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Outstanding Investor Digest

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

Investors featured in this Issue:

Other Investors in this Issue:

Companies & Investments in this Issue:

Volume V Number 8 October 31, 1990

AN UPDATE ON THE FINANCIAL STOCKS
ROBERT NOEL, ALAN HOEFER, CHARLES BRANDES ET AL.
"CAN FREDDIE COVER ITS FANNY?"

Following publication of our last issue, in which more than a few top managers extolled the virtues of Freddie Mac, it became the latest casualty among financial stocks — declining nearly 40% to $32 per share. Subsequently, more than a few of you called requesting that we do a followup.

We therefore bring you the following potpourri of opinion — pro and con — from Robert Noel, Alan Hoefer, Robert Ross, Charles Brandes and Steve Wallman on Freddie Mac and

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WINDSOR FUND'S JOHN B. NEFF
"SEVERAL CONTRARY OPINIONS:
NO OIL CRUNCH, NO RECESSION & NO ARMAGEDDON."

Prior to the arrival of John Neff in 1964, Windsor Fund had lagged the S&P 500 in each full year of its existence (since 1959). Since 1964, however, Windsor has outpaced the index in 18 of 26 years and earned a compound return of 14.4% per year vs. 10.4% per year for the S&P 500 during the period.

Neff's success has not gone unnoticed by his peers. Reportedly, Neff is the manager chosen most frequently by

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AN OID INTERVIEW WITH TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE, JIM CLARK & JOHN SPEARS
"IF THE PESSIMISTS ARE RIGHT, WE'LL ALL BE DEAD.
IF THEY'RE NOT, WE'LL ALL BE A LOT RICHER."

Started around 1920, Tweedy, Browne's client list is a "Who's Who" of value investors — including Ben Graham, Warren Buffett and Walter and Edwin Schloss, among others.

Having managed outside money alongside their own since 1968, Tweedy, Browne has built one of the best and most consistent track records in the investment business. During the 22 years ended December 31, 1989, TBK Partners earned a compound return of 18.9% per year vs. 10.8% for

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CARRET & COMPANY'S PHIL CARRET
"SOME TIMELESS PRINCIPLES
FROM A TRULY LONG-TERM INVESTOR."

Among the many admirers of Carret & Company's Chairman Emeritus Phil Carret is one Warren E. Buffett. Says Buffett, "I am an unabashed enthusiast. He ... knows an extraordinary amount about business ... [and] markets. If there were a hall of fame for investment advisors, he'd be among the first ten in it."

Carret founded Pioneer Fund in 1928 — a full six years before Ben Graham wrote his 1st edition of *Security Analysis*.

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TWEEDY, BROWNE'S CHRIS BROWNE,
WILL BROWNE, JIM CLARK & JOHN SPEARS
(cont'd from page 1)

the S&P 500. Here are Tweedy, Browne's year-by-year performance figures for the overall partnership along with net returns to the limited partners:

Year*	TBK Overall Return	TBK Limited Partners	S&P 500 Total Return
1959	+26.1%		+12.0%
1960	+19.8%		+0.5%
1961	+31.3%		+26.9%
1962	-1.9%		-8.7%
1963	+23.4%		+22.8%
1964	+28.3%		+16.5%
1965	+25.5%		+12.5%
1966	+28.9%		-10.1%
1967	+61.1%		+24.0%
1968	+27.6%	+22.1%	+8.8%
1969	+12.7%	+10.2%	-6.2%
1970	-1.3%	-1.3%	-6.1%
1971	+20.9%	+16.7%	+20.4%
1972	+14.6%	+11.8%	+15.5%
1973	+8.3%	+7.5%	+1.0%
1974	+1.5%	+1.5%	-38.1%
1975	+28.8%	+23.0%	+37.8%
1976	+40.2%	+32.2%	+30.1%
1977	+23.4%	+18.7%	-4.0%
1978	+40.6%	+32.5%	+11.9%
1979	+25.6%	+20.5%	+12.7%
1980	+21.4%	+17.3%	+21.1%
1981	+14.4%	+11.6%	-2.7%
1982	+10.2%	+8.2%	+10.1%
1983	+35.0%	+28.2%	+44.3%
1984	+18.2%	+14.7%	+4.8%
1985	+24.8%	+20.1%	+14.6%
1986	+14.0%	+11.3%	+31.8%
1987	+30.2%	+24.4%	+43.5%
1988	+0.5%	+0.4%	-9.7%
1989	+15.4%	+12.3%	+31.5%
1959-89	+20.9%	N.A.	+10.4%
1968-89	+18.9%	+15.3%	+10.6%
1976-89	+21.9%	+17.7%	+16.0%

*The 1968 figures are for the nine months ended September 30, 1968. The figures for 1969-87 are for the 12 months ended September 30 of each year. The 1988 figures are for the 15 months ended December 31.

Lest you believe that the firm is resting on its laurels, TBK Partners has earned a compound annual return of 21.9% per year since 1976, when three of the four current general partners were in place, vs. 16.0% per year for the S&P 500 during the same period. Here are Tweedy, Browne's general partners today along with the date each joined the firm: Chris Browne (1969), John Spears (1974), Jim Clark (1976) and Will Browne (1978).

The following excerpts were selected from a conversation with them during a recent visit to their office and from several subsequent conversations. We hope you enjoy it as much as we did preparing it.

OID: Tell us about Tweedy, Browne.

Chris Browne: The firm was started around 1920 by Forest Berwin Tweedy, who was known as Bill Tweedy. When he went into the brokerage business, he tried to find a niche where he wouldn't have much competition because he felt that as a single proprietor, he couldn't compete with the big firms of that day.

So he found a niche trading inactive and closely held securities. These were companies that might have 50 to 150 stockholders. Tweedy would go to the annual meetings and copy down the shareholder lists — which I guess they let you do in those days without a court order. And he'd send out postcards to the shareholders, soliciting people who wanted to sell or buy — because the most obvious buyers and sellers of a company's stock are its existing shareholders. So he established a postcard business in making markets in these stocks and continued doing that in the '20s and the '30s.

In the early '30s, Ben Graham went into the money management business and wrote *Security Analysis*. He had a very simple premise that there are two values to every share of stock: One value is what he calls the private market value or intrinsic value — which is the amount of money that would accrue to each share of stock were the business sold in an arms length negotiated transaction between a knowledgeable seller and a knowledgeable buyer. The other value is the last quoted price on the stock exchange.

As Graham put his investment principles into practice and looked for cheap stocks, he kept running into the name of Tweedy in the old pink sheets because inactively traded securities didn't have anyone following them. As a result, they tended to trade at big discounts from their intrinsic value. So Graham became a brokerage client.

That continued into the '30s. In 1943, my father — Howard Browne — and Joe Reilly left another brokerage firm and went into business with Tweedy as Tweedy, Browne and Reilly doing the same sort of business. They moved their offices to the same building on the same floor as Graham Newman Corporation.

In those days, you had to deliver securities. So it was much easier to move next door to your major client because you just took the securities down the hallway.

OID: The good old days — before electronic data transfer.

Chris Browne: It was very different. But with the coverage of three people versus one, they could expand their market making activities — which they continued doing in the '40s and '50s.

All through this period, the firm was primarily a market maker in undervalued stocks, not an investor. As they accumulated some excess capital, however, they set up an investment account, began to pick and choose among what they thought were the most undervalued securities and put a portion of their excess capital into it.

In 1958, Bill Tweedy died. And the partners had a

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TWEEDY, BROWNE'S CHRIS BROWNE,
WILL BROWNE, JIM CLARK & JOHN SPEARS
(cont'd from preceding page)

feeling that they needed at least three partners in order to make sure that there was always somebody there in case the NASD walked in and tried to find a principal. Enter Tom Knapp.

Tom Knapp was a referral from Walter Schloss, who had desk space with Tweedy since about 1952 when he set up his own operation. And I use the term "desk space" as opposed to office space because we didn't actually give Walter an office until 1972.

James Clark: A closet actually.

Chris Browne: He didn't get a door until about 1980. So he's come a long way in his nearly 40 years with us. Next thing he and Edwin will want is a secretary.

OID: Or even a second phone.

Chris Browne: When I started working in 1969, Walter's desk was between the front door, the water cooler and the coat closet. So every time someone wanted a drink of water, Walter would have to scrunch into his desk so that they could get by.

OID: Unlike our spacious, lush world headquarters. But that sounds like Walter all right — no frills at all. Incidentally, how did you meet Walter?

John Spears: Walter placed orders with Howard to buy and sell securities for Graham Newman.

Clark: And as I mentioned, we were next door to Graham Newman. So when he started his business....

OID: Being in your offices was even more convenient than being next door.

Chris Browne: That's right. So Walter introduced us to Tom Knapp in 1958. Tom had been at Graham-Newman. And Tom came down, met Joe and Howard and agreed to become a partner in the firm. Then they didn't hear from him for six months.

Finally, my father asked Walter, "What the story with this guy? Is he going to show up or not?"

So he called Knapp. And he said, "Oh, yeah. I forgot." So he came down and started becoming active in 1958.

And the transition from being a brokerage firm or a trading firm making markets in inactive securities to an investment firm really started at that point. He brought some capital — more capital than the partners had at that point. And he was less interested in selling cheap stocks at a one point markup than he was in retaining them.

Walter tells a funny story about when Warren Buffett started in the business. Walter brought Warren down and introduced him to my father also. And he became a brokerage client, buying a lot of cheap stocks from Tweedy — as almost everybody has in this business.

OID: Among the value community, anyway.

Chris Browne: Yes. Warren Buffett said to Walter, "This guy Howard Browne can't be very smart."

Walter said, "What do you mean?"

"He's selling me all these ridiculously cheap stocks."

Walter said, "He doesn't have enough money to buy all of them himself, Warren. So he lets people have some of them."

OID: A funny story, but an important point.

Chris Browne: Quite true. And through the years, that transition developed. With the arrival of Tom Knapp in 1958, we started keeping track of the investment results. Nobody else had done that before.

From '58 to '68, it was the general partners' capital. Then in 1968, for the first time we had investors in the firm other than the general partners.

In 1968, Joe Reilly retired. He was about 65 at the time. And he retired with two stipulations: One, that he would have an office to come into — and he's still coming into that office almost 23 years later. And two, that he take his partnership interest in the form of his pro-rata share of every single security holding we owned. He just took his share of the portfolio and he kind of managed it on his own.

To replace Joe Reilly, again adhering to the rule of three partners, they found Ed Anderson. Anderson had a Ph.D. in Physics. He was with the Atomic Energy Commission out in Idaho. He and a good friend of his, Dick Bechtel, in the late '50s or early '60s started investing in stocks as a hobby.

They'd run across Ben Graham's books and had started studying them. They put together a little investment club of people they worked with and got to know different people in the business. They founded Anbec Partnership — from their names: Anderson and Bechtel.

Ed's hobby thus became first his avocation and then his vocation. And sometime in the '60s, he left the Atomic Energy Commission and went to work for Charlie Munger Vice Chairman of Berkshire Hathaway.

OID: Small world.

Chris Browne: Charlie had Wheeler, Munger at the time, which was a specialist firm on the Pacific Coast Stock Exchange that also served as his investment pool. As I recall, it was originally a specialist firm on the Pacific Coast Stock Exchange and Charlie Munger bought into it.

Charlie figured out that he couldn't get rich enough quick enough by just being a lawyer. So he decided to go into the investment business.

OID: At Buffett's suggestion, no less.

Chris Browne: Munger turned Wheeler, Munger into an investment partnership. Ed was an analyst there working for Charlie and running his little pool.

And Ed had gotten to know Tweedy through the years because of repeatedly running across Tweedy's name as he piled through the pink sheets. He made a pilgrimage to New York, he met the partners and asked if he could buy some of the stocks that they'd found. So he became a brokerage client also.

In '68, they asked him to join the firm. He moved his partnership into the general partner's pool — then called Tweedy, Browne and Knapp, today called TBK Partners.

Interestingly, in '68, the firm was actually supposed to be just called Tweedy, Browne because they only answered the phone Tweedy, Browne — and never used the Reilly because it was too long to get out.

But the fellow in the back office who ordered the stationary assumed that since Tom Knapp had been a

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TWEEDY, BROWNE'S CHRIS BROWNE,
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partner since 1958 and Joe Reilly was leaving, they'd drop Reilly and add Knapp. So they got a shipment of all this stationery with Tweedy, Browne and Knapp on it. And it was cheaper to change the documents and re-name the firm Tweedy, Browne and Knapp than to throw away the stationery and start over.

So that's how Tom Knapp got his name on the shingle.

OID: We can hardly wait to see what happens when you reorder next.

Chris Browne: You and me both. Anyway, we took in outside money for the first time in 1968. And the transition from trading to investing accelerated.

Then, in 1973, we became a registered investment advisor. We did that because we had accumulated shares in a closed-end mutual fund called the Cambridge Fund. The Cambridge Fund had originally been something called the Jaffe Fund. Wilton, or "Wink" Jaffe is the Marlboro Man in Adam Smith's first book — the guy who used to show up in the office in cowboy boots.

He had some problems, but he was out of the business. He turned the fund over to a young portfolio manager. It was a lousy stock market. The net asset value had declined. But the share price had declined even more. So we were buying into the portfolio at about 50% or 60% of net asset value.

And then, the stock started to dry up. And we found out that there were two other guys who were doing the exact same thing we were. So we met to see if we could agree on some course of action. We couldn't. And we eventually wound up buying out their interest and taking control of this thing. And in order to manage it, we had to become a registered investment advisor. So that's what we did.

So we had control of what was originally a $10 million pool that was down to about $3-1/2 or $4 million by the time we got control of it — with about a million shares outstanding.

By today's standards, it wasn't a major amount of money. But for us in those days, it was pretty significant.

Clark: And it had the advantage of tax losses. We could go from $4 or $5 per share in net asset value to $10 without paying any taxes.

OID: Sounds great.

Chris Browne: Especially in those days. People may be complaining about raising the tax rate from 28% to 33% these days. But in those days, I think the marginal rate was 70% on dividend and interest income.

Clark: And 35% on capital gains.

Chris Browne: Kennedy had lowered it from 90% to 70%. People were much more tax conscious. Plus, it gave us the advantage that we could buy in shares of our own portfolio if and when they traded at a discount from the portfolio. There can be no greater bargain in the world than to buy yourself at a discount.

OID: Depending on who you are, of course.

Chris Browne: Being a registered investment advisor, we began to quietly take on a few individually managed accounts.

OID: In "Superinvestors of Graham and Doddsville", Buffett tells a funny story about first meeting Knapp on the beach. Then, 35 years later, he saw him on the beach again. Only this time, he owned the beach.

Chris Browne: Tom was probably our most eclectic investor. When I first started working, there was one whole room devoted to these geodesic survey topographical maps. And he had this little network of brokers up in Maine who would find him little parcels of land. Apparently, they all had to be waterfront parcels or he wouldn't buy them. While he never revealed how much land he actually bought, we've heard rumors that it's 10,000 or 100,000 acres — who knows how much it was. But he bought it all at bargain prices.

It was not unlike one of the stocks he bought in the early days I was here. Tremont Lumber was a typical Tom Knapp stock. I think he bought his early shares at $120. And then he bought some at $210. This was a company that was in the timber business. Tom's analysis, as I recall, was that at $120 a share, he was buying the land for around $10 an acre. That kind of appealed to him.

OID: I believe we understand why.

Chris Browne: It was 80% owned by a little old lady. When she died, she left her 80% interest to a foundation that she established. Her pro-rata share of the dividends had been about $100,000 a year.

The trustees of the foundation, who were not the management of the company, decided to find out exactly what this Tremont Lumber was. They had a timber cruise done, valued the assets and wound up selling it for $385 million, 80% of which was hers. So overnight it became a fairly significant foundation.

She had no idea what it was worth. We wound up getting about $4,300 a share for the stock after owning it for about 2 years.

Will Browne: One of Tom's big hits was when he sold a big parcel of land back to the Bureau of Indian Affairs for a big profit. Tom had a Midas touch even on obscure pieces of property in the back woods of Maine.

Chris Browne: Tom had one rule: He'd never buy from an individual. He only bought from a broker. So whoever the seller was, if they were that stupid to sell it to Tom, it was the broker's fault for not advising him.

OID: So he had a pretty good nose for bargains.

Clark: Usually, but not always. Have you heard the story of Tom [Knapp] and Warren [Buffett] trying to corner the market on a particular issue of stamps?

Chris Browne: Oh yes, the famous Blue Eagle stamp.

OID: No, we haven't.

Chris Browne: The Blue Eagle stamp was a four cent airmail stamp which went out of production in the early '60s. Tom and Warren wrote every post office in the U.S. in a town with a population over 25,000 and offered to buy all of their Blue Eagles at their face value — 4¢ apiece.

Will Browne: Only because the Post Office never sold stamps at a discount. They won't do it.

Spears: That's right. It's a relatively efficient market.

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TWEEDY, BROWNE'S CHRIS BROWNE,
WILL BROWNE, JIM CLARK & JOHN SPEARS
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Chris Browne: Tom had a garage full of these stamps. And all through the years, we weren't allowed to get a postage meter because we had to eat up this inventory of Blue Eagle stamps. We used to send Warren Buffett the pink sheets every week. And by the time postal rates kept going up and you had to put more things in the envelope, there'd be two rows a foot long of blue eagle stamps running across the envelope. The postmen used to grumble every time he saw it because he'd have to stamp every one of them cancelled.

I wonder what they ever did with all of those stamps. I believe they still have some.

OID: Why did they want to corner the market on Blue Eagle stamps?

Will Browne: They thought they'd become a collector's item, so that they'd trade at a premium to their four cent face value.

OID: But it never worked out?

Chris Browne: They are selling for more now. But I think on a time-weighted basis, they haven't really made that much money.

They could immediately wipe out any premium because the inventory the two of them have would flood the market and knock out the belly of the Blue Eagle stamps.

Clark: They didn't pay more than the intrinsic value, so they could cash out at any time they wanted.

Will Browne: But I'm not sure if it got marked up enough to produce a decent return.

OID: So even Super Investors....

Will Browne: Two of the interesting points about the firm are that during the entire 70 years of our history, we've had nine general partners — eight of whom are still alive. Seven of those eight have for all practical purposes left all of their net worth in the business to be managed in an identical fashion to that of our clients.

The one partner who took his money out was Joe Reilly. And as we mentioned, he took his interest out in a pro-rata number of shares of every stock that we owned.

OID: Essentially keeping the portfolio intact.

Will Browne: So there's been tremendous continuity. There's an investment philosophy that binds everybody together. It's really a methodology that we're all practicing and, hopefully, getting better with in a qualitative way as time moves on.

To a great extent, we think of ourselves as being in the business of managing our own money. We have substantial amounts of money here from the 4 current general partners and their families — in excess of $50 million. So those are two things which bind us together — our philosophy and the fact that we're all managing our own money. We're in the enviable position of being able to manage other people's money in the exact same fashion as our own.

OID: It's all relative. We consider solvent enviable. But what are your total assets under management currently?

Spears: About $950 million.

OID: How would you describe your investment approach?

Chris Browne: For years, Tweedy, Browne was known as the primary dealer in inactively traded securities. But all that really did was to give them the foundation for the idea of buying things cheap.

And while we still have $16 million or so invested in inactively traded securities, we've translated that to the entire market of 10,000 public companies. Originally, we applied the criteria to one segment of the marketplace. And today, we apply it to everything.

We like to say that we are not a "small cap" manager, but an "all cap" manager. We don't limit ourselves to something above or below a certain capitalization level.

If it's cheap, we'll buy it. We don't care if it's a $10 billion market cap or a $1 million market cap.

OID: It sounds a little like the way Walter Schloss described his approach to us. He said, "If it's cheap, we'll buy it."

When we asked him to elaborate, he said, "Isn't that enough?"

Chris Browne: Warren Buffett pointed out in his "Super Investors of Graham and Doddsville" that of the seven investors whose records he listed — one of which was ours — that each one of these guys basically had a different portfolio. In a manner of speaking, each practiced the same religion, but belonged to a different church.

We're probably a little more inter-denominational than say Warren, who's very concentrated, or Bill Ruane, who's somewhat less concentrated and, like Warren, only wants good businesses. We like good businesses, but we'll also buy not-so-good businesses, asset plays, free cash flow companies.

OID: But when you say cheap, do you mean cheap relative to private market value, assets, intrinsic value, earnings or the measure that we tend to use — i.e., fictional value?

Chris Browne: We look at things that are cheap on a private market value basis, on a net current assets basis, on a discount to book value basis, an earnings yield basis, etc. There isn't any one set of financial criteria.

Because if we had that, we'd eliminate a lot of things we could buy. They are all just different forms of practicing the concept of buying undervalued stocks.

OID: You've been cautious for some time. For example, in your February letter, you pointed out how high returns for extended periods have historically been followed by periods of mediocre returns.

Chris Browne: I don't know if cautious is the right word as much as frustrated. If you're an inveterate bargain

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TWEEDY, BROWNE'S CHRIS BROWNE, WILL BROWNE, JIM CLARK & JOHN SPEARS
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Will Browne: You're going through a period now where you're seeing some of the euphoria and excesses being washed out of the stock market. And in some cases, rational pricing is going out with it.

And it's interesting that theories always seem to evolve to support prices of stocks at that time. Remember how one of the theories about the stock market in 1987 was that our stock market could never go down because it was priced so cheaply relatively to the Japanese market?

OID: Or that we'd float away happily ever after on a sea of liquidity.

Will Browne: All those things are very interesting. And you wonder where they are today, where all that Japanese money is as people disinvest from equities. And in this kind of adversity, you begin to find opportunity.

Spears: The list of candidates — of things that seem at first glance to be selling at half or less of what we think the business or the assets are really worth — has widened considerably. In a bull market, the list gets smaller and smaller. You get to know the names. You look at something and maybe you look at it again six months later. Maybe it's changed. Maybe the company is really more valuable now.

But we're seeing a lot of brand new candidates today.

OID: When Saddam Hussein made his latest blunder on August 2nd, how much cash were you holding?

Spears: Most portfolios that we manage were 30% to 35% cash as of August 2nd.

Chris Browne: Some higher.

OID: And how much cash are you holding currently?

Clark: About the same — because the cash hasn't shrunk and the stocks are down a bit. We do have a little less cash.

Chris Browne: Our value stocks didn't start to decline when Saddam Hussein invaded Kuwait. They started to decline last October and have been declining ever since. Except for a narrow portion of the stock market, everything else had already gone down 10% or 20% or more.

Saddam Hussein just took another 5% or 10% off. But then you saw some of the larger cap stocks, too, really getting hit. It's been a fairly uneven hit to the stock market. A two-tiered market developed.

My own impression is that Rostenkowski's bill to limit takeovers in 1987 scared all the arbitrageurs. And I'm of the opinion that his bill was a more important factor in the market crashing than was the budget or trade deficit. Germany and Switzerland have trade surpluses and budget surpluses. Yet their stock markets crashed more than ours did. So clearly that wasn't the primary reason for it.

Then there was a little bit of return to normalcy with a couple of deals — for example, Sterling Drug. In the first part of 1989, everybody thought there was going to be a recession. So they all decided to own the "super safe stocks" — the pharmaceuticals, the food companies and so forth. And those things went up an astronomical 42% in 1989 in the so-called "flight to safety".

OID: So-called is about right.

Chris Browne: Exactly. As a business, I'd rather own Coca-Cola. But I don't know whether I want to own it at 24 times earnings. And Wal-Mart's been a great business. But it's not a licensed franchise. At 28 times earnings, I don't consider it to be a secure place to have my money.

It's not unlike the early '70s when most stocks were going down, but the Nifty Fifty were popping along. In 1973, portfolio managers couldn't own enough Avon at $125. A year and a half later, it was $17.

So there can be risk in those things. That's what's happened in the last year or two. Stocks like Merck and Philip Morris have been the engines that have kept the averages high.

Clark: And it's shown by the difference between the performance of the S&P 500 and the Value Line indexes in 1990. The S&P, which is capitalization-weighted, is down about 11%. The Value Line, which is equally weighted, is down closer to 27%. It's our view that the Value Line index more accurately represents what's happened to a majority of the stocks, both listed and over-the-counter, than does the S&P 500 where Exxon accounts for 268 times the weighting of the 500th company.

OID: And the NASDAQ?

Clark: It's down about 28% — about the same as the Value Line.

OID: It seems that stocks of companies that disappoint in even the slightest degree are being taken out and shot.

Will Browne: We don't own the security. But I noticed recently that Scott Paper announced that they expected earnings to be 85 cents instead of $1. The stock had been $40 or $41 a share. And it opened at $32 or $33. The same thing happened with Ingersoll-Rand. The stock was $40 or $41 and it opened at $34.

They are just taking these things out and shooting them. Now maybe they were too highly priced to begin with. They were certainly at levels that we weren't willing to pay.

Chris Browne: Ingersoll-Rand at 9 times earnings isn't outrageous. It's not 20 times earnings.

The whole psychology has changed in a couple of months. It went from stocks being the only thing that any rational person would ever want to own no matter what the price you had to pay to who would ever want to own stocks.

Look at retailers. The concept now, I guess, is that no one's ever going to K-Mart or a J.C. Penney again.

OID: Or The Limited.

Chris Browne: They've decided to knock 40% to 50% off the price of some of those stocks. You're starting to see dividend yields higher than P/Es.

Clark: Which is something we welcome.

Chris Browne: That's a real value green light. And if you have the kind of client who will ask you, "Why would you want to own that — because it's going to be a bad Christmas and they earn a third of their money in the fourth quarter every year?"

We'd say, "That's why the stock is selling where it is." And our assumption is that if this is a lousy Christmas, either next year or the year after that, things will recover.

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TWEEDY, BROWNE'S CHRIS BROWNE,
WILL BROWNE, JIM CLARK & JOHN SPEARS
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OID: Or that we'd float away happily ever after on a sea of liquidity.

Will Browne: All those things are very interesting. And you wonder where they are today, where all that Japanese money is as people disinvest from equities. And in this kind of adversity, you begin to find opportunity.

Spears: The list of candidates — of things that seem at first glance to be selling at half or less of what we think the business or the assets are really worth — has widened considerably. In a bull market, the list gets smaller and smaller. You get to know the names. You look at something and maybe you look at it again six months later. Maybe it's changed. Maybe the company is really more valuable now.

But we're seeing a lot of brand new candidates today.

OID: When Saddam Hussein made his latest blunder on August 2nd, how much cash were you holding?

Spears: Most portfolios that we manage were 30% to 35% cash as of August 2nd.

Chris Browne: Some higher.

OID: And how much cash are you holding currently?

Clark: About the same — because the cash hasn't shrunk and the stocks are down a bit. We do have a little less cash.

Chris Browne: Our value stocks didn't start to decline when Saddam Hussein invaded Kuwait. They started to decline last October and have been declining ever since. Except for a narrow portion of the stock market, everything else had already gone down 10% or 20% or more.

Saddam Hussein just took another 5% or 10% off. But then you saw some of the larger cap stocks, too, really getting hit. It's been a fairly uneven hit to the stock market. A two-tiered market developed.

My own impression is that Rostenkowski's bill to limit takeovers in 1987 scared all the arbitrageurs. And I'm of the opinion that his bill was a more important factor in the market crashing than was the budget or trade deficit. Germany and Switzerland have trade surpluses and budget surpluses. Yet their stock markets crashed more than ours did. So clearly that wasn't the primary reason for it.

Then there was a little bit of return to normalcy with a couple of deals — for example, Sterling Drug. In the first part of 1989, everybody thought there was going to be a recession. So they all decided to own the "super safe stocks" — the pharmaceuticals, the food companies and so forth. And those things went up an astronomical 42% in 1989 in the so-called "flight to safety".

OID: So-called is about right.

Chris Browne: Exactly. As a business, I'd rather own Coca-Cola. But I don't know whether I want to own it at 24 times earnings. And Wal-Mart's been a great business. But it's not a licensed franchise. At 28 times earnings, I don't consider it to be a secure place to have my money.

It's not unlike the early '70s when most stocks were going down, but the Nifty Fifty were popping along. In 1973, portfolio managers couldn't own enough Avon at $125. A year and a half later, it was $17.

So there can be risk in those things. That's what's happened in the last year or two. Stocks like Merck and Philip Morris have been the engines that have kept the averages high.

Clark: And it's shown by the difference between the performance of the S&P 500 and the Value Line indexes in 1990. The S&P, which is capitalization-weighted, is down about 11%. The Value Line, which is equally weighted, is down closer to 27%. It's our view that the Value Line index more accurately represents what's happened to a majority of the stocks, both listed and over-the-counter, than does the S&P 500 where Exxon accounts for 268 times the weighting of the 500th company.

OID: And the NASDAQ?

Clark: It's down about 28% — about the same as the Value Line.

OID: It seems that stocks of companies that disappoint in even the slightest degree are being taken out and shot.

Will Browne: We don't own the security. But I noticed recently that Scott Paper announced that they expected earnings to be 85 cents instead of $1. The stock had been $40 or $41 a share. And it opened at $32 or $33. The same thing happened with Ingersoll-Rand. The stock was $40 or $41 and it opened at $34.

They are just taking these things out and shooting them. Now maybe they were too highly priced to begin with. They were certainly at levels that we weren't willing to pay.

Chris Browne: Ingersoll-Rand at 9 times earnings isn't outrageous. It's not 20 times earnings.

The whole psychology has changed in a couple of months. It went from stocks being the only thing that any rational person would ever want to own no matter what the price you had to pay to who would ever want to own stocks.

Look at retailers. The concept now, I guess, is that no one's ever going to K-Mart or a J.C. Penney again.

OID: Or The Limited.

Chris Browne: They've decided to knock 40% to 50% off the price of some of those stocks. You're starting to see dividend yields higher than P/Es.

Clark: Which is something we welcome.

Chris Browne: That's a real value green light. And if you have the kind of client who will ask you, "Why would you want to own that — because it's going to be a bad Christmas and they earn a third of their money in the fourth quarter every year?"

We'd say, "That's why the stock is selling where it is." And our assumption is that if this is a lousy Christmas, either next year or the year after that, things will recover.

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TWEEDY, BROWNE'S CHRIS BROWNE,
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And I've bought the stock at 5-1/2 times earnings. So doesn't that make sense?

OID: That too will pass — along with the panic.

Chris Browne: Right.

Will Browne: What you hopefully have is perspective. In a quick perusal of history since the Second World War, we've had four fairly significant wars and God knows how many minor wars. We've had six or seven bad or bear stock markets depending upon how you interpret it. We've had an energy crisis, the Cuban Missile Crisis, several banking crises — and I'm not trying to diminish the importance of a lot of bad banks. We've had the tanker loan crisis, we've had the foreign loan crisis and a variety of things.

And I suppose deep down in the depths of our hearts, we have to be optimists that somehow they'll be resolved and that some of the investments we're making today can hopefully in two or three year's time have made us a lot of money given the nature of the business that they're in and the prices we paid.

We're all going to continue to brush our teeth, read newspapers, get up in the morning and wash our clothes. These things will go on, we think.

OID: Sounds awfully optimistic to us. But maybe Saddam Hussein will allow us to do those things.

Spears: About what the market seems to be expecting. However, we assume some continuity of human behavior.

Will Browne: If there's Armageddon, it probably won't matter. In the meantime, stocks have to trade. You can't warehouse stocks. You can't put 'em in the freezer and leave them there. So they change hands.

There are people who say that now is not the time to own stocks. So they sell stocks. And stocks trade — and they simply trade down.

Chris Browne: Saddam Hussein is a perfect example of why market timing can be such a frustrating exercise. To the best of my knowledge, there was no one saying that come some time in the summer of 1990, somebody's going to invade Kuwait and threaten the supply of oil. There are so many extraordinary circumstances that affect stock market and economic activity.

When you look at LBO black books — and we've looked at some of them — they're hysterical. There are companies that probably never made projections beyond two years. They suddenly had ten-year projections. It was the great hockey stick. Earnings had been flat for years, but the day that they bought it, earnings were going to go straight up because they were going to manage the assets better.

Businesses don't even think that far in advance. They may think that far in advance strategically, but they don't have an exact budget of SG&A and sales and profit margins and the rest of it for 1995. That's absurd. So trying to predict what's going to happen in the world is ridiculous.

The fun thing for us though, is that there's always so much overreaction. One of the clearest examples was the Cuban Missile Crisis. Tom Knapp tells the story about missiles steaming towards Cuba, with Kennedy blockading it. And I'm sure it was fairly hairy at the time. But the stock market was plunging.

Some friend of Tom's said, "It doesn't make any sense. The market must be saying that the world is going to come to an end. And God only takes cash. Either the world will have thermonuclear war and I'll be dead and it won't matter anyway or they'll somehow resolve it and the stock market will recover."

And, of course, that's exactly what happened. And that's the mentality we have today. Americans have had 200 years of relative stability. Yes, we've had financial panics. We've had financial crises. The key to weathering every one of them is to not be leveraged so that you can ride through these situations.

The only underlying faith we have to have is that somehow the world will right itself. It's hard to have that opinion when you look at what's going on in Washington today where the jackasses can't figure out how to resolve the budget. One of the Congressmen was quoted as saying that this was the biggest comedy hour in the country right now. It's just crazy. But they'll figure it out somehow.

Spears: It's messy, but compared to the alternatives...

PORTFOLIO REPORTS estimates the following were Tweedy, Browne's largest equity purchases during the quarter ended 9/30/90:

1. AMERICAN CYANAMID
2. WOOLWORTH CORP
3. MULTIMEDIA INC
4. PHH CORP
5. US LIFE CORP
6. K MART CORP
7. MELVILLE CORP
8. GANNETT CO INC
9. WHITMAN CORP
10. MANUFACTURERS NATL CORP
11. AMERICAN EXPRESS CO
12. MCGRAW HILL

OID: Really. We understand that Winston Churchill described democracy as the worst possible form of government — except for all of the others.

Chris Browne: Right now, one of the most serious things affecting the economy is the lack of credit. Someone told me the other day that a contractor couldn't borrow money to build out an office space for a grade A tenant to move into.

Banks are the ultimate lemming in many ways. They go overboard each way. Now you can't borrow any money for anything. And that could have a serious impact on certain segments of the economy. So again, if you aren't hocked up or if the money you're hocked up with is 20-year term with a nice safe coupon, then you're in good shape and you can ride through these periods of lack of liquidity.

Will Browne: And take advantage of the opportunities.

OID: Absolutely. One very successful investor tells us that he looks for sectors where money is not available because that's usually where the bargains are. I guess that logic would bode well for markets in general.

Chris Browne: The other great myth, which is always

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fun, is that the high end never gets hit, that the great stocks will maintain their value and so forth.

Maybe everybody who's running money today was born in 1980. If they go back to 1975, they'd know that New Yorkers were turning in the keys to their apartments. General Foods was selling at four times earnings.

Coca-Cola's business will probably do very well. But the world may decide that 23 isn't the proper P/E. So the stock may not do as well.

Spears: We've begun to hear from pension consultants that the value approach is dead. The less frequent occurrence of takeovers has perhaps made them come to that conclusion.

Obviously, to us, the real value of a business is still the most significant transaction. It's amazing to me that people treat a transaction involving the exchange of 100 shares as a valuation benchmark of great significance.

We still think that multi-million dollar transactions involving 100% of a corporation's outstanding shares are of some significance as compared with those involving 100 or 1,000 shares. You may agree or disagree with their valuation. But it is still a transaction of some significance compared to those involving 100 shares or 1,000 shares, which can occasionally knock prices down 10% or 15% or up 10% or 15%.

Chris Browne: I sort of like the idea of people saying that value is dead and alluding to takeovers, because it tells me that they really don't know what value investing is. Maybe they think it's a takeover lottery ticket and that that's the only way to make money as a value investor.

But part of the reason that some of the value investors underperformed in the last five years was a significant cash component. It was a big drag on performance. Our stocks did a heck of a lot better than the overall portfolio and, in some cases, started to approach the results of the S&P 500. But our results in the '70s were about the same as our results in the '80s.

OID: On an absolute basis.

Chris Browne: That's right. And to my knowledge, we didn't have a rash of junk bond-financed takeovers in the '70s. That's not the only reason a stock goes up. Stocks can go up because people decide it's undervalued.

There are a lot of stocks out there. And the market isn't efficient in valuing securities.

Clark: In the short run. In the long run, it is.

Chris Browne: That's right. Eventually, it will trade around its intrinsic value. An obvious example is Boeing. Boeing's at 15 times earnings because it's got 10 years of aircraft backlog and people think it's great. On the other hand, United Technologies is at 8 times earnings and has a 10-year order backlog of engines to stick on those airplanes. It's not their entire business, but the other parts of their business are equally attractive:

There's Otis Elevator, which is kind of like a razor blade business — you know, we'll give you the elevator for free if we can have the service contract for 50 years. That's a good business. And Carrier Air Conditioner has been a pretty good business.

So to my way of thinking, the market is clearly inefficient. Boeing's at 15 times earnings and United Technologies is at 8 times earnings. They should be roughly comparable.

Spears: In the early '70s, Avon traded at 60 times earnings. In the early 1970s, the growth theory of investing assumed you could pay almost any price for a stock and the price would continue to grow at the level of the earnings growth. If that becomes a very popular theory again, if that's considered a safe way to make money, then it will make things more difficult for people like us looking to buy $100 bills for $50 apiece.

Chris Browne: An example is Wal-Mart, whose stock market capitalization is greater than Sears, K-Mart, J.C. Penney and Emerson Electric combined, despite the fact that these companies are together earning roughly three times more.

And remember, even though Wal-Mart's earnings are growing at over 20% per year, these companies' earnings are growing at something like 5% to 8% per year. In order for Wal-Mart's earnings yield to equal that of these other companies, their earnings have to more than triple.

I'm not sure that even Wal-Mart thinks they can triple their number of outlets. I know they have expansion plans, but I don't know if it's triple. That's a gargantuan thing to have to do.

Will Browne: Wal-Mart is apparently a great company and an extremely well-run corporation, but it's an issue of pricing. Is that a rational way to allocate your assets in the investment business? We conclude that it's not. The issue is how it's valued.

Spears: You can almost bring that back to the idea of performance measurement — a value-oriented investment approach versus an index. There is no assurance that the retailer that we buy at 5 times earnings is going to perform in the stock market better than Wal-Mart in the future. But we think that from the standpoint of managing real money, it just makes a heck of a lot more sense to be in a very, very undervalued investment.

OID: It's clear you care more about intrinsic value, earnings and assets than management because one of your biggest purchases was American Express.

Chris Browne: That's a great example. If you look at American Express' travel-related services business and IDS — which are their real jewels — and if you forget about their biggest problem, which is Shearson...

OID: I'm sure they'd like to forget about Shearson.

Chris Browne: And if it were us, we would. We'd say enough, go. But it's got their blue box on it so they're not going to do that. They'll figure their way out of it.

Spears: Give it to Primerica.

OID: With a dowry.

Chris Browne: At the current price, you're buying those businesses for about 7 times after-tax earnings. That's only 5 to 5-1/2 times pre-tax earnings. And it's had 18 years of uninterrupted growth in the mid-teens.

OID: That really is amazing.

Chris Browne: You almost don't have to do a private market valuation with numbers like that. But if you looked

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at the P/Es that other similar businesses with that kind of record have sold for, you'd see that they're off the chart.

But don't get me wrong. I don't presume that American Express will be taken over. But the market can certainly realize that this is sort of stupid and move it up.

Clark: Their capital allocation has been less than perfect.

Chris Browne: If we only had a Tom Murphy running American Express, we'd have an $80 stock.

OID: What is it currently?

Clark: It's at $20-1/2, down from $40.

Chris Browne: American Express got caught up in the old financial supermarket concept of buying all these businesses and putting them together. We kept hoping that they'd knock on our door. We were ready, willing and able to go at 20 times earnings.

They could charge it. And we might even negotiate it down to 18.

OID: We could never understand the arguments about achieving incredible synergies.

Chris Brown: You and me both. Despite some bad decisions, you've still got this business. That's the beauty of a good business.

Clark: The management of their travel-related services is very good.

Spears: Management of their information services business and IDS seem to be doing a very good job.

Chris Browne: It's sort of like Warren [Buffett]'s observation that given his choice between a good business or a good management, he'll take the good business any day.

OID: I believe he also observed a couple of years ago that he wishes he'd bought more good businesses with bad managements.

Do you remember your cost on American Express?

Clark: We paid as much as $28 and as little as $20.

OID: Portfolio Reports shows a real "Who's Who" of investors buying American Express — including GEICO, First Manhattan, Legg Mason, and Templeton.

Chris Browne: American Express was a great buy at $28. It's a greater buy at $20.

OID: Noel tells us that the travel services businesses are excellent, that they're dominant worldwide and that they have lots of growth ahead.

Chris Browne: True. Just one example, if you go on a business trip and you don't know how much entertaining you may wind up doing and you pull out that old card, you don't have to worry about running into a limit. We use the green ones because they seem to work just as well.

Citicorp has these great ads about someone needing to have an extra $300 for a personal emergency and they call up Citicorp and request the added credit limit. You don't have to do that with American Express.

Clark: It seems to be the only international card without a credit limit. The others all have credit limits.

OID: The 7 times after-tax earnings is for what?

Spears: Everything excluding Shearson. You get the travel-related services, information services, IDS and the American Express Bank.

OID: Mostly terrific businesses, too.

Clark: Except the bank.

Spears: The travel-related services business' return on equity is about 29%. On its tangible capital, IDS earns 44% pre-tax. They have some wonderful businesses.

OID: And you're not worried about them taking the capital and flushing it?

Will Browne: That's been the worry all along.

Chris Browne: Of course, we are. But we hope they've learned a lesson — at least for awhile.

OID: Any other bargains you could tell us about?

Chris Browne: They're all over the spectrum. One is Kent Financial. It's a great one. It's a little company — approximately 6.9 million shares outstanding and the stock is trading around $7/8s — so you can't buy much of it.

OID: Let's leave our financial condition out of this.

Chris Browne: Sorry. You may remember it as the old Texas American Energy — which they sold off. It's now a pile of cash. They have a book value of $3 a share, of which all but 15¢ is cash.

OID: Wow.

Chris Browne: It's run by Paul Koether who is sort of a value investor. He bought control of it. He owns 38% or so. And he's buying more.

I don't know what he'll do with it. But for 30¢ on the dollar, Kent Financial is a savings account with somebody who's not an idiot running it. It's your classic cheap stock.

OID: But why is it selling at 70% off?

Chris Browne: I think one of the reasons is that he changed the name so that people couldn't keep up with it, but that he could keep buying it up. He doesn't want anybody else to buy it. He wants to buy it himself.

OID: So the company's obviously not repurchasing its own shares?

Chris Browne: You've got it. If you took your savings account, broke it up into shares of stock and saw they were selling at 30% of their value, you might not want to let that get out either.

OID: I might even change the name occasionally, too.

Chris Browne: It's amazing. If you hit the old symbol, it says "symbol not found". Most people probably figure that it's disappeared.

OID: Shareholder relations in reverse. Thank you for sharing that little tidbit.

Some investors have told us that there's so much fear and disgust surrounding financial stocks today that some are terrific bargains. Are you finding other bargains in that area besides American Express and

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Kent Financial?

Will Browne: I think everybody reading your publication has found a few. It's a classic example of throwing the baby out with the bath water. There are, we think, very solid investments in the banking area.

I don't know how low they'll go. But for example, we've owned Manufacturer's National for some time. Our original cost in some portfolios was $20 a share. And we're currently buying it for accounts that don't have it at about $38 a share.

It has a book value of $48. With earnings of $7 to $7.50 a share, it has an earnings multiple of 5. In other words, we're getting a 20% earnings yield. It pays a 6% dividend yield. Its reserves exceed its non-performing assets. About 1-1/2% of its portfolio is nonperforming. And that includes other real estate owned. They have about a 1.9% to 2% loan loss reserve. They have a very strong capital base. They have 140 branches. They have not made and do not have a lot of real estate construction loans.

It's based in the Midwest. The Midwest has not had the real estate excesses that you've had in other parts of the country. We sometimes joke that the definition of a real estate boom in the Midwest was to have less demolition.

One of the Taubmans owns in excess of 5% and sits on the board. So we think we have some good owner-type thinking on the board. And we're getting a 20% earnings yield on it while we wait.

Spears: And similar banks have traded at 15 times earnings in acquisitions.

Will Browne: And earnings have grown, so you're getting a buildup in value. It's not a stagnant investment.

OID: How well managed are they?

Chris Browne: Considering their record and the fact that they don't have a bunch of lesser developed country loans and real estate construction loans, pretty good.

Clark: They're conservatively managed.

Spears: They've avoided the fads.

Chris Browne: It's an industry where you don't generally attract geniuses because there isn't much you can do other than take in money and loan it out. So the key is not to pay too much for the money you take in and not to lend it to people who can't pay you back.

Will Browne: When you ask how well managed are they, we look at their record — what they've done and not done — relative to other people in the industry. What other people have done to put themselves into big problems, they haven't done.

OID: Staying out of harm's way.

Chris Browne: That's right. If you do that, you'll make a decent spread. They make a very nice return on equity for their stockholders. On that basis, it's pretty well managed. They have an awfully nice return on their assets.

OID: Over 1%, which is no small feat in banking.

Will Browne: On the other hand, I don't know that you can create a Cap Cities in the banking industry. They're in a commodity business lending money — trading money. The characteristics aren't there. Within their industry, I think they've done a pretty good job.

Chris Browne: Actually, if you see a bank growing like a Cap Cities, you should probably short it. Invariably, any great growth financial services company in the banking sector usually winds up running into a stone wall.

Jim Clark: Look at the S&Ls. They were all growing, at least in deposits, rather rapidly.

OID: After watching our Allied Bancshares sink into the sunset, we know what you mean only too well. Any other bargains you can tell us about?

Spears: We've recently been buying some shares of U.S. Life Corporation which is listed on the New York Stock Exchange. The price is $28 a share. Tangible book is $54. It's earning about $4.30. So it's selling at 6-1/2 times earnings and at half of its book value.

OID: Sounds cheap all right.

Spears: And it gets better. We had an actuary examine the company's convention statements. He estimated that their true value on a liquidation basis considering their assets and life insurance in force was about $60 a share.

They have a dividend of $1.48 — so their yield is 5.3%. And they're buying in their own stock. They have 15.9 million shares outstanding. That's after having bought in 8.7 million shares over the last few years at an average price of $31 a share.

OID: So they've bought in over a third of their shares at levels above the current stock price.

Will Browne: Virtually no junk bonds.

Spears: That's right. Junk bonds are a small portion of the total investment portfolio and add up to only about 19% of net worth.

Chris Browne: And that's the key — percentage of net worth. It's silly when Travelers says that nonperforming assets are only a certain percentage of total assets when total assets are 20 times equity.

OID: Exactly why a bank is always potential leveraged disaster.

Will Browne: That's right. At 5% non-performing, there goes all the equity.

Chris Browne: U.S. Life doesn't have a real estate component of any significance either, I think.

Spears: At U.S. Life, mortgages are 48% of net worth. In contrast, Traveler's mortgages are 8 times net worth.

Chris Browne: Travelers has 16 times the real estate exposure.

Spears: And shareholder's equity at U.S. Life is 21% of the company's total assets. By comparison, at Travelers, equity is 5% of total assets.

OID: So they're better capitalized and less exposed to risky asset areas.

Spears: Exactly. It's also encouraging that two officers have been buying stock. In May, U.S. Life's CEO, Gordon Crosby, bought 1,000 shares at $39.50. Then, in September, Richard Chouinard, their senior investment officer, bought 2,000 shares at $29 to $30.50.

In addition, the controlling interest in the company

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trades in the marketplace. The officers and directors own less than 5% of the outstanding shares — so that every share we own has possible takeover value.

Chris Browne: If they bought in all of their stock at the current market price except for one share, not only would the one share have an infinite rate of return, but they would still have a better equity-to-assets ratio than Travelers.

OID: Amazing. But is that like saying they have a higher net worth than us? Is Travelers way under industry averages, are these guys way over or both?

Spears: Travelers is somewhat under, but these guys are way over.

Chris Browne: In a rising market, Travelers is going to produce much higher earnings. That's why U.S. Life's earnings on book are not so great. But it's not leveraged. In fact, it's very under-leveraged.

OID: How would you rate U.S. Life's management?

Spears: You could say that they've managed in a contrarian fashion within the life insurance industry. For example, they don't have junk bonds equal to 5 times their net worth. Their mortgage loan exposure is very small in relationship to capital.

Will Browne: And it hasn't grown significantly in the past year or two.

Chris Browne: U.S. Life would probably be considered a much better managed company if they took capital out of the business by making a $20 special dividend. They'd have a higher return on capital and people would think that it's a better business.

OID: It looks like earnings have been pretty flat for a long time, with earnings growth of 3% or 4% a year for the last 10 years — a real yawner, but an earnings yield of 16-1/2%.

We noticed that you've also been a buyer of Franklin Resources. What's your rationale there?

Spears: Franklin Resources, as you know, is a manager of mutual funds, with 90% of their roughly $40 billion in assets under management in fixed income and money market mutual funds.

That business has the wonderful high return on capital characteristics that Buffett looks for. It's the kind of business where people have actually gotten rich just by owning the business, not by buying it at a discount from its true value.

OID: And you guys should certainly know.

Spears: We're certainly comfortable with the business. All of their income really is free cash — cash you can put in your pocket or that you can use to make acquisitions — because to generate earnings increases requires almost no capital investment. If they get another $100 million of assets under management at a 50 basis point fee, their income goes up by $500,000. But they don't have to invest much additional money in receivables, inventory or in property, plant and equipment.

So given the same earnings growth, shareholders enjoy higher returns at the same P/E than if you bought shares in a hardware store company earning 10% on capital, for example. If a hardware store company's sales go up 10%, they may need 10% more capital employed in inventory, account receivables and so forth. So, at a P/E ratio of 10, the 10% earnings yield for the hardware store isn't represented by cash.

Other things being equal, if you have two companies both selling at 10 times earnings, one with a very, very high return on capital and the other one with a so-so return on capital, the high return company that requires no reinvestment to have the growth in earnings will pay you twice. You'll get your earnings yield in cash plus the growth in the value of the business.

OID: It sounds like your classic, excellent business.

Spears: Exactly.

OID: Only this is a growth stock, isn't it? And I didn't know you guys bought growth stocks.

Chris Browne: As long as we don't have to pay for it. And at the current price, we don't think we're paying for it.

OID: Tell us about their fundamentals.

Spears: Their current stock price is $28. We've paid between $17 and $25.50. It's earning between $2.40 and $2.60. Its stated book is $6.92. But that's all cash.

Clark: And they don't seem to compete with Dreyfus and Fidelity.

OID: Why is that — because they're in their own little distribution channel that they dominate?

Spears: I think that's correct. They sell their funds both through ads in the *Wall Street Journal* and the *New York Times* and through brokerage firms.

Clark: But primarily brokerage firms, isn't it?

Spears: Yes, but the ads feed the whole process.

Clark: Also, they give the brokerage firm that sells them a portion of the management fees. They may give them 10 basis points.

John Spears: There's a continuing annuity.

OID: And Fidelity and Dreyfus don't do that?

Clark: No. They're direct sale only.

Spears: Evidently, switching between mutual fund groups involves a lot of paperwork. There's inconvenience involved. So their redemption levels are very low.

Will Browne: And again, because they're primarily money market and bond funds and not equity-oriented, they don't have to worry about panic redemptions as much.

There have been some acquisitions in the money management business. And the last acquisition in the money management business that we noticed was in 1989. Trans-America bought Criterion Group for about 12 times operating income. If you assume a similar valuation for Franklin Resources, you come up with a $40 to $45 value.

OID: Any other bargains?

Clark: One we've been buying recently is PHH Corp. They do fleet management and relocation services. It's had a terrific long-term record. I think they've had only one year in 44 in which continuing operations have been down. And

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this year, continuing operations are going to be down — probably in both segments.

Spears: The reason their auto fleet management segment is down is that people are pulling in their horns a little and keeping their cars for four years instead of three. But really, you can look at that as a deferred revenue because PHH makes quite a bit of money on the initial sale. And to the extent that the fleet is aging longer, they'll simply make that money back when it's reversed. It isn't as if they've lost the sale forever.

In the relocation services segment, earnings will be down because companies are relocating less. But they don't really take a risk on the real estate that they buy. They just may make less money on a fee basis if the price of real estate declines during the time in which they hold it.

It's down from a high of $37. At 7 times earnings, a 6% dividend yield and less than book, we're buying what's historically been a very, very good growth company.

Chris Browne: And it's a very liquid book.

Clark: And it's also a very good cash generator.

OID: I'll say. Value Line shows free cash flow of over 10% in 1991, increasing to more than 20% in 1993-95.

Clark: That's because it has no plant and equipment. It's kind of like an advertising agency — with leaseholds and desks.

OID: What then does the book consist of?

Clark: Basically, the book consists of homes and automobiles that they've purchased on behalf of their clients, where they're not at risk for the ultimate sales price on either property. In a sense, they're acting as a financial intermediary for their clients. So the book is basically cash and an inventory of homes and cars for which there's no risk to them.

Chris Browne: It looks like it's leveraged. You see a lot of debt there. But it isn't leveraged because they've got a guarantee from the likes of IBM.

Clark: It's basically a finance company with a very diversified group of clients — generally Fortune 500s. They're not at risk. They just manage that pool of assets. And over time, they've been pretty good at it.

They've ventured into new areas occasionally. And they've not worked out.

OID: Peter Lynch calls it de"worse"ification.

Clark: We couldn't say it better. But they're selling off their interior design and construction division.

It's having a bad year. It may even have a bad year next year. But it's below book value, at 7 times earnings and has a 6% dividend yield.

OID: And you can live with that.

Clark: We can live with it very easily.

Chris Browne: There's a rationale, I think, that given their position and their industry, they should continue to have growth. The market has gotten to the point where it's very unforgiving of flat to slightly down earnings.

OID: A mild understatement.

Chris Browne: True. But it's one thing if a stock's at 30 times earnings. Maybe it shouldn't have a flat quarter or a flat year. But at 7 times earnings, give me a break. You can have a flat quarter or a flat year.

Clark: Or even a down year.

Chris Browne: Exactly.

OID: It's 1973 all over again. Noel said the same thing about Wells Fargo last issue. If earnings remain flat, he expects their P/E ratio to expand from 3-1/2 times earnings to 6 or 7 times earnings.

Will Browne: And we're seeing the same phenomenon in retailing stocks. Investors anticipate a weak Christmas. They know that many retailers earn most of their profits during the Christmas season. So they're dumping them.

OID: Surely investors are capable of looking beyond this Christmas.

Will Browne: You'd think so. But we had three retail analysts up here to give us background on some retailers. Each one named three stocks we should own — Wal-Mart, Toys R Us and Home Depot. That was it.

It's the only place where each felt that investors in retail stocks should have their money. Those were the ones that were really going to make you your money.

Chris Browne: Every trend goes on forever — until it changes.

OID: Great saying.

Will Browne: Maybe those are the best businesses in the industry. But they're not monopolies. And they're priced like they are.

OID: So they're not bargains. But which ones are?

Clark: K-Mart is a good contrast to the Wal-Mart story because in many ways they're direct competitors.

Will Browne: K-Mart is a business and a stock that everybody hates. You can't find a kind word to be said about these people. They're generally thought of as being right behind Sears in terms of disappearing — with Wal-Mart driving them out of business everywhere.

We don't believe that will happen. We think there's more chance for something good to develop in people's view of that business than in terms of further negatives.

K-Mart is now selling below book value. It's got almost a 7% yield. It's trading at about 7 times earnings. We see $4 to $4.50 in earnings from this company in the not-too-distant future unless retailing is dead. And the stock is currently at $25 to $26.

Chris Browne: And while it's not as well positioned as Wal-Mart, it's certainly better positioned than Sears.

Will Browne: There's no comparison.

OID: Does that qualify as saying something nice?

Chris Browne: They're spending money to change their inventory mix and upgrade their stores. And they have the ability to do that.

They'll be a decent earner. And again, if I have the alternative of owning a Treasury Bill earning 9% or K-Mart stock at 13%, I'd rather own the K-Mart stock.

I don't know how I'll make my money in it. But if I buy a whole bunch of stocks with earnings yields significantly

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greater than Treasury Bill yields, I'll make money.

OID: Less good has to happen, more bad can happen and you can still make money.

Chris Browne: Exactly.

Spears: And we'll have anywhere from 30 to 70 different K-Mart-type bets. We don't know that K-Mart will work out. But if we have a diversified portfolio full of stocks with the value characteristics that K-Mart has, we believe that we've got a very good chance of making money.

OID: Are there any others firmly in the bargain camp?

Chris Browne: Another one is Syms. You know his motto: If it doesn't sell in 3 hours, we reduce the price. If it doesn't sell then, we pay you to take it away.

And it has a franchise name. Everybody knows the name "Syms". It's simple. They've invested lots of money in it. Sy Syms is to discount clothing what Frank Perdue is to chickens. Everybody knows his and/or his daughter's face.

Spears: There are 17.6 million shares outstanding. It trades on the New York Stock Exchange at $7. Syms' family owns 80% of the company. Earnings have been steadily growing. For example, their earnings even increased in '82.

We spoke to them recently. And despite the slowdown in the New York economy, their stores in this area are doing just fine.

OID: Because people are looking for bargains and are trading down to save money?

Chris Browne: It's easy to walk past Paul Stuart where the average suit's $1,000 and go to Syms where it may be $150 if you're worried about how much disposable income you're going to have next month.

OID: What's their niche?

Spears: They have a programmed price discounting system. If they don't sell a dress within 10 days, they mark it down a certain percentage. Then if it doesn't sell in the next 5 days, they mark it down again.

Chris Browne: They buy overruns and closeouts — brand name merchandise usually.

Clark: I went to one that used to be downtown when our offices were located there and walked through it. It just seemed to be pipe rack clothing — just racks and racks and racks of clothes with big sale tags on them.

Spears: Low overhead. They have 25 stores, of which 13 are owned. And they own their own distribution center.

OID: When you say they own their stores, you're referring to the real estate?

Spears: That's right. They own the real estate in total.

Chris Browne: It gives them a lower return on capital, but a higher asset value.

Spears: Most retailers, of course, lease their stores. Stated book value is $8.08 a share. Total debt is 73¢ per share. So it's not a leveraged company.

Chris Browne: And that's just financing some inventory bulges.

Spears: That's right. The debt fluctuates with his opportunistic purchases of closeouts.

Chris Browne: His inventories may not be as steady as most retailers because he has to be so opportunistic and act when there's a block of inventory available.

OID: So times like these might not be bad for him. It might offer him an opportunity to buy cheap inventory.

Spears: Correct. And maybe some cheap real estate. He seems to buy his sites opportunistically, as well.

OID: Even better. Tell us about Syms' fundamentals.

Spears: They're earning $1.09. So it's selling for 6.4 times earning. It's selling for 86% of book value.

It's had steady after-tax profit increases. Profits went from $5 million in 1980 to $19 million in 1989 and did increase during the 1982 recession year.

They have 25 stores today and plan to open 3 to 5 stores a year, depending on opportunities. They say that their stores generate profits very quickly.

Chris Browne: Sy Syms and his daughter, Marcy, own 80% of it. And with it selling at a discount to book value at roughly 6 times earnings, it makes no sense for them to be a public company. The reason to be a public company for a control shareholder is to be able to raise cash at a premium — or at least what the business is worth, not to have an understated value. There's absolutely no point.

It'd be very easy for them to pay the public a fair price and go private.

OID: It just sounds incredibly inexpensive.

Spears: This kind of business could be worth 15 to 20 times earnings.

Will Browne: At this point they'd have to do a 250,000 for 1 reverse stock split to freeze us out as a fractional shareholder — which happens sometimes in these situations.

OID: Are there any real negatives here? It basically sounds too good to be true.

Will Browne: I suppose if the economy deteriorates beyond anyone's expectations, maybe Syms' earnings get hurt. But Sym's won't go out of business. And down the road, Syms will probably be back.

OID: Probably owning a lot more than it did before.

Chris Browne: Exactly. It's just about the only unleveraged retailer in New York. We've LBOed our department stores. Except for Lord and Taylor, I think, it's the only un-LBOed department store in New York.

As a result, they'll be one of the few retailers left with dry powder if things get really hairy.

OID: At a little over 6 times earnings, it's hard to argue with Syms.

Spears: Our thoughts exactly.

[Editor's note: Next issue, we'll bring you the second and final installment of our interview with the general partners of Tweedy, Browne.]

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