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DIGEST
14 East 4th Street, Suite 501
New York, NY 10012
(212) 777-3330

Outstanding Investor Digest

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

Volume V Number 7 September 27, 1990

Investors featured in this Issue:

Other Investors in this Issue:

Companies & Investments in this Issue:

TIGER MANAGEMENT'S JULIAN H. ROBERTSON, JR.
"MORE CONSERVATIVELY INVESTED THAN EVER BEFORE. EXCEPT WE DO OWN A FEW FINANCIAL GEMS."

Under the direction of founder and general partner Julian Robertson, Tiger Fund has compounded its equity capital at approximately 40% per year since its inception on May 5th, 1980 through year end 1989. Even after fees to the general partner, Tiger limited partners have enjoyed returns in excess of 30% per year.

For the first three quarters of 1990, a period in which the S&P 500 was down 6.22%, Tiger was up a strong 18.5%.

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AN OID INTERVIEW WITH ENGEMANN & ASSOCIATES' ROGER ENGEMANN ET AL.
"I FEEL LIKE A ONE-EYED CAT IN A FISH STORE. EVERYWHERE I LOOK, THINGS LOOK GOOD."

Growth stock manager Roger Engemann & Associates has earned a compound annual return of 19.8% per year after all fees and expenses on its unrestricted accounts for the 19 years ended December 31, 1990 vs. 12.0% per year for the S&P 500. Performance figures were provided by Roger Engemann & Associates.

Roger Engemann's unbridled optimism and unique brand of out-of-favor growth stocks make him stand out like ... well — like an optimistic money manager.

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GINTEL EQUITY MGM'T'S BOB GINTEL, ED CARROLL ET AL. REGIONAL SHAREHOLDER BRIEFING & OID INTERVIEW
"WE PREDICTED RAIN IN 1987, TOO. ONLY THIS TIME, WE BUILT THE ARK."

Investors who joined Robert Gintel's limited partnership, R.M. Gintel Investors (March 31, 1967) and stayed with its successor, Gintel Fund, have seen their equity compound at the rate of 16.4% per year after all fees and expenses vs. 10.5% per year for the S&P 500.

One Gintel client investing $1,800 in September 1960 saw his equity grow at the eye-popping rate of 24.6% per year

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CURMUDGEON ROBERT NOEL — UPDATE & CRISIS REPORT
"NOTHING LIKE A GOOD OLD-FASHIONED PANIC TO CREAT A COLOSSAL BUYING OPPORTUNITY."

Robert Noel is an independently wealthy private investor with more than a little in common with Super Investor Warren Buffett (a comparison which Noel would contend he doesn't merit). Noel has demonstrated a remarkable ability to differentiate between panics that are warranted and those that aren't — or as he puts it, "when to look the other way and when not to" — and to profit very nicely therefrom.

For example, among the numerous perceived disasters

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PASADENA GROWTH FUND'S
ROGER ENGEMANN ET AL
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The last time we spoke with Engemann was in January of 1988, with our knees still shaking from October 1987. The Dow Jones Industrial Average was slightly over 2,200.

In an *OID* interview in our issue of January 27, 1988, Engemann told us, "I think the economy's slowing down. We'll have lower interest rates and a cap on inflation as a result. And the stock market will take off. A year from now, the market will be 30% higher than it is now."

By early January 1989, the Dow had, believe it or not, advanced by almost exactly 30%.

Following Saddam Hussein's invasion of Kuwait, Engemann has been equally optimistic, if not more so. As we reported last issue, in his August 8th letter to clients, Engemann wrote:

"BUY NOW! It wasn't only the Kuwaitis that got shot last week. Some of the most established high quality companies in America also took a few rounds."

"...Once every 3-5 years, serious long-term investors get an opportunity to attend a common stock fire sale. We strongly believe this is one of those opportunities.... This is an opportunity for wise investors to buy now."

With optimists as rare today as they were following the '87 Crash and in light of his remarkably accurate forecast at that time, we thought the time was right to learn more about Engemann's thoughts today. The following excerpts were selected from several recent conversations with Engemann and senior analysts Jim Mair and John Tilson:

OID: Does your recent letter mean you're optimistic?

Engemann: Absolutely. But how'd you know?

OID: Just a lucky guess. But didn't you hear that you're supposed to be selling — like everybody else?

Engemann: I must have missed the announcement. In fact, the day we wrote that piece, I invested a bunch in our Pasadena Growth Fund personally. And I put more money in the Pasadena Growth Fund today.

So far, we've lost our shirts. But we've done that before — and I know we'll get it back.

OID: At least you own your shirts. But it sounds like you eat your own cooking.

Engemann: Yes. Our whole corporate pension fund and most of my personal savings are in there. Almost all of my relatives and employees have money in there. And my wife's money is all in there. And my ex-wife's money, too.

OID: Send us an account application right away.

Engemann: We've always felt it was the moral way to go — to put your money where your clients' money is.

OID: At the same price no less. You mentioned Pasadena Growth Fund earlier. What's the difference between it and Fundamental Value Fund?

Engemann: The Fundamental Value Fund was designed for retired people. A retired person by instinct wants to go from stocks to bonds but it's definitely the wrong thing for him to do because he still needs growth. Retired people often live another 20 or 30 years. That's a long time to be drawing down savings.

For that reason, we set out to create a fund that was more stable than the stock market, but that would still grow a lot. The Fundamental Value Fund is about 70% stock and 30% bonds. Although I generally don't like bonds, we put them in there to cushion things a little bit.

That fund, however, has actually done incredibly well since inception. It's appreciated at a compound annual rate of 20% since it was established in June of 1987.

OID: But the reason your super-bullish quote caught our attention — besides the fact that it stood out like a stand-up comic at a funeral — is the fact that you displayed impeccable timing in 1987. As we recall, in early 1987 you were still very bullish. But very shortly before the crash, on October 8th, 1987, you raised lots of cash for one of the very few times in your career.

Engemann: The third time in 21 years.

OID: And within two weeks of the crash, while we were still quivering like jello, you jumped right back in.

Engemann: We bought as soon as it dropped.

OID: Were you as smart this time?

Engemann: Unfortunately not. We didn't raise any cash this time. It kind of worked the three times we've done it. But I felt like I was gambling by being out of the market.

As I get older, I get less interested in market timing. Our job is to keep people on the ship long-term — on the old gravy train. The only time I want to get out is when our stocks are just clearly ridiculously expensive.

That was the case in 1987. In the October 8th, 1987 memo you mentioned, we pointed out that P/E ratios were higher than they'd ever been except for one other occasion. That was extraordinarily expensive. Portfolio insurance was the "in" word that year. And it caused institutions to do ridiculous things.

OID: We didn't realize institutions needed a reason to do ridiculous things.

Engemann: Good point. This year, our stocks never got that expensive. The Dow got to 14 times earnings at the peak. But that was somewhat misleading because earnings were somewhat depressed, whereas they were somewhat inflated in 1987. So stocks were only about two-thirds as expensive as they were in 1987.

And our growth stocks, which sold for 30 or 40 times earnings at their peak in 1987, only sold for 21 or 22 times current earnings at their peak this time. And if you look at next year's earnings — which is the way we do it, the P/E about a month ago was about 15 times next year's earnings. And now the P/E on our growth stocks is around 11-1/2.

OID: For companies growing how fast?

Engemann: We figure our companies' average rate of growth is about 22% right now.

OID: So their growth rate was 1-1/2 times their P/E ratios and now it's nearly double. I understand that relationship tends to lead to good things more often than not.

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PASADENA GROWTH FUND'S
ROGER ENGEMANN ET AL
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Engemann: Absolutely. Especially if you can have any confidence in your estimates. And the figures I'm quoting you are only for our highest quality stocks.

OID: Not your patented "flying fur".
Engemann: No "flying fur". We're talking about the "Nifty Fifty" of today.

OID: That certainly inspires confidence. But you mean "Nifty Fifty" quality without the "Nifty Fifty" price.
Engemann: Exactly. The highest quality companies, starting with Boeing and going through Wal-Mart — Philip Morris, Eli Lilly, Walt Disney, etc. I mean real, real quality. In fact, their average return on equity is 26% and we think their five-year earnings growth rate will be 22%.

They didn't get anything near as expensive this time as they have in the past. People just haven't paid attention to growth stocks since 1983. And I believe that they've just forgotten how to value growth stocks.

OID: Forgotten?
Engemann: Absolutely. Everything since 1983 has been about valuing buyout candidates — which is completely different. When you value buyout candidates, you look for crummy companies selling below book value. And you try to figure out what would be left if you borrow as much as possible, cut up all the pieces...

OID: And get rid of management.
Engemann: Exactly. Yechh-type investments. Those companies usually deserve to sell for less than book value.

OID: But they were finance-able.
Engemann: "Were" is right. They're not now.

But our companies are exactly the opposite. They don't generally sell for less than book value. They're special companies. And I think they'll be the super companies of the next few years — partially because people have forgotten how to value them.

It sounds kind of trite, but you have to look ahead — because if you look current, they'll always look too expensive. For example, Wal-Mart may be selling for 24 times current earnings. But when you use next year's earnings, it's only 19 times. That's how you have to look at growth stocks.

OID: But even if you accept that 19 times is cheap, isn't it dangerous to look at next year's earnings?
Engemann: It is. But there just isn't any other way to buy growth stocks. Again, however, there is one really important caveat — you have to have confidence that the earnings will really be there.

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If you asked me what General Motors or Dow Chemical would earn next year, I wouldn't have a clue. They could lose their shirts or do great. But if you asked me about Wal-Mart, Circus Circus, Walt Disney, Dreyfus or Eli Lilly, I believe my estimate would be worth listening to. Those companies control their destinies and they're almost certain to grow in almost any economic environment. And that's very important.

To make it as simple as you can get, if your company comes through for you earnings-wise, your stock will do fine — regardless of the stock market. And if your company doesn't come through for you, you'll do crummy — again regardless of the stock market.

OID: Just what Peter Lynch says.
Engemann: Growth stock investors today are sort of like a one-eyed cat in a fish store.

OID: Sounds like an Engemann original. But what does it mean?
Engemann: Haven't you heard the old rock and roll song: Imagine a one-eyed cat in a fish store — he has to move his head all over the place because he only has one eye. And everywhere he looks, things are good.

OID: And that's the way you feel right now?
Engemann: Yes. It's 1987 all over again. Only I feel like it's even better for us today than it was then because our segment is more attractive today.

We calculate that the Dow is selling for about 12 times current earnings vs. about 16 times current earnings for our large growth companies. Relative to next year's earnings, we calculate the Dow's P/E at 9 times vs. 11-1/2 times for our growth stocks.

And for all of the reasons I've mentioned, we believe that our stocks are worth a hell of a lot more than the Dow. Actually, it seems that a lot of our companies have managed to sneak into the Dow Jones Average — like Philip Morris, Boeing, Coca-Cola, Merck. Most of the Dow companies are growing quite a bit slower than these.

People had finally begun to gravitate toward growth stocks before the crash in 1987 and again before the recent decline. So I think they'll come back like crazy. The reason they'll do that is because the earnings are growing when the other earnings aren't growing or are unpredictable.

Also, it was such a stunner in 1987. People couldn't comprehend that it could happen. Now they've seen it happen. And stocks went up again. They've seen a few other hundred point drops, too. My feeling is that this time people won't be stunned for so long.

OID: But what about the fear that it's a different ballgame today for a whole long list of reasons and that we're either in or about to enter a recession?
Engemann: As I mentioned in my letter of August 6th, it's just a myth that recessions are bad for stocks — a widely held myth, but a myth nonetheless.

People are not looking ahead. When they get scared, they can only see about three inches in front of their noses. And they start making stupid remarks about deficits or debt or shooting or oil prices or something else weird.

They do that instead of paying attention to what's really going on — which is that Wal-Mart was $36 and now it's $25.

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OID: In other words, if everybody seems to be thinking that way, they're very likely to be wrong.

Engemann: Exactly. And like I said in my letter of August 6th, since 1945 there have been 13 years in which the S&P's earnings went down. Only half of those were recessions by the way. But in those 13 years, the stock market was only down in one of them.

OID: Talk about the reverse of conventional wisdom.

Engemann: The only down year was 1957. In all of the other years, the stock market was up a lot. In fact, the average rate of return was 22% in those 12 up years.

OID: And the one year that was down wasn't down much, as we recall.

Engemann: That's right. It was only down 10% or so.

OID: So supply and demand for money drive the market in the short run more than corporate profits.

Engemann: Absolutely. In the short run, the market is dominated by interest rates. If there's a major change in interest rates, it'll swamp any change in earnings. In the long run, it's dominated entirely by earnings. The stock market and the economy are highly related, only not in the way that people think.

But stock prices are so much more important to me today than they used to be. When I started out twenty years ago, P/E ratios were so outrageously high all the time that timing the market was probably important. Today, stocks are so cheap that I don't think it's really worth thinking about timing unless they really get out of line.

OID: What is worth thinking about?

Engemann: We believe that stocks are not pieces of paper, but partial interests in companies. That has not been a very popular viewpoint for the last 7 years.

Second, we have a total belief in the importance of earnings and earnings growth. And we strongly believe in the importance of going to visit companies.

In fact, what we do is very similar to what Peter Lynch describes in his book, *One Up On Wall Street*, if you omit the comments about turnarounds. We believe in not trying to time the market and focusing on companies and getting to know their operations as well as you can.

And we do it with very experienced guys. A lot of people, if they ever send anybody to visit companies, send younger less experienced analysts. That's a crock of manure.

OID: You don't have to mince words with us.

Engemann: Peter Lynch personally goes out and visits those companies along with their other people. We also send our best people out to visit them.

We don't send out junior analysts to visit companies and come in and explain it to the senior analysts who then explain it to the portfolio manager.

Our best analysts go out and visit the company and decide if we're going to buy it or not, and they tell the portfolio manager who works for them what we're doing. John Tilson and Jim Mair each have about 25 years of experience. And they're very bright people. They're the ones we send out to visit companies.

So if there's a big difference between us and most growth managers, I'd guess that's it.

OID: And unlike many other growth managers, an earnings disappointment in a single quarter won't cause you to sell a stock, will it?

Engemann: Absolutely right. And that's where good analysts come in. How important is the down quarter? What's the reason for it? What do you think will happen in the future?

Lots of times, we'll make mistakes, of course. But that's where an analyst really earns his money. To do it mechanically and just sell automatically because of a down quarter is crazy.

For example, Merck recently announced that they were going to have a slow period. Their stock dropped a lot. And then, when you read why it was going to be slow, you saw it was because they were doubling their sales force.

But that's clearly a controllable expense. And I don't think they'd hire the salesmen unless they expected them to be productive. So it's crazy that the stock market would be down on Merck for that.

OID: For which you're no doubt grateful.

Engemann: Yeah, sure. It gave us a terrific opportunity to buy Merck cheaper — which we did. It's a beauty. I'd jump on it with two feet right now.

OID: Please don't hedge.

Engemann: Merck is down from $90 to $73. Our estimate for next year is $5.35. For 14 times next year's earnings, you can buy one of the most awesome companies in the world. It's just an incredible investment. I think they spend $900 million annually on research. They're very diversified.

They're incredibly profitable. They deserve a high multiple, if not the highest in the business.

OID: And Value Line shows them earning 40% on capital. That's not too shabby.

Engemann: And notice that their debt has been going down quite a bit the last few years. Surely, people aren't going to decide to get sick or not based on the economy. And these guys have 10 or 15 major drugs that produce $100 million or more. What a great company.

OID: And they're buying back shares, too.

Engemann: Which, of course, makes sense when their stock is so cheap.

OID: Could we trouble you to tell us about some other cheap stocks?

Engemann: Sure. My only problem is to decide which ones are especially striking. It's almost hard to choose. But you have to make room for Carnival Cruise. We've owned it a long time. It's one of our larger holdings. It's a super cash flow company.

And its stock has just been decimated recently. It's $13-3/8 today, which is 9-1/2 times current earnings and 6-1/2 times next year's earnings which we estimate at $2.05. And we expect earnings growth of 20% per year over the next 5 years.

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OID: Value Line seems to agree. They're projecting 25% earnings growth. Either way, the projected earnings growth rate is roughly double this year's P/E multiple and roughly triple next year's.

Why so cheap?

Engemann: People just assume that if the price of oil goes up, people will stop taking cruises. But that's not true.

OID: Are there any valid fears here?

Engemann: I'm just guessing. But a lot of people have factored in the impact of an imminent recession. Maybe they'll be right and maybe they won't. I don't believe in trying to forecast the economy that much.

A friend of mine sent me a letter from renowned economist Milton Friedman yesterday. Somebody asked him if the Fed had been too tight for too long and whether that meant that we were therefore going to have a recession.

Friedman said, "They've probably been a little too tight. But economists have a terrible record of forecasting the economy. So I don't know."

OID: But stock market participants are smarter. And that's why Carnival Cruise is so cheap.

Engemann: Exactly. They're factoring in all of the worst fears of huge oil price increases, long gas lines and a deep recession — all muddled up into one big black cloud. And that's what I think is hanging over the entire market right now.

OID: Suppose that there is a recession, would the fears for this company be well founded?

Engemann: I don't think so. I believe that people would still go on cruises. And Carnival Cruise has short cruises for the average person that don't cost too much.

But again, the main impact of a recession would be to bring interest rates down. And I think all stocks would do well — even if earnings were temporarily not all that great. So even if Carnival's earnings were impacted, I think the stock would still go up.

And the earnings impact of a recession varies widely even within a single industry. Within the casino industry, Circus Circus tends to be affected very little, whereas New Jersey casinos stand to be affected a lot more.

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Also, management matters tremendously. And Circus Circus is just an incredible buy today.

OID: We're all ears.

Engemann: Circus Circus is selling for $43-1/2. They earned $2.60 the fiscal year ended January and we estimate $3.20 for next fiscal year. But the important thing is that for calender year 1991, they'll probably earn $4.25.

OID: If your estimates are correct, you're talking a mere 10 times next year's earnings. But why do you expect such rapid earnings growth?

Engemann: The major reason for the earnings gain is that they just built the Excalibur Hotel.

And for 10 times next year's earnings, you're getting one of the best managed companies in America in any business. Circus Circus is a phenomenal company.

I believe they've bought back nearly a third of their shares in the last couple of years.

OID: Value Line shows that they've reduced shares outstanding from about 38 million to 27-odd million.

Engemann: Isn't that something? And they've built the Excalibur Hotel, which is the world's largest hotel with 4,000 rooms, at the same time. It's packed every day.

OID: Sounds too good to be true. Why is it so cheap?

Engemann: Circus Circus is a terrific company with great free cash flow and all of that. But because most gambling companies are not doing well — especially the ones in New Jersey — Circus Circus' stock has dropped from $70 to $43-1/2. And what's funny is that one of the reasons why the other casinos have done so poorly is that they've had business taken away by Circus Circus.

The net result is a fabulous opportunity to buy a really well managed quality company at a very cheap price.

OID: What about management impresses you so much?

Engemann: I like the fact, of course, that they own so much stock. And everything was done from an owner's point of view — and still is.

OID: How refreshing.

Engemann: They plan and execute extremely well. And they have vision. For example, they went into Laughlin — a little town in Nevada which nobody had ever heard of. Laughlin has since become a booming gambling arena. And they've gone into Reno. And each place they go, they just continually expand their rooms and expand their casinos.

They really cater to the family and to the blue collar worker.* For example, they have entertainment for children — which has really exploded at the Excalibur. They'll soon have an RV [recreational vehicle] park where customers can park for up to three days.

And they are such great planners. The Excalibur is a classic example. One of their competitors, Golden Nugget, built the Mirage. The Mirage Hotel has a little less than 3,000 rooms and cost well over $600 million to build. The Excalibur has 4,000 rooms, but cost under $300 million. So their nut to cover is so much less. And they'll charge $45 a night for a room instead of $80 to $100 at the Mirage. That leaves people more money to spend on entertainment which translates into higher slot machine profits.

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OID: A powerful combination.

Engemann: Yes, it is. Everybody feels like they're getting good entertainment value. Our analysts went to see Excalibur last week, in fact.

OID: Few casinos in Value Line have grown as rapidly. And none have grown as rapidly and remained so profitable. Performance-wise, they look like the class of the industry.

Engemann: I'd say so. And they have approximately $150 million a year in excess cash flow. That cash flow will allow them to buy lots of their own shares.

OID: With insider ownership at 29%, it doesn't sound like you have to worry about management not being shareholder oriented or losing interest.

Engemann: That's right. They have two people — Pennington and Bennett — who started the company. They used to own most of it.

Over the past few years, Pennington in particular sold shares — which are a big chunk of the shares that have been bought by the company. It's a nice source of shares for the company to buy. In fact, I wouldn't be shocked if Circus Circus bought a bunch more right now.

OID: Does the fact that management is such a big seller suggest that they might know something that you don't?

Engemann: I don't think so. Pennington and Bennett were entrepreneurs, builders and homebuilders who got together, bought Circus and made a monumental success out of it. My feeling is that Pennington is retiring and putting money into bonds.

OID: You're not concerned about how well the company will be managed in their absence?

Engemann: Not at all. They put younger guys in charge quite a number of years ago. They're just the overseers. They make the big strategic decisions — like making Excalibur 4,000 rooms instead of 2,000. And the younger managers have a stake in the company as well.

OID: Another widely held concern — how much would their business be hurt in a recession?

Engemann: I just don't know. I do know, however, that Circus Circus has had to turn away customers like crazy all the time for years — good times and bad. And there are other hotels and casinos that are running well below industry averages all the time — good times or bad.

And their Excalibur is a major destination resort. So people should be going there first for the next year or two if they go anywhere at all — just to see what it's all about.

OID: In a nutshell, then, you have a superior company with $6 per share of free cash flow selling for roughly 10 times next year's earnings with very high returns on capital, buying its shares back.

Engemann: That's right. We've made so much money in Circus Circus. We started buying it in 1984 for $6 or $7. And we just keep buying it.

OID: Ron Baron's also buying casino stocks. Would it be correct to say you believe they're cheap generally?

Engemann: Oh, yes. They are now. But historically, they have tended to be more volatile than the market. And they've been that way recently, too.

OID: Circus Circus and Carnival Cruise sound great. Are you finding any more like those?

Engemann: We like Walt Disney a lot.

OID: Isn't it still pricy?

Engemann: We don't think so. At $89, it's selling for 15 times current earnings and 12 times next year's earnings — which we estimate at $7.50. On a calendar year basis, we expect them to earn $7.90. We think it's pretty cheap.

OID: Why is 12 times next year's earnings cheap — aside from Disney's fantastic management and their unique franchise?

Engemann: Disney does have a unique franchise and highly talented management. But they have a great deal more. They have a great balance sheet. They have the prospects for very fast growth.

In addition, they have extremely controllable earnings. They can beef up earnings any time they want. They can sell land. They can bring out more of their old movies. They made a deal with one of the premium cable channels where they made a huge amount of money just for allowing the service to show Disney's movies first. All that stuff is very profitable for them.

OID: Very high margins.

Engemann: Exactly. Walt Disney World is awesome. The neat thing is that old people go.

And Euro-Disney is coming on in France in 1992. Disney coins money out of that business. There's little or no money required up front. They should have a big boost in earnings coming onstream in two or three years. There's a lot to like.

OID: But is it a bargain?

Engemann: We feel that the bottom multiple for Disney is 12. That's how low it gets. So we have virtually no downside from here. It should sell for 25 times current earnings.

That 25 times earnings, incidentally, is what it's sold for the last few years. So it's not a pie-in-the-sky figure. Anything that's growing that fast and has earnings that controllable deserves a pretty good multiple.

Right now, it's selling for 15 times current earnings. It's almost a classic growth stock. We're super hot on it.

OID: With Eisner at the helm and their name recognition, they've got to be the class act of the entertainment industry.

Engemann: Exactly. It's awesome what they can do. And 12 times next year's earnings seems dirt cheap to us. In fact, if it went to what we think it's worth in the next year and a half, it would go up 115%.

You have to think ahead. In a bear market, everybody

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thinks about 3 inches in front of their noses. But next year is only a few months away. Once things start clearing up, people will think, "Hey, maybe we're not headed down the tubes. By the way, what's Disney going to earn this year. Almost $8? You're kidding me. Oh, I can't believe it."

And away the stock will go. At 25 times earnings, Disney will be around $200. That's it in a nutshell.

OID: I see that Disney's earnings haven't exactly been savaged in past recessions.

Engemann: That's right. And it's such a different company today than it was then. They have tremendous control over their earnings today. I went to Disneyland Monday and lines were an hour long. And it's cheaper than going overseas.

My son, for example, couldn't care less what's happening in the economy or the stock market. He just wants to go to Disneyland.

OID: Excellent point. I see you also own Price Company — which is one of Wal-Mart's competitors. As I recall, at your client conference this year, you quoted Sam Walton as saying that Price Company was better managed than his own stores.

Engemann: I asked Sam that question about Sam's [Wal-Mart's discount warehouse operation] when the two of us were alone. Sam's are doing between $50 and $75 million per year per store. And Price Clubs do between $150 and $200 million a year per store. I asked Sam, "Why is that? Why is there such a big difference in the volume?"

He said, "Two things. Number one, ours are in somewhat smaller towns. But number two, theirs are better managed. We really haven't focused on Sam's yet. We've been spending all of our time and energy on Wal-Mart so far. Right now, we're about to start putting more emphasis and attention on our Sam's and do better in those stores."

OID: What a compliment. And Portfolio Reports estimates that Price Company was Pasadena Growth Fund's 2nd largest holding and your largest purchase last quarter.

Engemann: Price Company has a bad reputation on Wall Street.

OID: So far, so good.

Engemann: Right. That was because everybody had these grandiose ideas as to how fast they would grow. And they did grow very fast for a long time. But over the last couple of years, they have continually disappointed people with respect to how many new stores they're putting in.

So with the stock way down, we went to see the company to see how things were going. The visit was extremely informative. Management believes that the disappointments are behind them and that they would be growing much faster from here on. And we're now talking about stores where Price Company has already signed the leases — not just based on hopes or plans.

Price Company management has had some personal problems over the last couple of years. But it looks to us like the very moment Wall Street is most down on them, they're getting their act together and have the resolve and the plan to grow faster. So we bought a ton of it.

OID: What's the current price?

Engemann: Price Company is selling for around $28. We estimate earnings of $2.45 this fiscal year — ended August — and $2.90 for next fiscal year. In fact, our calendar year estimates for next year are $3.10, which is only 9 times next year's earnings.

OID: That sounds mighty cheap for a company that's as well managed and as rapidly growing as Price.

Engemann: It really is. Price Company is one of our cheapest stocks for sure. Wal-Mart is more expensive because no one has any questions about it. But Price is in the doghouse. So we expect their stock to do better than Wal-Mart's over the next year or two.

OID: Makes sense to us. For the longer term, how do Price and Wal-Mart stack up competitively?

Engemann: Price Company does not have the depth of management that Wal-Mart does. They're not as smooth as Wal-Mart. But still, they've done a real good job.

OID: I'll say. Even with the disappointments of the last few years, Price's revenue has grown by more than 38% per year over the last 5 years. And their inventory turnover is nearly 20 times and growing.

Engemann: That's right. Even though they haven't had as many new store openings as they would have liked, their old stores are just doing terrific. There's never been any question about those stores.

OID: How do they manage such incredible inventory turnover? Price is averaging nearly 20 inventory turns. Even Wal-Mart is only averaging 6.

Engemann: To be fair, you're comparing apples and oranges. Wal-Mart's warehouse operation, Sam's, is probably averaging turnover that's pretty darned high, too. It has to be since their gross margin is only 9%. So you have to get a lot of turnover to make any money. That's the whole idea behind those stores.

If you ever go to one of those stores, everything seems unbelievably cheap — not just a good deal, but incredible. They carry a lot fewer items than a Wal-Mart or a K-Mart — in fact, a tenth as many. But their store is a lot bigger and they stock a lot of each item.

And they only put an item in their store if it's a real good deal — a real good deal. And then they mark it up 9% on average.

OID: Wow.

Engemann: And they don't mark up cigarettes and stuff like that at all. They sell it to you at cost.

OID: As a traffic generator?

Engemann: There's two things there. First, it does generate traffic because nobody can buy cigarettes cheaper. So grocery stores, liquor stores, mom and pop stores will all go to Price Club for their cigarettes. When they're there, they'll see all these other things they can buy, too, probably cheaper than they can buy ordinarily.

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But truthfully, Price Club makes a lot of money on cigarettes. The way they do it is by charging their customers right away and paying for them 30 days later.

OID: Fascinating. Does Price face a competitive risk once Wal-Mart begins to focus its attention on the warehouse sector?

Engemann: Sure. But their location on the west coast, where Wal-Mart is just now opening its first Wal-Mart store and where they have yet to open any Sam's means they won't face it right away. And again, Sam [Walton], himself, feels that Price Club is by far the best performer in that area. So if I know him, it won't be the first area where he opens stores.

OID: You know both companies and both managements very well. You've even been quail hunting with Walton on several occasions. What's your sense of what's likely to happen down the road?

Engemann: Wal-Mart will just keep putting on its hubs. It's put a distribution center in Porterville near Bakersfield. And they'll saturate California within 400 miles of that distribution center. And he's starting in towns like Lancaster — which, by the way, is where I was raised.

OID: Small town boy makes good.

Engemann: Thanks. A tiny town of 10-20,000 people — just like he would do in Arkansas. And he'll open stores in all the little towns and dominate them very quickly. We have them all over California just like the rest of the country. So he'll go there first and get a very solid base. And then he'll start bringing in the Sam's stores — probably not too far behind. He wants all of his stores close enough to his distribution centers so that he can stock them overnight — because they never, never want to have their shelves empty of anything.

And he'll do the same thing in Washington and Oregon and the Northeast.

OID: What will happen when Price and Sam's go up head to head? Will Wal-Mart avoid it? And, if not, what's the likely outcome?

Engemann: The likely outcome is that Sam will win because Sam always wins. They asked that same thing about K-Mart 15 years ago. People were saying, "Jiminy Christmas, when he goes against K-Mart, it's going to be all over." And by the time he did, it was all over — for K-Mart.

It's neat, too, because Sam will build so many stores so fast. I don't know how many stores Price Club is bringing on next year off the top of my head. Let's say it's 10. Well, Sam's could build 20 easily. And he'll just start scooting right by you. In the long run, Sam will get his costs down lower than Price Club, probably — just because if anybody can do it, he can.

OID: Do you have any estimates for five-year growth rates for revenues and earnings?

Engemann: We're using 20% for Price Club and 25% for Wal-Mart.

OID: If you're right, Price Company's growth rate is double its P/E multiple on next year's earnings.

Engemann: That relationship is what we call our Value Ratio. And, for Price Company, it's a whopping 2.2. We think that's a pretty good deal.

OID: Agreed. We noticed that you bought a few more shares of Berkshire Hathaway.

Engemann: Yes, we keep buying it whenever it's cheap enough. At $5,800 or so, we figure you're not paying any premium for Warren Buffett. So we keep adding to it.

OID: An appraisal that's consistent with what we hear from others and with our own assessment.

Engemann: Pasadena Growth Fund will be volatile as is any growth fund. So we believe Berkshire Hathaway provides us with a little anchor to reduce the volatility.

OID: And you know Buffett will do the right things under almost any circumstances.

Engemann: He'll make a lot of money for us. There's no doubt about it.

PORTFOLIO REPORTS estimates the following were Engemann & Associates' largest equity purchases during the period of 8/1/90 through 9/11/90:

1. RHONE
2. PEPSICO
3. GILETTE
4. CIRCUS CIRCUS
5. REUTERS
6. MCI COMMUNICATIONS
7. PRICE CO
8. HOME DEPOT
9. WALT DISNEY
10. CARNIVAL CRUISE

OID: Portfolio Reports estimates that you also bought some Cap Cities last quarter.

Engemann: Cap Cities is one of our largest holdings. The reason I don't mention it as a spectacular bargain — even though it's dropped 200 points — is because their growth is slow right now.

I think it probably is a great bargain. In fact, it's selling for only 11-1/2 times our estimate for next year.

OID: Is it really?

Engemann: We estimate that Cap Cities will earn $39 in 1991. And it's selling today for $451.

OID: Interesting. During the first quarter of 1990, Cap Cities reported buying back 877,200 shares at an average cost of $469.

Engemann: I hope they are. It's a very good idea.

The reason the stock is down there is more than just the stock market. They've announced that over the next few quarters, their growth is going to be slow.

And it's funny, everybody is kind of waiting for their network to be better. And it's been the stations that have been carrying them. Now the stations are faltering and the

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network is doing OK.

We certainly own a ton of it and we're adding to it. I don't know if it's a screaming buy right now or not — it depends on when their growth gets back on track.

OID: It doesn't sound like you're taking too much risk in Cap Cities at 11-1/2 times next year's earnings.

Engemann: Oh yeah. At 14 times current earnings, you're darned right. The risk, I think, is zilch. In fact, I'm convinced we'll make a ton of money.

But personally, if I was going to buy something in here, I'd rather buy something where I know the earnings are intact over the next few quarters at least — as well as the longer term, because those will snap back the most. You can always back and fill with Cap Cities. It isn't like we don't already own enough of it. It's 4% of our assets.

OID: According to Portfolio Reports, you were also a recent buyer of Dreyfus.

Engemann: Dreyfus, I think, is a screaming buy. It's dropped from \$38 to \$26. They have a super monopoly going for them, \$700 million in cash and one heck of an operation.

They dominate their business. The Dreyfus lion, their logo, is one of the most recognized logos anywhere. If anyone tries to start a money market mutual fund to compete with Dreyfus, it's a joke.

Dreyfus is king — Dreyfus and Fidelity. They have a real lock on the business. They're not a perfect monopoly, of course. But they are the big names.

Critics say, "Well yeah, but Dreyfus is mostly in fixed-income stuff." But that's been smart really, because that's what's been popular for the last 5 years. If equities got popular, they could go out and buy an equity operation easily — with their small change. The name would then be Dreyfus and the assets would come rolling in. I just have tremendous enthusiasm for that company.

And with respect to their stock, I think they either have or will shortly have \$20 a share in cash. On a \$26 stock, that's really something. You're not paying much for the rest of the company.

OID: Sounds amazing.

Engemann: We think so. They're just smart guys. They're very conservative. Right now, they're doing that money market fund for no fee. And they're just going to keep doing it to gain market share and recognition. Then they'll start charging a fee on it and earnings will explode.

OID: What are you projecting for their earnings?

Engemann: Their earnings have been flat for a while. They earned \$2.21 in 1988. Last year, they earned \$2.04. And this year, we think they'll earn \$2.00. But we think they'll earn \$2.50 next year. At \$26, they're selling for slightly over 10 times next year's earnings.

OID: From there, what sort of growth are you projecting?

Engemann: We're expecting 20% per year growth.

OID: What are the most serious risks here? Is their lion sick or something?

Engemann: Not to my knowledge. I can't think of any serious risks.

Again, once they start charging fees on their money market fund and invest their cash, you should see some nice earnings growth. There's \$700 million just sitting there in short-term tax-free money market instruments. That's certainly not their long-term game plan.

OID: Why are they holding so much cash?

Engemann: I don't know. I think they're just waiting for the right opportunity.

OID: Portfolio Reports also shows you buying another company in the same business — Franklin Resources.

Engemann: Yeah — for the same reasons basically. Dreyfus is the no-load player and Franklin is the load player. Franklin kills you with service. They're extremely popular with the banks, the savings and loans and the brokerage firms in the money market and bond areas.

I thought it was a joke that they would ever be successful. And now they're a huge company.

OID: Value Line estimates that Franklin Resources has increased its revenues and earnings per share 20 times and 50 times, respectively, since 1983. That's fast.

Engemann: We think it will slow down, of course. But earnings could grow 20% per year for the next 5 years. We project earnings this fiscal year of \$2.35 and next fiscal year of \$2.75. For the next calendar year, we're projecting \$2.80. With Franklin at about \$26-1/2, we estimate that it's selling for only about 9-1/2 times next year's earnings.

OID: Why so cheap?

Engemann: Whenever the market is out of favor, people tend to get down on anybody that's associated with the market even more.

OID: Guilt by association.

Engemann: That's right.

OID: Why won't people be right?

Engemann: In the case of either Dreyfus or Franklin, if people are unhappy with one sector, they'll just switch to a different type of fund. I don't think you'll have many people leaving as long as they're treated well. Dreyfus and Franklin both treat their clients very well.

OID: Portfolio Reports also shows you buying Loews. Is that another Berkshire Hathaway-type holding?

Engemann: Sort of. We think of it as a cross between Berkshire Hathaway and Philip Morris. They have two great businesses: insurance and tobacco, not to mention CBS.

Loews has been a loser in the stock market for some time now. It's dropped from \$134 down to \$85.

OID: It's awfully hard to argue that it isn't a great bargain. We see a lot of smart managers buying it and/or agreeing that it's dirt cheap— Robert Ross, John Constable, Robert Noel among them — and, of course, Loews itself, through its share repurchases.

Engemann: And we agree. But in this period right

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now, when you need protection, it's not providing much. But we feel very secure that Loews will come through. And it's certainly a cheap stock.

We estimate earnings of $11.50 in 1990 and $13.00 in 1991. At $85, Loews is selling for 6-1/2 times next year's earnings.

OID: Dirt cheap. Any good reasons at all for it to be so cheap?

Engemann: I don't think there's much. They're not growing very fast. And lately, people have been down on all of their businesses — from CBS to insurance to tobacco.

OID: What sort of earnings growth rate are you projecting?

Engemann: For the long run, we project 15%. But for the next few years, we expect it to be slower than that.

OID: And your rationale with MCI?

Engemann: They're the up and coming telephone company. It continues to be a very volatile stock. We made a ton of money in it. And lately, we've been losing a bunch. People are always worried about MCI competing with AT&T.

OID: That they'll get spoiled?

Engemann: Must be. They come through year after year after year. So there isn't too much of a story to tell.

MCI's stock is currently at $31-3/8. We're projecting earnings of $2.80 for this year and $3.30 for next.

OID: A little over 9-1/2 times next year's earnings sounds awfully cheap for a company that's growing so rapidly.

Engemann: Yes, we expect 20% growth. And we do think it's cheap.

OID: Value Line expects it to grow even faster in earnings — 29% per year. Why is the market dumping on that one so much?

Engemann: It's just always been volatile. But I think it'll be a barnburner when the market turns.

OID: Portfolio Reports estimates that both you and Buffett were buying Philip Morris last quarter. What's your rationale there?

Engemann: Philip Morris, of course, is still a great bargain. It's selling for $44. And we're looking for earnings of $3.85 this year and $4.70 next year.

OID: That's only 9-1/2 times next year's earnings.

Engemann: And it's dropped from $50 to $44 — which is no big deal. It was even down to $41 at one point. So it isn't really down that much.

I wouldn't say that it's necessarily a screaming buy, but I just love it long-term. This is one that has really come through for us consistently. It's one of our largest holdings.

OID: Given your holdings in Philip Morris and Loews, do you have any thoughts about the tobacco liability issue?

Engemann: Yeah, I don't worry about it at all. To collect damages, plaintiffs have to prove that they got sick using cigarettes — and that's impossible. There are just too many ways people can get sick. With all the warning labels on the pack, I just don't think it's a big issue.

But I'm certainly glad other people do. It keeps the multiple down. So you have a company growing at 20% a year selling at 10 times earnings. That's why we've made so much money in Philip Morris. All these things have been said for 20 years — at least.

OID: And not only does that allow you to buy their shares, but it allows them to buy in their own shares.

Engemann: And they buy them all the time — when they're not buying General Foods, Kraft and Jacob Suchard. Philip Morris is one heck of a company.

OID: Any other screaming bargains?

Engemann: I think Reuters is a screaming bargain. I'll tell you a little bit about it. And Jim Mair and John Tilson can tell you more.

Reuters is just a super-powerful company — not in the stock market information area, but in the currency and bond area. And they're totally capable of doing it in the stock market, too. They could create their own trading system that could circumvent the stock exchanges.

OID: Fascinating.

Engemann: Reuters is just whomping and stomping everybody. They just don't have a close competitor.

Reuters provides information to investors — particularly for currencies and bonds. They're headquartered in England.

It's a monopoly business. It's a company that's going to be right in the middle of all the action for savers over the next 20 years. It's very well run. And it's selling for 11-1/2 times our estimate of next year's earnings and 15 times current earnings.

We just have a lot of faith in them. We don't think anyone could come close to knocking them out of the box. They're big all over the world. They will probably be setting up the equivalent of a future stock exchange. It's technically feasible that in the next 5 years, you won't need the New York Stock Exchange. I think they can do it. It would be 24-hour trading. And you could trade right through your terminal without needing specialists.

OID: Value Line shows revenue and earnings growth of 35% and 40% per year, respectively.

Engemann: People projected 30% per year growth out into the hereafter. Management thought people were getting too excited. So the company announced that people were too aggressive on their estimate of Reuters' prospects. The stock dropped like a rock from $71 to about $41-1/2. But it's still probably going to grow pretty fast.

When we spoke with them subsequently, they told us that business is great — without any question. It's just not as great as people were pumping it up to be.

OID: Tell us about their product.

Engemann: If you want to know anything about currencies or bond rates, you can get their system. They

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used to deliver their product through printers but now they put terminals in your office.

You can actually get all the information you need to make a trade from them. They have developed trading systems, too — where people like Merrill Lynch can use their system to actually place orders.

But Jim Mair and John Tilson are more familiar with Reuters than I am.

Jim Mair: Reuters is a widely misunderstood company. Most people think of it as a newswire company — like Dow Jones' newswire. It's the origins of the company, but it's only a very small part of what they do today.

They provide an electronic information network throughout the world. They virtually control the market for foreign exchange quotations. They're developing a satellite system that should be able to provide the information to their customers much more efficiently and at a much lower cost. In effect, they're a prime beneficiary of technology and the declining cost of telecommunications.

In addition to that, they're a beneficiary of the more sophisticated PC terminals that are proliferating and facilitate trading in financial futures as well as currencies.

Once they develop this network more fully — and it's already the broadest network in the world today — they'll be able to pump more and more information through the pipeline that they're installing in their customers' offices — more quotes, historical databases, live news services, etc. The information that will be pumped over these networks during the next 10 to 15 years is going to be incredible. The technology is advancing at an increasingly rapid pace. And Reuters is at the forefront of that phenomenon.

For example, right now they're installing Money 2000. Once they get that product in, they'll install Dealing 2000, which will allow users to execute foreign currency trades. In other words, users won't even have to talk to each other. The service will automatically match buy and sell orders.

OID: So we should also be shorting the brokers?

Mair: Not so much the brokers as the exchanges. I think that the New York Stock Exchange, the American Stock Exchange and some of the others are going to be impacted. The American Stock Exchange just came to an agreement with Reuters to jointly develop a market-making mechanism for trading private placements — securities that have not been registered with the SEC — that will be owned by Reuters. As you know, that's a multi-billion market that's rapidly growing.

With Dealing 2000, Reuters will start to earn a fee on each transaction. And that's a new source of revenues and profits for them. That system is being beta-tested right now in a number of client accounts.

Reuters' stock, however, has recently been hit hard because of investor concerns about whether or not the product is going to come out on time — and management says it is on time — and the insurance ramifications, which management has assured people is not a problem.

OID: Tell us about their earnings.

Mair: They're based in London and report in pence and pounds so you have to be a little careful. We basically look at it in terms of dollars, but you still have to factor in the impact of exchange rates.

We're looking for earnings of $2.75 this year — which we think is very conservative given the fact that they earned $2.50 in the trailing 12 months. We expect $3.60 next year. Given Reuters' very high return on equity, its high free cash flow, its brilliant future and its worldwide franchise, we believe that 11-1/2 times next year's earnings is just a giveaway price.

OID: Value Line's numbers are somewhat different than yours. What could account for the difference?

Mair: I'm not sure. It could be due to the exchange rate conversion from British pounds to American dollars.

OID: Isn't Dow Jones a force to be reckoned with in electronic information?

John Tilson: We've owned Dow Jones. And we sold it some time ago. Dow Jones didn't recognize the revolution that was occurring on the electronic side of the information business. Reuters, on the other hand, was very early to recognize it. They understood that they weren't just in the business of collecting news items and that there was a bigger thing going on — namely how to transfer things electronically.

Dow Jones made a big commitment by buying Telerate at a very expensive price — which again was a company we owned briefly and sold once it became apparent they were headed down a dead-end street. And once they got their foot in the water, they had no choice but to go through with it. They have a very difficult time ahead of them because they're so late to the party.

Mair: Telerate isn't really comparable with Reuters anyway. But if you look at the R&D spent by Reuters, if you look at the cash flow, if you look at any of the muscle that Reuters has versus Telerate, you can see that the war is over. There really never was one. There really isn't any serious competition for Reuters, although there's lots of competition for Telerate.

Tilson: It's like the classic case of companies that failed to recognize what business they were in. Dow Jones clearly didn't go down the right path. What is the future of a Dow Jones if they can't get into an electronic world?

Similarly, what is the New York Stock Exchange but a very exclusive men's club if you will?

OID: It depends on who you ask, no doubt.

Tilson: They're not interested in having any other people join up in their club because they own the book. But if there's a better way to do it and they don't see it or don't do it, what are institutions who are controlling equity and debt markets likely to do over a long period of time? I submit that they will migrate to the most efficient market. And the guys at the stock exchange could wind up standing there with their books and no entries in them because the market just completely went away from them.

OID: How fast do you expect earnings to grow?

Tilson: We're using 25% earnings growth over the next 5 years.

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OID: If those numbers come through, you're talking a growth rate that's more than double the P/E ratio. Not too shabby.

What can you tell us about management?

Mair: Renfrew has been around for some years. And he's the one who basically saw the future in the quoting of financial instruments and the potential of computers for transmitting information for foreign exchange markets. He headed up that area in the late 1950s and early 1960s at Reuters. And that area now dominates the entire company. Only 10% of revenues is left in the newswire area which, of course, was the historical basis of the company.

Tilson: You have to be impressed by their cash flows and their financial characteristics. Reuters has a 44% return on equity. It's a huge cash generation machine.

Mair: And the free cash is just going to soar. They've been spending a tremendous amount of money — between the development of this Money 2000 and the Dealing 2000 and some of these other products and their satellite system.

Tilson: That's going to be winding down. And they've been expensing it all.

OID: So they should simultaneously see reduced outlays, savings from satellite transmission and revenues from new products — made even better by very conservative accounting.

And isn't the cost of serving the marginal subscriber very little?

Mair: Right. Once you get the pipeline in, you can add subscribers or pump more information over it at very little additional cost.

Tilson: There are very strong economies of scale in this business.

OID: Aren't there some negatives here? How would Reuters be affected by a recession?

Mair: One of Telerate's bigger customer bases was savings and loans. They were not a factor for Reuters whose primary customers are banks generally.

Reuters is really a prime beneficiary of all of the major trends toward growing worldwide prosperity, peace and interdependency.

And if there were some kind of worldwide disaster or a disaster within the international banking community, Reuters would be in an excellent position to weather it. They're by far the strongest player in the business, have very strong cash flow, are invulnerable to competition and have a great franchise that's simply unparalleled. We don't foresee any major problems.

OID: Switching to a highly controversial company, tell us about Sotheby's.

Tilson: We own Sotheby's only within Pasadena Growth Fund. It's a very, very, very small position.

OID: Because it's very, very, very unpredictable?

Tilson: Absolutely. It's very difficult to predict and extremely volatile. And we think it always will be.

OID: Sounds great so far.

Tilson: What attracted us to Sotheby's is the same thing that attracts us to lots of diverse businesses, namely the ability to control its market. Sotheby's basically divides up the worldwide art market with Christy's.

If you believe in the continuation of rising wealth worldwide and if you believe that inflation is something that is likely to be with us for most of our lives, then I think you can make a case that Sotheby's is a very good business.

OID: Over the long run, those sound like pretty safe bets.

Tilson: We think so. Finally, for Sotheby's to do well, liquidity has to continue to be there.

OID: I wonder why Sotheby's is such a popular short?

Tilson: I remember when they were talking about shorting that stock. It was primarily because they believed that the speculation in collectible goods' prices was peaking and that there was going to be a correction in price.

But Sotheby's doesn't own these things. They're just acting as the middleman and brokering it. So even if prices soften, is that any reason to believe that activity will totally dry up and that no transactions will occur? And if transactions occur at a lesser price, their business will decline, but it will not go away.

Sotheby's has told people that they don't expect their auction sales in their big year end period to be as good as last year because they don't have the same caliber of merchandise that they have had in recent years. While there has been some softening in demand, there's also been less desire on the part of sellers to put their prizes up for auction.

If you have several years when earnings go up at a lot faster rate as you did in 1988 and 1989, it just stands to reason that it's not sustainable and it has to correct. But we do know that over a long period of time, revenues have grown at a 15% annual rate. And I think there's every reason to believe they'll do something like that in the future.

But we also look at a company and ask ourselves what the value should be for a franchise-type business with a 50% return on equity. One of the things that makes it such a good business is their strong barriers to entry.

You have to be able to source merchandise. If you're not in contact with the people who own these things, then how are you going to conduct your business? Small auction houses simply can't get the right merchandise. Sotheby's and Christy's have a worldwide network of representatives who are in very, very close contact with museums, very high net worth individuals and so forth who are collectors of all the various different things that fall into the collectible category.

We're not short sellers. But if I were a short seller, there is only one thing in the world I would ever short. And that's a business that I'm absolutely sure is a bad business and already substantially in trouble.

In my opinion, Sotheby's is a good business. It may go through its lulls. It may have some down periods. But over a long period of time, it will do fine.

I wouldn't ever be short a good business. That's just speculating. But the shorts will have their day. When the

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market goes too much against them, they'll have to cover.

OID: Do you consider Sotheby's to be well managed?

Tilson: I think they're very well managed. In the last few years, management has done almost everything right.

Mair: You mentioned all of the bears in the stock. Those guys were right about the stock, but for the wrong reasons. That happens frequently. Bears were talking about the big bubble in art prices that was going to burst.

Tilson: I remember that *Barron's* wrote an editorial on "The Collapse of the Art Market".

Mair: And none of those things has happened.

Tilson: Sotheby's stock hasn't declined because of a collapse in the art market, but because business slowed.

OID: What are you guesstimating for earnings?

Tilson: I don't know how the numbers are going to come in this year, but I think they'll come in between \$2.05 and \$2.15. We started the year thinking they might do \$2.50.

Next year, considering the turmoil we're looking at right here, we'd have very low confidence in any number that we might give you. But we spoke with the company and discussed their revenues and costs if the art market were to decline by 30% from here. And they were comfortable with our estimate that in such an event, they would earn \$1.50.

To me, frankly, that sounds crazy. I'm not using the \$1.50 estimate because I don't expect the art market to drop 30% in the next 12 months unless there's some sort of major liquidity crisis worldwide. But could it be flat or trend slightly down? Certainly. So I'm using an estimate of around \$2.00.

OID: Either way, with Sotheby's stock around \$11-1/2, you're talking 6 to 8 times earnings. That sounds bargain basement cheap in any case.

Tilson: Exactly. It's a very cheap stock and a very good business with an excellent franchise with significant barriers to entry and a market that is attractive long-term and earning 50% return on equity, more or less, and that will pay out a substantial portion of its earnings in dividends. It's conceivable that we could have a 10% yield on this stock over the next 12 months.

OID: Bottom line then, while art is probably overheated short-term, it sounds like the selling of Sotheby's has just been way overdone.

Mair: Exactly.

Tilson: I think so. I can't predict the stock market after 25 years, so there's nothing to make me think I can predict the art market. But let's assume that it does go down. There are still going to be transactions.

It's like the stock brokerage business. If there only weren't so much competition and you could control the commissions you charged, you could build a case for that being a pretty good business no matter what happens in the stock market. And that, effectively, is Sotheby's situation.

OID: Exactly why stock brokerage is not a terrific business and why Sotheby's is.

The other criticism we've heard is Sotheby's entry into art financing. Couldn't that entail substantial liability and be a major negative?

Tilson: It's grossly misunderstood and grossly overplayed. Sotheby's does two things which, incidentally, Christy's didn't do and has started to do. First, if you have art to sell, Sotheby's will guarantee you a price that you'll receive on selling — assuming that they believe it will be easy to sell. You can even borrow money against those paintings from Sotheby's. However, they will only lend 50% of their low estimate of value.

Alternatively, you can obtain their price guarantee, where they guarantee a minimum price to get a collection and then they take a percentage of the profits over and above that or, if it goes below that, they eat the loss. In the time that they've been doing this, they've made a lot of money on it and have lost very little.

OID: The way few junk bonds went bad for awhile?

Tilson: It is a business risk. There's no question about it. But it's for a high reward. They're not betting any sizeable sums of money that would threaten the financial viability of this company. It's an attempt to obtain a competitive advantage.

The one that I loved was the much reported case of the gentlemen who got into trouble with the Van Gogh *Irises* painting. He paid \$53 million for it and still owed money on it — as I understand it, he owed \$17 million.

When he went through his liquidity crunch, he put it up for sale. We understand that the J. Paul Getty Museum bought it from him for \$60 million. In the meantime, Sotheby's was on the hook for \$17 million — roughly 30% of his sales price. Yet these short sellers were running around announcing Sotheby's imminent demise. It is just baloney.

But because Sotheby's usually loans money or makes guarantees on a confidential basis — because that's what the client requests — Sotheby's can't clear the air. So consequently, they'll probably always be victims of rumors and innuendos.

But at 6 times this year's earnings, we can live with it.

OID: Makes sense to us.

Tilson: Absent disaster on a grand scale, it's hard to see how Sotheby's won't work out from \$11-1/2.

A few months ago, everybody expected worldwide prosperity. Now, they seem to expect the end of the world. It could happen, but I don't recommend investing that way.

OID: Our sentiments exactly. Thank you, gentlemen.

—OID