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Outstanding Investor Digest

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

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Investors featured in this Issue:

BERKSHIRE HATHAWAY'S WARREN BUFFETT & CHARLIE MUNGER...1, 4, 16, 18, 19, 21, 24, 29, 32

FIRST PACIFIC ADVISORS' GEORGE MICHAELIS ...1, 26, 32

GROWTH STCK OUTLOOK'S CHARLES ALLMON...2

LEGG MASON'S DAVID NELSON...2, 32

REICH & TANG LP'S ROBERT F. HOERLE...31

WALTER & EDWIN SCHLOSS ASSOCIATES LP'S WALTER & EDWIN SCHLOSS...1, 13, 32

STRONG/CORNELIUSON FUNDS WM CORNELIUSON & DICK STRONG...2,

SWANSON CAPITAL MGMT'S STEVEN A. SWANSON...3, 32

WEDGE CAPITAL MGMT'S RICHARD X. HODDE...3, 32

Other Investors in this Issue:

FIDELITY MAGELLAN'S PETER LYNCH...11

GRAHAM, NEWMAN'S BEN GRAHAM ...11, 13, 14, 15, 18, 19, 24

MUTUAL SHARES' MAX HEINE & MICHAEL PRICE...14

SOROS FUND'S GEORGE SOROS...24

TEMPLETON FUNDS' JOHN TEMPLETON...22

Z-SEVEN FUND'S BARRY ZISKIN...20, 21
(and more.)

Companies & Investments in this Issue:

BETHLEHEM...28
CAMPBELL SOUP...22
CAP CITIES...8, 29
CHICAGO MILWAUKEE...24
CHICAGO NORTHWESTERN...24
CLEVELAND CLIFFS...17, 18
COCA COLA...12
CRUCIBLE STEEL...13
DOVER...29
EMERSON ELECTRIC...29
FARMERS GROUP...30
FEDERATED DEPARTMENT STORES...10
GEICO...6
GENERAL FOODS...22
GENESSE & WYOMING RAILROAD...16
GILCHRIST...13
HARVEY HUBBLE...29
ILLINOIS CENTRAL...13
ILLINIOS TOOL WORKS...29
INTL PAPER...28
JEDDO HIGHLAND COAL...16
KRAFT...22
LTV...24
MANVILLE...27
MEDTRONIC...31
MERCHANTS NATIONAL PROPERTY...16
MESABI TRUST...17
MISSOURI KANSAS TEXAS...13
MORSE SHOE...23
MORTON THIOKOL...31
NAPA CHEMICAL...29
NORTH EUROPEAN OIL...27
PENN CENTRAL...14, 25
PILLSBURY...30
RAMADA INN...2
REVCO...14
ROHR...26
SVC MERCHANDISE...23
TIMKEN COMPANY...15, 18
UNION CARBIDE...28
US STEEL...15, 28
VERMONT MARBLE...16
WATKINS JOHNSON...22
WEIS MARKETS...29
WHITEHALL CORP...22
WW GRAINGER...29
(and more.)

INVESTOR SENTIMENT MAY BE POSITIVE, BUT NOT AMONG MANY OF OUR WALLFLOWERS.

In recent months, general investor sentiment has apparently shifted dramatically as bear after bear has thrown in the towel and jumped on the new bull market bandwagon. But you sure wouldn't know it from talking to our managers.

For whatever it's worth, we last observed such a disparity in sentiment in the months preceding the Crash. Anyway, here's a partial sampling of some of the contrary opinions we're hearing along with some of the stocks each

(continued on page 2)

BERKSHIRE HATHAWAY ANNUAL MEETING WARREN BUFFETT & CHARLIE MUNGER "WE DON'T MIND GIVING AWAY THE FORMULA. ONCE YOU'RE AHEAD, THEY WON'T CATCH YOU."

Warren Buffett is considered by many to be the most successful money manager around. To understand why, one need look no further than his numbers.

Each $10,000 invested in Buffett Partnership, Ltd. in 1956 and reinvested in Berkshire Hathaway stock at the Partnership's termination in 1969 would today be worth well over $25 million after all fees and expenses. (The investor would have incurred only about $50,000 in income taxes during the entire 33 years.) In fact, those figures understate

(continued on page 4)

WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S WALTER & EDWIN SCHLOSS — PART II "CHEAP IS GOOD ENOUGH."

As reported last issue, Graham-Newman alumnus Walter Schloss formed Walter J. Schloss Associates in 1955 and was joined by son, Edwin, in 1973. Selected by living legend Warren Buffett to be among his "Super-Investors of Graham and Doddsville," the Schlosses have consistently run circles around the broad indexes.

For the 33 years ended 12/31/88, Walter J. Schloss Associates earned a compound annual return of 21.6% per year on equity capital vs. 9.8% per year for the S&P 500.

(continued on page 13)

FIRST PACIFIC ADVISORS' GEORGE MICHAELIS SOURCE CAPITAL ANNUAL MEETING "WE DON'T TRY TO PREDICT THE UNPREDICTABLE."

According to Lipper Analytical Services, Source Capital was the best performing diversified equity closed-end fund for the 5 and 10 years ended 12/31/88. For the 12 years ended 12/31/88, Source's net asset value and common equity value grew at compounded annual rates of 16.2% and 18.9% respectively (vs. 12.2% and 13.3% per year for the Dow Jones Industrial Average and the S&P 500, respectively.

(continued on page 26)

WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS — PART II
"CHEAP IS GOOD ENOUGH."

As reported last issue, Graham-Newman alumnus Walter Schloss formed Walter J. Schloss Associates in 1955 and was joined by son, Edwin, in 1973. Selected by living legend Warren Buffett to be among his "Super-Investors of Graham and Doddsville," the Schlosses have consistently run circles around the broad indexes.

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Here again are Walter J. Schloss Associates' annual return figures — along with those of the S&P 500 — for each of the 33 years ended 12/31/88. All performance figures are before fees to the general partner and were provided by Walter & Edwin Schloss Associates, LP.

Year	Annual Return	S&P 500 Total Return
1956	+6.8%	+6.6%
1957	-4.7%	-10.8%
1958	+54.6%	+43.4%
1959	+23.3%	+12.0%
1960	+9.3%	+0.5%
1961	+28.8%	+26.9%
1962	+11.1%	-8.7%
1963	+20.1%	+22.8%
1964	+22.8%	+16.5%
1965	+35.7%	+12.5%
1966	+0.7%	-10.1%
1967	+34.4%	+24.0%
1968	+35.5%	+11.1%
1969	-9.0%	-8.5%
1970	-8.2%	+4.0%
1971	+28.3%	+14.3%
1972	+15.5%	+19.0%
1973	-8.0%	-14.7%
1974	-6.2%	-26.5%
1975	+52.2%	+37.2%
1976	+39.2%	+23.8%
1977	+34.4%	-7.2%
1978	+48.8%	+6.6%
1979	+39.7%	+18.4%
1980	+31.1%	+32.4%
1981	+24.5%	-4.9%
1982	+32.1%	+21.4%
1983	+51.2%	+22.5%
1984	+8.4%	+6.3%
1985	+25.0%	+32.2%
1986	+15.9%	+18.5%
1987	+26.9%	+5.2%
1988	+39.4%	+16.8%
1956-88	+21.6%	+9.8%

As we reported in Part I of our conversation with the Schlosses, they are generally somewhat publicity shy and consented to an OID interview only following alternate begging and threats by an unidentified ~~editor~~ party.

The following excerpts were selected from a series of highly enjoyable conversations with the Schlosses at their office in Manhattan. The second part of a two-part interview, we hope you enjoy it as much as we did:

OID: As Buffett has repeatedly observed, the number of Graham alumni who have achieved exceptional success is quite remarkable.

Walter Schloss: It really is. I'll always be grateful to Ben Graham for his giving me a chance to work for and learn from him as a young security analyst. He was always interested in helping young people. There's no question that I, Warren and many others learned a great deal from him.

Ben was a very sweet guy. He graduated number one in his class at Columbia and wanted to go into philosophy. But he couldn't make any money in it.

OID: Sounds like publishing.

Walter Schloss: Jerry Newman's brother, Douglas, went to school with Ben. He was so impressed with Ben that he had his brother Jerry meet him. And that's how they met. At the time, Graham worked for an old brokerage firm — Newberger, Henderson & Loeb.

Ben was fairly rigid in his investment discipline at Graham-Newman. When I was working there, we'd buy related hedges. We bought Crucible Steel convertible 5% preferred and shorted the common. And in those days, you'd get a long-term gain and a short-term loss. Then the Treasury changed the rules.

I always thought it tied up a lot of capital. But when you could borrow money very inexpensively, the preferred paid a dividend of 5% and the common paid nothing.

We shorted them at parity. If they went up, you had a long-term gain and a short-term loss. If they went down, the 5% preferred went down less — maybe it went from $100 to $80, whereas the common might go from $20 to $6. Then, he'd buy back the common and sell off the preferred.

OID: So it was extremely low-risk investing.

Walter Schloss: That's right. They couldn't lose. Graham basically didn't want to lose so he did that.

He also did liquidations — some of which took a long time. They were profitable in the '30s. Today, you hardly see any liquidations at all. Generally, companies can sell their assets for more than they would receive from liquidating them.

There were also unrelated hedges, which turned out not to be so good — we did a study of a number of them and it turned out they were not particularly profitable.

OID: Unrelated hedges?

Walter Schloss: For example, Graham decided that Illinois Central was a cheaper railroad at the price then than Missouri Kansas Texas. So he bought Illinois Central and sold Missouri Kansas Texas short.

While it may have been true statistically, it worked out very badly. It's very difficult to short one railroad and buy another over a short period of time. Maybe over a longer period of time, it would work. Anyway, we stopped doing it.

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
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And then we bought common stocks. The idea was to buy common stocks selling at two-thirds or less of working capital. If working capital was $100 a share, they paid $67 or less for the stock. And that was a great idea.

Of course, in those cases, there usually wasn't too much debt. But they were often tertiary or secondary companies — like Gilchrist, which we bought. It was cheap. It was a secondary department store in Massachusetts. They had rents to pay which were a heavy expense.

Today, if a company has very good space in a shopping center, it's often viewed as an asset. In those days, it was viewed as being onerous.

OID: Because there is so much more inflation today?

Walter Schloss: That's right.

I think the big change was the huge debt of these companies which 20 years ago didn't really exist. The large amount of debt against the assets of these companies makes them very vulnerable.

In those days, a lot of the railroads were in bankruptcy. Graham would buy the bonds — usually the first mortgage bonds — of these bankrupt companies.

Today, they're forming big funds to buy bankrupt companies and make their profits on the reorganization. That wasn't so popular in the '30s and '40s. I'm not so sure that because of the current competition to get into this field, that they may not be overpaying today.

In the case of bankrupt securities, the company would work out a reorganization plan. But before the plan would be put into effect, when-issued securities would start trading.

Graham would buy the first mortgage bonds and sell off the when-issued securities. They would sell off everything — $500 worth of first-mortage bonds, $300 worth of second-mortgage bonds, $100 of preferred and $100 of common — they'd sell it all off and they'd walk away with 15% profit.

Henry Crown did the same thing. The difference is that he'd keep the new common stock — which might represent only 5% of the proceeds — and wind up controlling the company.

I thought Graham hadn't thought it through. His argument was, "Look, we made 15%. Why tie up our money in the common?"

But the common enjoyed tremendous leverage. Graham missed an opportunity. Of course, that's with the benefit of hindsight.

OID: As we mentioned, we had the great pleasure of speaking with Mutual Shares' Max Heine a few weeks before his death. He told us that over his entire career the best performers in his portfolio had been his bankrupt bonds.

We asked him why he invested in anything else. He said he couldn't get enough of them to fill his portfolio. Randy Updyke said the same thing.

Walter Schloss: That's the problem. You can't get enough of them — and everybody wants to do it. It's sometimes not worth the trouble — particularly when there are all kinds of lawyers and so forth.

OID: Updyke agreed that where you are in the economic cycle is important, as well. This late into an expansion, they may be less of a bargain.

Edwin Schloss: That's a good point.

Walter Schloss: One of the great investment successes we had was with the Penn Central bankruptcy.

The only mistake we made was in buying the first mortgage bonds. They worked out well but the junior bonds worked out even better. New York Central bonds, which were selling for $50 on a $1,000 bond, worked out at par whereas the senior bonds, which we bought at $150, worked out at par.

But I was trying to be conservative. Anyway, we did very well with the Penn Central bankruptcy.

OID: Not bad.

Walter Schloss: It was a fabulous success. And in retrospect, you wonder why it worked so well. I guess it was in the '70s and people were scared.

The problem in investing, I think, is timing. You may be right. But in the long run, we're all dead. Even if you're right, if it takes 20 years to work out, it can be a disaster.

Things usually take longer to work out but they work out better than you expect.

In the meantime, the economic cycle can change. Somehow, I don't think we've really been too happy with those reorganizations.

Edwin Schloss: No. And there are too many people now who are focused on doing the same kind of thing.

You can tell by the behavior of bankrupt securities. When a company went into Chapter 11 ten years ago, we usually had a period of 3 months to accumulate a position if we were interested.

OID: Where the stock was inefficiently priced?

Edwin Schloss: Exactly.

Walter Schloss: Now you have one day.

Edwin Schloss: Or less. Sometimes, it's the same day that the stock moves down sharply and then recovers. It's discounted that fast.

Walter Schloss: Too many people chasing too few goods.

OID: That too will change, right?

Edwin Schloss: I guess the new trick will be reorganizations of leveraged buy-outs — like Revco.

OID: That's what Michael Price, Peter Cundill and Charles Brandes all say.

Walter Schloss: You really have to know your stuff on those things.

Edwin Schloss: That's right. It's more complicated — like a pyramid — with debt upon debt upon debt.

Walter Schloss: You have to know the laws of the states in which they're incorporated, their judges, how they've ruled in the past, and which properties are valuable. I don't think we're really set up to do that.

Edwin Schloss: We're not.

OID: How would you summarize your approach?

Edwin Schloss: We try to buy stocks cheap.

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
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OID: Might you be just a tad more descriptive?

Walter Schloss: Each one is different. I don't think you can generalize.

In the old days, Graham had a very good theory — you just buy below working capital and you don't worry too much about the business they're in — don't worry about management, earnings or anything else.

I think it worked until about 1960 and again in the 1973-74 break.

But I think you just have to look at each situation on its own merits and decide whether it's worth more than its asking price.

OID: But everybody's got his/her own bias. For example, Graham would be called a value investor and so would Buffett. But their approaches are very different.

Walter Schloss: Warren wants franchises and good businesses. We do too, but we're not willing to pay for them so we don't buy them. I guess we buy difficult businesses.

As Warren would say, he likes to row downstream and we like to row upstream.

OID: Could you give us an example?

Walter Schloss: The Timken Company. Edwin discovered it for us. We believe it's a good company in a tough business — highly competitive, heavy industry. We own stock in it at a lower price. Timken spent some $450 million on a new steel mill a few years ago and recently announced that they intend to spend up to a billion dollars over the years on additional modernization and development of new techniques in their field.

There are about 30 million shares fully diluted. Roughly 20% of Timken stock is controlled by family members. The stock sells around $35 with a reported book of that amount but they have a big inventory reserve and are the low-cost producer in their field.

The FTC has fined foreign competitors for dumping tapered roller bearings in the United States. Competition is tough and there is no franchise but we think they make an excellent product. As a survivor, they run a tight ship. We think they have a good chance at some point to earn a decent amount on their blood, sweat and tears. You couldn't duplicate their plants for what they carry them for on their books. But there are no guarantees.

OID: In terms of the way you look at a stock, relative to the way Graham looked at a stock or Buffett looks at a stock, how do you look at it differently?

Walter Schloss: Basically, we like to buy assets.

OID: Why assets? Why not earnings?

Walter Schloss: Assets seem to change less than earnings. You could argue that assets are not always worth what they're carried for.

Graham made an argument at one point that inventory was a plus, not a minus. In an inflationary period, having a big inventory might be very helpful. While in a deflationary period, a big inventory would not necessarily be good.

But if you are going to have to liquidate inventory in the next week, that would not be good for you. If you have a nice inventory and business is alright, you benefit from having that inventory. So I don't know. It may be a wash, depending on other factors.

How do people value inventory? Fifty percent of what it's carried at? It may be worth more than that. Generally, it's not as good as cash or receivables — we know that. But it may not be as bad as some people say.

If you have two companies — one with a plant that's 40 years old, another with a new plant — both are shown on the books but the new plant may be much more profitable than the old one. But the company with the old one doesn't have to depreciate it. So he may be overstating his earnings a little bit by having low depreciation.

OID: Lies, damn lies and financial statements?

Walter Schloss: That's often the case. Ben made the point in one of his articles that if U.S. Steel wrote down their plants to a dollar, they would show very large earnings because they would not have to depreciate them anymore.

Would that be proper? Of course, he didn't think it would be. But that means a company could really increase its reported earnings.

And that's only one of the reasons why Edwin and I aren't wild about earnings. They can be manipulated — legally. If people are just looking at earnings, they may get a distorted view.

Edwin Schloss: I think a lot of people have been hurt by buying something solely on the basis of a low P/E. We could go for a low P/E or for a high P/E. Basically, earnings are hard to predict.

Walter Schloss: If a guy estimates earnings of $2.25 and it turns out to be $2.50 — that shouldn't really change the value of the stock that much. But the stock price often changes radically when that happens.

On the other hand, with book value at $25 a share, you'd be rather surprised if the next year it fell to $15.

OID: So earnings are much more volatile than book value?

Walter Schloss: That's right.

Edwin Schloss: Also, we like to see if we can buy something with earning power behind it. With some of these growth companies, you're happy if they earn 50¢.

Walter Schloss: That's true. With these growth stocks, if the growth doesn't continue, you can get stuck.

If observers are expecting the earnings to grow from $1.00 to $1.50 to $2.00 and then $2.50, an earnings disappointment can knock a $40 stock down to $20. You can lose half your money just because the earnings fell out of bed.

If you buy a debt-free stock with a $15 book selling at $10, it can go down to $8. It's not great, but it's not terrible either. On the other hand, if things turn around, that stock can sell at $25 if it develops its earnings.

Basically, we like protection on the downside. A $10 stock with a $15 book can offer pretty good protection. By using book value as a parameter, we can protect ourselves on the downside and not get hurt too badly.

Also, I think the person who buys earnings has got to follow it all the darn time. They're constantly driven by earnings, they're driven by timing. I'm amazed.

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
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I look in that little stock guide book and I see some stocks trade 20% of their market in one month. We'd prefer to avoid the volatile issues with huge trading volume.

Edwin Schloss: I think there's going to be a shakeout in the OTC Market. There are too many little companies in there that I don't think are all that wonderful — many of them are penny stocks and dead wood.

OID: You don't sound like fans of penny stocks.

Walter Schloss: One of the things people are most foolish about is that they think the market price of a stock on a per share basis reflects the total price of the company.

They forget that if a company has 100 million shares outstanding and it sells at 10¢ per share, that it's selling for $10 million — even though it's selling at 10¢.

Whereas, if another company has only 100,000 shares outstanding and sells at $20, it's selling for only $2 million. Many people think the first company is cheaper than the second based on the per share price.

OID: Like the guy who orders a medium-sized pizza when asked if he'd like it cut into 4 slices or 8. His reply: "Only 4 please, I could never eat 8."

Walter Schloss: Exactly. Back in the 1930s, there were a lot of these companies with a very small number of shares outstanding selling at $20. People didn't want to pay $20.

Now you're getting this crazy thing where people are buying options which is another gimmick similar to buying penny stocks. They're in somewhat the same kind of category — they're both junk.

OID: Like being scared away from Berkshire Hathaway when it was selling for $150 per share.

Walter Schloss: Because it's selling for $150 per share instead of looking at the implied value of the company — at that time, $150 million.

People do not take into consideration the market value of the company they're buying. They just look at the price per share rather than the value of the company.

Warren has been very good at valuing companies.

OID: In treating shares as fractional interests in businesses?

Walter Schloss: That's right. I don't think we're as good at valuing businesses as Warren. We just figure it's worth more than we're paying when we buy it.

They're bigger companies than we have in most cases. But it's very difficult for us to buy a lot of small companies.

We've learned not to have too much in unmarketable securities because you can find that you're stuck with them. In a bad market, you just can't get out.

(continued in next column)

Edwin Schloss: But if you do buy an inactive security and you really think it's undervalued, stay with it even if you grow impatient. Once you sell it, you can't always buy it back.

Walter Schloss: That's true. If somebody's got 1% or 2% of their money in an inactive security, that's fine. But if they have 20% or 25% and they want to sell it because they're nervous about it, they're stuck. Then they have to sell it to some fellow who specializes in taking advantage of those guys.

OID: On the other hand, Buffett recommends buying your stocks as though you're not going to be able to sell them for ten years.

Walter Schloss: Warren came to me in 1962, as I recall and he said, "Walter, I'm too big to hold these small holdings. But you're small and you can take them."

This package of securities was worth about $65,000 at the time. So I said, "Warren, how are you valuing them?"

So he said, "I'll sell them to you at the price I carry them at."

I said OK.

OID: Cost or market?

Walter Schloss: Their market price at the time.

So we bought Genessee and Wyoming Railroad, Vermont Marble, Jeddo Highland Coal and Merchant's National Property — we just bought them as a group.

And they all worked out beautifully except for one which I still have. And that one's gone up to ten times what we paid for it. But they all worked out.

They were small and you really couldn't sell them. I mean you could sell them to an over-the-counter broker who'd take advantage of you if you don't know your prices.

But I remember those because they were so inactive and yet they were good values. I doubt if you could get something like that now.

OID: How has your approach evolved?

Walter Schloss: We just try to buy cheap stocks. That's really all. We try to buy things that are out of favor — stocks that others don't want.

OID: Being as specific or unspecific as you wish, what's out of favor today?

Walter Schloss: I don't want to talk about stocks particularly, because you have an influence on it.

OID: I hate to beg in public, but could you give us an example or two to help us understand your thinking process?

Walter Schloss: Cleveland Cliffs may give you a good example of our thinking process. Their primary business was selling iron ore to steel mills. We bought their stock not because we were looking for a cheap investment in the steel industry. We looked at the stock because we thought it was a good value.

Cleveland Cliffs was the best company in its field. As I recall, Warren bought a lot of it at around $18 a share and later sold it around his cost. But then, when the steel industry was in decline and so many of these companies defaulted on their debt, and the biggest shareholder sold his share because he no longer liked the industry, the stock

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
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went down to $6 a share. We bought a lot of it.

OID: Going where others feared to tread.

Walter Schloss: That's right. We bought it although there was talk of bankruptcy. If we'd lived in Cleveland, we probably wouldn't have bought it because we would have been too close to all the bad things.

Anyway, after we bought it, the company started to do better. They've sold off some assets and bought back some stock.

We didn't buy it knowing what would happen. But we did like the idea that it was the low-cost iron ore producer and they have 50% of the reserves in America.

OID: Is that low-cost within America?

Walter Schloss: With the low dollar, it makes it tough for foreign competitors. They're even exporting a little.

Edwin Schloss: A weak dollar helps.

Walter Schloss: So it came together. But the point is that we felt it was cheap. The people in Cleveland were scared to death. There was a proxy fight among other things.

Edwin Schloss: When we were buying it, nobody wanted it. Now, it's being written up by investment houses.

Walter Schloss: Sometimes an industry can appall you so much that you don't buy cheap stocks.

OID: Did you look at Mesabi Trust?

Walter Schloss: The Mesabi Field is a high-cost field. But it's a good example. Mesabi had an agreement where they would get a royalty on all the ore that was mined from the Mesabi field. But once the price of iron ore went to the point where it didn't pay for them to mine that ore, it was all over.

There's a case of a stock that fell from to $10 to $3.

OID: Below $2, I believe.

Walter Schloss: Maybe Mesabi will work out. But I'd much rather be in a low-cost producer.

You can argue that a high-cost producer is a more speculative mine and the place to be at the right price. Of course, the low-cost mine is safer — I'd be more comfortable with a lower cost mine.

But you can often have more upside with a high-cost producer. If the cost of iron ore went way up, Mesabi stock could go back to $10 again. But we're not smart enough to know which industries will do well. That may help us in the long run. We look at companies rather than industries.

OID: Speaking of cheap stocks, what's cheap today?

Walter Schloss: We don't see much that's cheap now. It's much more difficult to find bargains today than it was 10 years ago.

OID: Yet you're fully invested.

Walter Schloss: We have to invest. But it's more difficult to find things today than it used to be. It's very hard.

I wouldn't want to change our standards and buy earnings instead of assets. I like the idea of buying assets. I think Edwin likes better quality companies. I don't dislike them but you pay more for them. The question is how good a quality do you want to get?

We could be wrong. One of the things you learn in this business is humility because you see your mistakes the next day. Many people make a mistake but they don't see it in the paper the next day.

OID: Doctors bury their mistakes. Newsletter editors publish theirs.

Walter Schloss: And you don't always know it's a mistake right away.

Edwin Schloss: It's also easier to know when something's cheap than when it's overvalued.

Walter Schloss: That's true. I had a guy come to me as a client many years ago and he said, "Walter, you're good at picking undervalued stocks. I think you ought to be able to pick overvalued stocks so I can short them."

I said, "it's a different ballgame. You can't put them in the same category."

A stock can be overvalued and then double in price as it becomes more overvalued. The same bunch of investors are not involved. In fact, it's not even an investor that's in an overpriced stock.

Concentrate on what you know and forget about everything else.

OID: Over the past 30 years, you've outperformed the S&P 500 by a factor of better than 2 times. Earning 2.2 times the S&P 500 is pretty remarkable.

Walter Schloss: Was it really 2.2 times? I'm really surprised it's 2.2 times the S&P 500. I knew we were better, but I didn't know it was that much better.

I'm very impressed by that.

OID: As are we. Anyway, that explains your humility. How'd you manage to do so well in 1987? You outperformed the S&P 500 by almost 3 times.

Edwin Schloss: The rust belt turned around. That helped.

Walter Schloss: We did very well for the first nine months of 1987. We were up 53%. Meanwhile, the market went up 41.5% for the first 9 months, but gave back all but 9% by the fiscal year-end. We came down from up 53% to up 26%. So we lost half of our overall profits.

We did well for the first nine months but we gave a lot of it back in that last quarter.

OID: Give me a break. You outperformed the market as it went up and as it went down.

Walter Schloss: In the past, it seemed that two good years in the market were invariably followed by a third year that was not so good — at least up until 1974.

Since 1974, we've had 14 fabulous years without any down years. That's never happened before and it'll never happen again — every single year since 1974.

That's unbelievable. If you look back, you see the Dow Jones hasn't gone down in 6 years and that's never happened before.

I don't think you'll find any 6-year period — except maybe in the '20s — where you've had 6 up years in the market.

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
(cont'd from preceding page)

OID: Probably not a very good omen for the future.

Walter Schloss: Terrible! And that's what I thought two years ago.

OID: Yet you remained 90% or more invested.

Walter Schloss: We're willing to buy bad businesses — and we find some.

Edwin Schloss: I don't think our companies are bad.

Walter Schloss: Cleveland Cliffs and Timken are not great businesses.

Edwin Schloss: Timken in its field is considered to be a fine company.

OID: Hardly the most glowing praise ever paid a company.

Walter Schloss: It's a good company in a tough industry.

Is it true that even your clients don't know what you're buying for them?

Walter Schloss: That's correct. And a little story might help explain why we don't tell them what we own.

One of our partners said, "Walter, I have a lot of money with you. I'm very nervous about what you own."

So I made an exception and said, "I'll tell you a few things that we own." I mentioned the bankrupt rail bonds and a couple of other things we owned.

He said, "I can't stand knowing that you own those kinds of stocks. I have to withdraw from the partnership."

He died about a year later. That's one of the reasons we don't like to give people specifics.

OID: You shouldn't blame yourself. He might have died anyway.

So you don't ever tell clients what you own?

Edwin Schloss: No, we don't. At the end of the year, we list a few of our holdings with the largest gain. But usually that's after we've sold most of our position.

OID: It's interesting to me that two of the vehicles with the best long-term records around don't report their holdings to clients.

Walter Schloss: Who's the other?

OID: Buffett Partnership. That's got to be a tremendous advantage — not reporting.

Walter Schloss: I think so.

OID: Shareholders can hardly be a positive influence — unless they're very unusual shareholders.

Edwin Schloss: So why did we agree to this interview?

OID: We all make mistakes.

Walter Schloss: The problem, of course, is that you can't do that as an investment company. You have to disclose your holdings and you can scare your clients.

OID: I believe Buffett was once quoted as saying something to the effect that behavior is irrational in direct proportion to the size of the projected payoff, irrespective of risk.

Edwin Schloss: Just like the golf story.

Walter Schloss: That's right. It's a perfect example of what he's saying.

Warren was playing golf at Pebble Beach with Charlie Munger, (Berkshire Hathaway vice-chairman), Jack Byrne (Fireman's Fund chairman) and another person.

One of them proposed, "Warren, if you shoot a hole-in-one on this 18-hole course, we'll give you $10,000 bucks. If you don't shoot a hole-in-one, you owe us $10."

Warren thought about it and said, "I'm not taking the bet."

The others said, "Why don't you? The most you can lose is $10. You can make $10,000."

Warren replied, "If you're not disciplined in the little things, you won't be disciplined in the big things."

I spoke with Warren and it's a true story.

Graham-Newman invited Warren to be a partner. But at that point, he wanted to go back to Omaha. A year after I left Graham-Newman, they went out of business. By that time, Tom Knapp [Tweedy-Browne] had taken my place.

OID: Why was Graham-Newman liquidated?

Walter Schloss: I really don't know all the reasons that went into it. But before they went out of business, they offered Abraham & Co., who they liked, the opportunity to take over the firm. But they didn't want to be involved in it.

I think it was Jack Bleibtreu, the senior partner, who didn't want to be involved because if they took over Graham-Newman, they'd have to disclose their holdings — so they turned it down. And Graham and Newman wouldn't allow anyone else to buy their firm.

OID: Why not?

Walter Schloss: By that time, they had enough money of their own. Abraham & Company said that they'd run it so long as Graham and Newman could be consulted. But Graham and Newman said, "We don't want to be consulted. We want out."

And they were not willing to lend their name to have someone else run it. I can understand it. They built it up and didn't want anyone to come in and hurt it. So they closed it down.

Many people said, "Oh, Graham and Newman are such a wonderful combination because they're so different and they don't agree about things. So if they ever agree about them, it's good."

I don't agree with that argument. It may have been good for Graham. But I like people who are sympatico, who don't disagree. Partners, it seems to me, should have somewhat the same point of view.

OID: You've actually done much better absolutely and relatively since Edwin joined you in 1973.

Walter Schloss: Well, I like working with Edwin. He has made it possible to continue running the partnership. I couldn't do it without him. Edwin has been invaluable in choosing stocks for us.

It is very difficult to run a one-man firm without anybody to talk to about things. Lots of times, your ideas may make sense to you but they really need somebody else

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
cont'd from preceding page)

to talk them out. I don't know who else I'd talk to about them.

OID: We volunteer.

Walter Schloss: Also, as regards working with Edwin, I've seen things happen in life that are unpleasant. It's trust. And I do think blood is thicker than water — or money.

If I had somebody there who wasn't in the family, in the back of my mind, I'd always be afraid of going away and God knows what.

When I go away, I'm not worried. Whatever Edwin does is fine. Peace of mind is very important to me. It's something you can't measure in dollars.

OID: Amen. I understand you guys don't even like to talk with managements of the companies you own. Is that true?

Edwin Schloss: You can waste a whole lot of energy running all over the country checking on managements of the companies you own. We only go to annual meetings if they're within a 20-block radius of the office.

Walter Schloss: I think I agree with Ben Graham. He didn't like to speak with management because he thought he would be influenced by what they said.

On the other hand, if you're smart enough.... Warren could go to an annual meeting and because he's very analytical and not emotional about it, he could analyze what goes on without being swayed by the fact that the guy talks well, acts well or whatever. He could probably do it. He's very good at it. I don't think I would be.

Besides, while it's nice to go to meetings, they're time consuming. I agree with the expression, "You never know all about a stock, until you own it."

OID: Quite often an extremely tragic expression.

Walter Schloss: Like the old story about the guy being pestered by a broker to buy something for $10 a share. The broker keeps pushing him and it gets to $8 a share. The broker keeps pushing him and it gets to $6 a share.

Finally, the guy says, "OK. Buy me a thousand shares. And when it gets back to the price I paid, sell it."

OID: The best humor in the investment business — at least outside this room — has got to be Buffett. Has he always been so witty?

Walter Schloss: He's always had a great sense of humor.

One of my favorites is the letter he wrote to his partners about compound interest. He pointed out that the Indians actually got the better of the bargain when they sold Manhattan to Peter Minuet for trinkets worth $24. It's just that they didn't invest it well.

In another letter, he pointed out how the guy who commissioned Leonardo Da Vinci to paint the Mona Lisa made a bum investment for the same reason — that he'd have had some monstrous sum of money if he'd invested only moderately well.

And he made a similar comparison with the voyage of Christopher Columbus in which he discovered America.

OID: Compound interest truly is a wondrous thing, isn't it?

Walter Schloss: It really is.

OID: Would you compare today's market to any historical period?

Walter Schloss: The 1987 break was much more like 1962 than it was like 1929. The market was far too high. And it revalued itself — much of it in one day.

But we never know where the market is going. In October of 1987 before the market broke, we were both saying that the market was too high.

OID: And we quoted Edwin on that point shortly before the crash.

You mentioned earlier that you prefer to be — and generally remain — nearly 100% invested. As I recall, before the Crash, you were 90% invested.

Walter Schloss: That's correct. Over any extended period of time, stocks generally outperform bonds. Most people who have been really successful in the securities markets say the same thing — that they're not smart enough to get into the market and out of it. So they tend to remain more or less in the market at all times. I don't know anyone who got rich owning high-grade bonds.

OID: What percent invested have you been over the years on average?

Walter Schloss: Very close to 100%.

OID: What's the most out of the market that you've ever been?

Walter Schloss: 10%. And again that was before the Crash.

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
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We try to buy good values and not worry too much about what the market is going to do. You could say, "How come you had 90% of your money in stocks if you thought the market was too high?"

Our answer was that what we owned didn't seem that overpriced. But when the market went down, our stocks went down too.

OID: But you were up more than the market before the crash and down less during it.

Walter Schloss: That's correct. And if we'd sold out, we might have missed being up 26% for the year. We did better by being in the market and not trying to figure it out.

It's the same thing today. I think the market may be vulnerable. I don't know what's going to happen. But I think I sleep better owning stocks than owning cash.

But everybody's different. You should own what you're comfortable with.

OID: Actually, that's debatable. Most people would probably do well to own what makes them uncomfortable — if only they wouldn't then sell at the worst possible moment. But it's fortunate for you and your partners that you're most comfortable in stocks.

Has your investment philosophy changed over time?

Walter Schloss: Yes, I think it has — largely because of the situation in the market. Graham-Newman used to buy working capital stocks — which I thought was a great idea. But by 1960, there were practically no working capital stocks. With the exception of 1974, at the very bottom of that market, there have been practically no working capital stocks.

A good way of seeing it is to look at Value Line's list of working capital stocks. If you go back 15 years, you'll see they have some on the list. Today, there are very few. And the ones that are on the list are really pretty bad — often with a lot of debt — especially in relationship to the equity.

With working capital stocks gone, we look next at book value.

Edwin Schloss: We used to look for companies selling at half of book. And if they weren't available, we looked for companies selling at two thirds of book. Now we're looking at companies selling at book value. But we hardly ever pay over asset value unless it's a special situation or franchise.

Many so-called fundamentalists don't even pay attention to book value anymore. They will after they lose half of their money. It's getting very tricky.

Walter Schloss: It seems now that everybody else is doing what we're doing — or at least a lot of people are. And many people have huge amounts of money to invest. So we try to get in between the rain drops.

OID: What has been your most common mistake?

Edwin Schloss: Being too aggressive initially — buying so much of a stock initially that when the price moved lower, it took too much capital to average down. We've occasionally bought so much that we couldn't buy as much as we'd like when it went down further without becoming overly concentrated.

OID: We can certainly relate to that. How much concentration do you utilize?

Edwin Schloss: It varies considerably. We'll own as little as 2,000 shares of a $5 stock. But if we really like something, we'll put as much as 10%-15% of the portfolio into it.

Of course, it depends on the situation.

OID: How do you add security in today's market?

Edwin Schloss: Recently, it's gotten to the point that a lot of the loaded laggards have been picked over to the extent that the things that are left selling at discounts from book value are not nearly as attractive as they used to be. Therefore, we're upgrading our portfolio so that many of our holdings might look more like Pioneer Fund than Graham-Newman's.

OID: Out of the garbage heap — for now.

Edwin Schloss: You have such a way with words — but that's exactly right.

OID: Barry Ziskin recently told us that asset-based investing has been more successful than earnings-based investing in recent years. And that's the biggest reason why earnings-based stocks currently offer better value.

Edwin Schloss: I agree with him. That's why we're shifting into higher quality companies as long as they're selling at reasonable prices.

The trouble with many growth investors is that they're overly concerned with quarterly comparisons. They have to depend on earnings to support the stock's multiple. Besides, their criteria are much too rigid. I know people who are looking for the perfect company that sells at 8 times earnings growing at 25%. You just don't find those companies around today. And they could be making a big mistake — either by buying things that are too pricey or by sitting on the sidelines.

Conversely, buying something at book value doesn't necessarily make it cheap. So many of these companies have been picked over.

In my judgement, the opportunity in today's market lies in the middle ground between the two. These companies aren't quite up there with the ones Buffett buys, but they're not bad.

The fact is that medium-sized growth companies have been overlooked — they fall between the cracks. They're too high quality for the asset investors and aren't growing rapidly enough for the growth buyers.

OID: Being neither fish nor fowl, they're neglected.

Edwin Schloss: Exactly — by both camps. So it's important to be flexible.

And we're in a different kind of market today than we were in the '70s, during which you could buy almost any kind of asset situation and make money.

OID: Have you observed any differences between what you and your father wind up favoring?

Edwin Schloss: When you've gone through the

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
(cont'd from preceding page)

Depression — as, of course, my father did — book value has been a tremendous benchmark to his approach. Buying companies which are selling at book value or at a slight discount from book is something that he wouldn't have considered ten years ago.

However, I do think he's become somewhat more flexible.

OID: Being willing to pay up a little?

Edwin Schloss: That's right — although I always get a little bit worried about shifting or changing criteria. It's too easy to destroy something that has worked so well for so many years.

OID: I suppose you could call beating the market by a factor of 2.2 times over 30+ years working well.

We understand that Buffett respects your dad tremendously.

Edwin Schloss: He admires his integrity and, as he describes it, his special strength when facing a headwind. He also says...

Walter Schloss: Let it go at that.

OID: Even though Buffett's approach and that of you and your dad is almost like night and day.

Edwin Schloss: That's right. Warren thinks that we operate a little like Noah's Ark.

OID: Two of every animal — dogs included?

Edwin Schloss: That's right. We tend to be generalists.

We prefer to invest in asset-rich situations but it's important to be flexible when so many are focusing on those situations.

OID: We agree with you and Barry Ziskin on that one. It's a novel thought, though — that for your dad and you to buy stocks at book value is a reach.

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Edwin Schloss: It certainly is.

OID: Most managers consider themselves to be virtuous if they buy something not too much over book. Most people don't think twice about paying two times book.

Edwin Schloss: Well, we do. We will not buy anything at twice book. We just have a rule about that. We simply will not do it.

But there are a lot of other factors we consider. For example, it's really important to concentrate on areas of the market that other people are neglecting.

OID: What else can you tell us about you and your dad?

Edwin Schloss: We often come into the office kind of late and we sometimes leave a little earlier than scheduled — sort of like the LIFO method of accounting — last in and first out.

OID: We'll keep that our little secret.

Edwin Schloss: On the other hand, we sometimes call each other at 11:00 o'clock at night. We frequently talk on the phone quite late. We have a tendency to get our best ideas at that time.

OID: Because of having fewer distractions and interruptions then?

Edwin Schloss: Exactly.

And speaking of interruptions, what amazes me about Wall Street is that there are so few registered reps who have any background in security analysis. It's surprising to me that we get calls from all these different brokerage houses — people who want to bring something to us. And yet, they don't know anything about what they're touting. They're just reading a racing sheet.

When a broker called me recently, I asked him what the book value was. He told me 25%.

OID: It was higher than 25%?

Edwin Schloss: Exactly.

They waste our time. We'd bring business to people if they'd come up with a good idea. But why should I give somebody business because they decided that they just uncovered IBM.

Their favorite line is, "It's moving! It's moving!"

That's what they usually do. They call up, "It's $21." Then they call up about 2 hours later, "It's $24." Then they'll say, "You missed 3 points but it's not too late to climb aboard." You know, "Hurry, hurry, hurry."

Meanwhile, all day over the loudspeaker at the firm, they've been touting it, so the stock usually plummets within a week or two.

Or if it doesn't plummet, they call you up after it goes up 50% or so and say, "You missed it, you missed it."

And after they tell you that you missed it, they think they've hooked you — that you'll be conditioned to buy the next hot one.

OID: Pretty sophisticated.

Edwin Schloss: Brokers will tell you crazy things. Whenever they say they have a hot one for you, right away I

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
(cont'd from preceding page)

get nervous. But they usually say something like, "You better buy it. It's selling at its all-time high."

I'll say, "What's it selling for?"

And they'll say, "Five and three-eighths."

OID: Pre-split, of course.

Edwin Schloss: Naturally.

OID: Anyway, the broker stories we hear never cease to amaze us. But that's not the way you find most of your ideas?

Edwin Schloss: No, generally not.

Over the 15 years I've been here and the many years my father has been in the business, we're aware of an enormous number of companies. And I have a fair idea of where something becomes reasonably priced. So I will quite often focus on industries that are out of favor.

For example, right now it would not be food stocks.

OID: Hallelujah on that one.

Edwin Schloss: Maybe there'll be another Kraft. But I'm not used to buying food stocks at these prices.

I remember the days when you could actually buy Cambell's Soup and Kraft and all those things at a 10% premium over book. Now they're going out at six times book. It's just another world.

OID: And you could buy General Foods at 25% of sales.

Edwin Schloss: Exactly. It's unbelievable. I don't find the food group at all timely. We tend to be overweighted in the capital goods sector.

For the last two years, we've been pretty strong believers in the Rust Belt stocks.

OID: You're not making a prediction? It's just because they're cheap?

Edwin Schloss: That's right. In the numbers, they're not as cheap as they were but I think they've been through their recession already. Many of the companies in heavy industry are somewhat attractive.

OID: What about the S&L's?

Edwin Schloss: I'm not crazy about banks or S&L's. Some of the S&L's look cheap based on the numbers. But I feel more comfortable with a company that actually manufactures something.

OID: Why?

Edwin Schloss: I'm worried enough about the financial consequences of the deficit that I just can't get worked up about anything to do with the banking system.

There's either too much regulation or not enough.

OID: No OID interview is complete without a little bank-bashing. Don't banks take most of the risks without very much of the rewards?

Edwin Schloss: I feel that way. But some of the S&L's still look attractive on a fundamental basis.

OID: No question about it. What else is cheap?

Edwin Schloss: Defense stocks.

OID: Are they cheap enough to buy?

Edwin Schloss: I think so. But I'm not interested in the obvious ones. I'm interested in some of the secondary defense companies in electronics like Watkins-Johnson and Whitehall Corp.

I know there's going to be major cutbacks in defense and I've read over the last 6 months about the fraud and so forth. But I think there's good value there.

Sometimes, Dad and I can sit at the desk for the entire day discussing the theatre, current events and social trends.

OID: Don't let your limited partners see this.

Edwin Schloss: If you're not in touch with what's going on or you don't see what's going on around you, you can miss out on a lot of investment opportunities. So we try to be aware of everything around us — like John Templeton says in his book about being open to new ideas and new experiences.

OID: What has your average turnover been?

Edwin Schloss: About 25% per year.

Walter Schloss: That's about right. But it depends on the market. If you have a very good market, then your turnover will be higher because we're selling stocks after they've gone up. Conversely, in a very poor environment, our turnover would be much lower.

OID: Do you have any preference for small, medium or large companies?

Walter Schloss: No, we don't have any preference. If it's cheap, we like to buy it.

Edwin Schloss: Today, we prefer medium-sized companies by and large.

OID: Is that in today's market or generically?

Walter Schloss: It depends on the market.

OID: Are there any areas or industries or companies you avoid?

Walter Schloss: Tobacco. We will not buy tobacco.

OID: For ethical reasons?

Walter Schloss: That's right.

OID: Anything else?

Walter Schloss: We try to avoid foreign companies. They have different standards and different problems. And the SEC is definitely a plus.

The information standards in the U.S. are quite good relative to the rest of the world. In many of these countries, people do things which are illegal here.

OID: Are there any areas you tend to have a preference for other than whatever's cheap and out of favor at the time?

Walter Schloss: Cheap is good enough. I don't want to tell people what kind of companies we own. Why should we tell them that? We like cheap stocks.

Edwin Schloss: Loaded laggards.

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
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Walter Schloss: That go up.

OID: Beating a hasty retreat, how diversified are you?
Walter Schloss: We own roughly a hundred companies.

OID: In terms of the market right now, basically you've said it's kind of difficult to find things. Is that because asset stocks have been bid up?
Walter Schloss: We're not ready to play the takeover game. Therefore, we tend to be out of the big companies, which is where the takeovers generally are.

OID: How tough do you find this market relative to other markets you've seen?
Walter Schloss: I think it's a tougher market than other markets because of the efficiency factor.

OID: But you find it tougher than 1969, for example?
Walter Schloss: It's not as tough as September '87 — which was a tougher market. There really wasn't so much around. In fact, we even had some cash.

OID: What about relative to 1972-73?
Walter Schloss: You have to understand that each market has a dynamic of its own. In 1972 and 1973, you had the so-called Nifty Fifty — and they were going wild.

On the other hand, many stocks were doing very little. We didn't do very well in that period because we weren't in the Nifty Fifty. And the other stocks were lagging.

OID: As we noted in our initial back-of-the-envelope study, some of the best managers underperformed during that period. I guess if you didn't buy tulip bulbs during tulipmania, you'd have looked bad, too — at least for a while.
Walter Schloss: That's exactly right. When the market collapsed, we were barely hit — because we weren't in the Nifty Fifty. This is not that kind of a market exactly.
Edwin Schloss: The secondaries were massacred in 1973.
Walter Schloss: But not our secondaries.
Edwin Schloss: We did better than the averages, but it was still pretty rough. We just had one or two situations that held up very well. But basically, most people were creamed in the secondaries.
Walter Schloss: That's right. Morse Shoe went from $40 to $2 or something.

OID: The 1974 equivalent of Service Merchandise. I can only imagine what we would have owned during that period.
Edwin Schloss: We look back at those prices. And there just aren't the bargains today that there were then. It's clearly not a period of bargains today.
Walter Schloss: If the market's going wild and you want to be in it, you either have to lower your standards to stay in the game or you buy stuff which may not participate because it's not part of the game at that time. In that case, you can miss the market because you don't get in on the way up — because you were buying stocks which weren't popular.

When the market goes down, these things maybe don't go down as much. Again, that's what happened to us in 1973 and 1974.

OID: You've consistently excelled in down markets. Yet it sounds like you will adjust your standards to find the best available bargains if there aren't bargains meeting your normal standards.
Walter Schloss: That's about it. We lower our standards to fit the situation — so-called relative value.

OID: Would you pay full value for something or would you hold cash first?
Walter Schloss: Just because we think a stock is undervalued doesn't mean we're right. We may be wrong in our judgment.

But if we had to pay full value for a stock because it was the only thing we could find, we wouldn't be in it.

OID: So even you guys have certain standards?
Walter Schloss: Believe it or not.

OID: How do you decide when to sell? Do you tend to sell when you find a better bargain?
Walter Schloss: I don't think we switch. Theoretically, that would be the smartest thing to do — when you find something cheaper, sell A to buy B. Logically, we should — we should say if this company is cheaper than the other, just switch.

But it's very difficult to judge the relative values of companies in different fields. It's difficult to come up with a figure. Also, many stocks we buy take years to work out. They don't go up right away after you buy them.

A stock gradually works itself into a good position and you become familiar with it. If you sell it because its relative value isn't there, you have to sweat out the new one for three more years. There's a life cycle to these things.

So we don't like to switch out of A into B. If we want to sell A, we'll sell A. If we want to buy B, we'll buy B. But we won't sell A to buy B.

OID: If that's the case, what is the most common reason for selling something?
Walter Schloss: I guess because it's selling at a price we think is reasonable.

OID: At fair value?
Walter Schloss: That's right. And we're probably selling it too soon — because lots of fair value stocks go up a lot more.

OID: Soros' reflexivity theory — where they may sell for more than they're worth.
Walter Schloss: Usually what happens is that when a company's earnings are getting better, its value goes higher; and it's somewhat difficult for us to adjust to the new facts. If we buy a stock at $30 and believe it's worth $50, once it gets up to $50, we may believe it's really worth $60. But it's hard to adjust to the new circumstances. So there's a tendency to sell too soon.

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
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It's very difficult in today's markets to know what fair value is.

OID: Besides balance sheets, what else do you look at?

Walter Schloss: You've got to get a feel of a company — their history, background, ownership, what it's done, the business they're in, dividend payments, where earnings are headed. You've just got to get a general feel of a company.

But as I've said, you never know all about a stock until you own it.

OID: Do you ever get involved in risk arbitrage?

Walter Schloss: No.

OID: Have you ever sold short?

Walter Schloss: Yes, we did, but it was an unpleasant experience. We made money in it, but it was unpleasant. So we just made a rule of not doing it.

OID: Buffett says the mathematics are very unattractive. Another of our subscribers puts it another way. He says he hates to play any games in which he can lose an infinite amount of money.

Walter Schloss: The problem we have with it is the emotional reaction. There are people who short the market who do very well, but they're a different type of people. We're just not that kind of people.

OID: What have been some of the mistakes you've made?

Walter Schloss: The mistakes we've made are in a couple of areas. One mistake we've made is believing what somebody says they're going to do. The arbitrageurs now, as a matter of policy, will not buy a takeover stock until it's actually announced a takeover.

There's one I recall in which we did very badly. It was announced that Chicago Northwestern was going to buy Chicago Milwaukee — I've forgotten the terms. But it was a good deal higher than the market price. So we bought it.

The stock market fell down and the deal fell through. If you own a stock which is a takeover attempt, do you sell it once you've gotten a big profit or is it better to stay with it until the deal goes through?

It's a tough one. We've made mistakes. It's very difficult to know which way to go.

OID: It's clearly a percentage thing; you're going to be right some of the time and wrong some of the time no matter what you do.

Walter Schloss: That's right. And it all depends on the people who are in it. I suppose another mistake we've made — I don't think we've done it so much — is to be involved with a company where the guys who are in it didn't have very good reputations, but the stock was really cheap.

We've found that people with a poor reputation, on the whole, are out to take care of themselves, not stockholders. I think we would just as well stay away from companies where the management is not too reputable.

OID: Looking for shareholder-oriented managements.

Walter Schloss: That's right. Obviously, you can't protect yourselves from mistakes. But we try to get in with people we feel are honest. That doesn't mean they're necessarily smart — they may be dumb.

But in a choice between a smart guy with a bad reputation or a dumb guy, I think I'd go with the dumb guy who's honest. Of course, you can't always protect yourself there, either. I guess the mistakes we've made are probably in those areas.

Sometimes, we may also be a little too greedy. For example, we may sometimes get into securities where there's too much leverage. When leverage goes against you, it can be very dangerous. We try to stay away from those kind of situations.

Actually, Graham didn't do that as much. He was buying companies with very little debt. In those days, there weren't takeovers. They'd be cheap, but they weren't very good. Because they didn't have debt, they didn't get into a lot of trouble.

But most companies now have debt — partly so they won't be taken over. It isn't quite as easy as it would have been just buying a working capital stock with no debt. And when you buy a company that has some debt, things can get worse, they can borrow more money when business gets bad.

Steel companies would be a good example of what happens. When a terrible industry turns down, a huge amount of debt can lead to bankruptcies like LTV and others. The leverage can destroy the companies in a downturn — whereas if they had very little leverage, they would be more likely to survive it.

OID: Have you invested much in bankruptcies?

Walter Schloss: Not really. Penn Central was an exception. And, of course, we did quite well with it.

OID: Why haven't you done more?

Walter Schloss: I think the main reason is that we didn't know enough about them. If you're going to do a job on knowing enough about them, you really have to spend an inordinate amount of time at it.

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WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
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To do them intelligently, you really have to know a lot about it — which means you have to pore over the legal cases and the background of it and court rulings.

OID: Why don't you look at business quality more closely?

Walter Schloss: I don't think I'm capable of it.

OID: I find that hard to believe.

Walter Schloss: Warren understands businesses — I don't. Warren understands insurance businesses — I don't. And he understands banking and publishing companies.

We're buying in a way that we don't have to be too smart about the business....

OID: Because of the asset protection?

Walter Schloss: That's right. If you buy a great business, how much do you pay for it?

The reason Warren did so well with the newspapers is that he analyzed the values of the individual units. I don't know how much he knew about the newspaper business, but he knew at what price each of a company's holding could be sold. I don't think I would be really good at that.

Also, Edwin and I like the idea of having a little action. That may not be good from a logical point of view, but it's good from an emotional point of view.

If we owned the same 5 companies for the next 10 years because we believed in the businesses and all we did was to sit here and look at each other, it would be no fun. It may be a profitable way of investing, but you have to have some fun in what you do.

If you're going to be on a baseball team and you're sitting on the sidelines watching, that's not good enough. You have to enjoy what you're doing. I really feel that Edwin and I like the idea of having a little competiton out there. By buying stocks, you're competing with the market in effect and you're doing something.

OID: With your feverish pace of turning over your stocks at the torrid rate of once every four years.

Walter Schloss: That's right, but we have a lot of stocks. If we only had 4 or 5 and we only bought and sold one stock a year — while it may be great for some people, I wouldn't like it. I like a little action in what we do. We like to have a little fun.

OID: Speaking of fun, what's the story behind the picture of Babe Ruth on your wall.

Walter Schloss: I always liked Babe Ruth and I saw him hit home runs back in 1927. And Edwin's brother-in-law knew that I liked him. So when he met somebody on a plane who had taken the original pictures of the Babe, he made a copy and gave it to me.

But the thing about baseball is that most people who played baseball originally back in those days didn't do it for money. They did it because they loved baseball. If they had wanted money, they would have done better in some other field. It was fun.

Today, I suppose it's a business. But it wasn't back in those days — it was a sport. And I think investing should be fun. Of course, it's much more than fun. It's also a business.

The other satisfaction I have is that the partners that I have, at least most of them, are not that wealthy, so I can give them some money. If you buy five stocks and you distribute very little to them, theoretically they can trade in their units. But most people don't do that. They want to get a return.

Back in the '70s or late '60s, Yale and a lot of other colleges tried buying growth stocks and selling off a certain percentage each year — Harvard didn't do the same thing. It didn't make any sense to Paul Cabot, their investment manager.

But many people fell for it. Many college endowment funds suffered. The Ford Foundation lost 1/3 of their capital. Why? Because they bought growth stocks which paid very little in the way of dividends. They were supposed to get it back in increased appreciation, but it didn't work that way.

And most people like to get the cash. Some get it and use it for living. Then you have a lot of stocks, and you buy things that are not growth oriented, which are undervalued and you tend to sell them when they work out and you move into something else. It gives you some realized gains and it creates a certain amount of pressure on us to get something else.

OID: And have some more fun.

Walter Schloss: I think you have to invest in a way that's comfortable for you.

We like to own stocks. It's very exciting.

If I retired, I doubt very much if anybody would call me because they couldn't sell me anything. I'd kind of disappear into the woodwork.

I think people in business are friends of people who are in business. And when they leave or retire or disappear, nobody's going to look them up and say, "Come on over. We've got some things to buy."

There's a kind of a comeraderie about people in business.

Some people may prefer to retire to Florida. I'm sure many people enjoy life there, going out to restaurants and playing tennis and golf. But I'm not willing to do that.

OID: And we hope you never will. Thank you again, Messrs. Schloss.

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