may have a slightly biased opinion....

A 2-3 YEAR HOT STREAK DOESN'T MAKE YOU A GENIUS.
IT'S THE LONG-TERM RECORD THAT MATTERS.

A lot of managers become infatuated with their stocks.

Attendee: Do you have any rules for determining your P/E ratios in picking stocks?

Dreman: Yes. What we do is we buy stocks with P/E ratios below the market multiple — and we normally try to be in the bottom 20%. There'll be other factors in there, but normally we are in the bottom 20% of P/Es.

And our discipline is that when they reach the market multiple, we'll sell them. That is because the results, as I mentioned earlier, so strongly favor this kind of strategy that we stay close to it.

Moderator: Are there any other factors in your sell discipline?

Dreman: We have a couple of other rules. We'll sell if a stock doesn't work out within two or three years. A lot of money managers become infatuated with their stocks — so we have a limit of 2-1/2 to three years, depending on how cyclical the industry is. And if it doesn't outperform the S&P by that point in time, we'll sell it.

In a majority of cases, passive mgn't is a better choice.

Attendee: You mentioned earlier that most money managers don't outperform the market. In your opinion, what's the benefit then of using active management?

Dreman: Well, that's a good question — and one that consultants never cease asking us. [He laughs.]

I think one of the real problems for most of us as investors — and this also comes from behavioral finance — is we take a hot streak of two or three years and we say, "That person is a genius." So we go with those — and we forget the long-term record.

You know, somebody like Warren Buffett has got a record of over 35 years. And, yes, he'll have his bad years — but not many. So if you find a manager with a really good record — and it has to be at least 10 years or more — then I'd go with him. Otherwise, passive management very often is a better choice.

I can't say anything negative about money mgn't stocks....

Attendee: What about the pessimism with active management and the publicly-traded money managers like Legg Mason, AllianceBernstein, Franklin Resources, and T. Rowe Price? Some of these stocks have had significant hits and are trading at significant discounts to the market.

Dreman: Well, being a money manager, I really can't say anything negative about money management stocks. [Audience laughs.] We're a little biased on that.

Their businesses are entirely different. There's no leverage in the business. And over time, their assets will probably go up. They may have a rough period for a while with markets. But over time, I think I'd certainly look at those stocks at the right price.

Some evidence early on that value investing worked....

Attendee: How did you end up becoming a value investor? And what's your favorite book on investing?

Dreman: I guess if I had to say, my favorite book would probably not be about investing, but it's an old classic on Wall Street: *Extraordinary Popular Delusions and the Madness of Crowds* — because it really explains as well as anything does human behavior and how wildly emotions can swing. It was actually written around 1850 by an Englishman named Charles Mackay.

As to how I became a value investor, I was sort of born into the investment business. My father was a commodities trader in Canada. And actually, he was a psychologist without knowing it. He always looked at bull and bear markets. And he was a contrarian — he'd always buy what everybody was selling. And we lived pretty well — so I thought he knew what he was doing. So it was just ingrained in me very early.

—OID

TOM GAYNER, MARKEL CORP

“Starting in the summer of 2007, financial markets entered a period of turmoil with the blow-up of a few subprime mortgage hedge funds serving as the detonator caps of a profound financial storm. Major institution after major institution has reported massive write-offs from ill-fated forays into a variety of overly complicated and unsound investments. We did not stray into this area in search of extra yield or extra return. Although we clearly don't get everything right and we make some mistakes along the way, our unwavering long-standing emphasis on quality in all of our investing activities has served us very well through this stormy period, and we do not face the troubles you see reported in the headlines....

“Today we believe that there are many productive long-term investment prospects. The very good news amidst the current market environment is that this is a rare opportunity to upgrade the quality of our holdings at attractive prices. The *very* best companies are on sale.... We are prudently invested and investing in a list of proven, long-term financially successful, global powerhouses, while maintaining an above-average level of margin of safety to acknowledge the heightened volatility and uncertainty of the current marketplace. The world continues to grow and develop — and in general, we have chosen to participate in this worldwide growth through companies with intangible brand values, manufacturing networks and intellectual expertise, rather than direct commodity exposures. While this puts us out of phase with certain turbocharged sectors of the market, we think we will enjoy long, durable and tax-efficient returns from this approach....

“For 2007 and 2008 together, we are only modestly behind the index, even though we have only limited exposure to the popular commodity sectors, and large exposure to financial and consumer-related firms. Included in these returns was an ‘other than temporary impairment’ charge related to our shareholdings in Citigroup. This has been a disappointing holding, as the company stumbled badly and did not manage the risks and day-to-day activities of its business well. While new management is now in place and the capital base has been augmented, the decline in the stock price and the circumstances caused us to recognize the loss. Fortunately, at the peak, Citi was only 3.7% of our equity portfolio. And it is a mistake from which we can both recover and learn. The other holdings which comprised the bulk of the write-down include Home Depot, Marsh & McLennan, and Comcast. While these three firms have been disappointing investments, their underlying businesses are showing positive trends, and, in my opinion, they are not permanently set back.”

Conference Call — May 1, 2008

CHRIS BROWNE & WILL BROWNE, TWEEDY, BROWNE FUNDS

“Every six or seven years, it seems the economy and/or the markets go through some form of crisis. It just seems that markets almost have a tendency to disequilibrium. And you could talk at great length about the behavioral aspects — which we happen to be firm believers in — that tend to contribute to these sorts of things. However, as we've gone through them, the one thing we could say about ourselves is that we are ultimately optimists — and by that I mean we don't happen to believe that the world will in fact come to an end. But when you're in the midst of this, there's an *enormous* amount of hysteria. There's more hysteria now than there might have been 20 years ago by virtue of 24/7 media coverage. You hear and read about it on every channel of media. So there's a concentration of bad news.

“Within all this, I think that one thing we know we *can't* find, nor are we going to spend our time *trying* to find — because it's such a low odds, low probability exercise — is a tipping point, where all of the sudden instead of the glass being half empty with a large crack in it and the water running out, people say, ‘Well, the glass seems to be filling up and someone's fixed the crack.’ And then markets will move the other way. The time it will take? We don't know. But if you look at market cycles with great difficulties, they've run somewhere around 3± years.

“In the meantime, our focus — through Ben Graham's point of view — is on trying to simply think of buying an interest in a business. We look at an individual business, and we ask, how is that business priced relative to what it might be worth? That is an exercise where your probabilities of being correct are far greater. And having a certain healthy appreciation for the limits of your intelligence and expertise keeps you out of a lot of trouble. And we've been able to stay out of a *lot* of trouble that other people have not been able to stay out of. We didn't see the point of getting a few more basis points on our cash by investing in portfolios of subprime mortgages. We'll take the crummy old rate which you get with U.S. government-guaranteed paper, because the increment you get paid for the risk that you take in no way pays you back if something goes wrong — if you're in that 100 year flood plain, which the credit markets were this year, and you have a 100 year flood.

“So we think that over time, we're going to do just fine. This is the kind of environment where in fact, in a perverse sort of way, we get to feel a little bit better.”

Annual Shareholders Meeting — April 4, 2008

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