Outstanding Investor Digest

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

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CUNDILL VALUE & CUNDILL SECURITY FUNDS' PETER CUNDILL & TIM McELVAINE
"MANY HAVE BEEN RESTORED THAT WERE FALLEN AND MANY SHALL FALL THAT ARE NOW IN HONOR."

During the 21 years Peter Cundill has been at its helm, Cundill Value Fund shareholders have enjoyed a compound annual return of 18.6% after all fees and expenses vs. 15.6% for the S&P 500 and 12.7% for the TSE 300.

As we told you in 1992, Cundill has lagged both indices for a calendar year or more only rarely — with payback in those few instances swift and sweet. Sure enough, his total return for '93 and '94 was double and quadruple that of

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BERKSHIRE HATHAWAY'S WARREN BUFFETT & CHARLIE MUNGER
"IF THE BUSINESS AND THE MANAGER ARE RIGHT, YOU SHOULD PROBABLY *FORGET* THE QUOTE."

Anyone investing $10,000 in Buffett Partnership at its inception in 1956, reinvesting the cash distribution at its termination in 1969 into shares of Berkshire Hathaway and doing absolutely nothing else would today own shares worth a hard-to-believe $125 million *after all fees and expenses.* Incredibly, the investor would have incurred only about $54,000 in income taxes during the entire 39-year period.

And, believe it or not, before fees, that $10,000 actually

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MARSHFIELD ASSOCIATES' SAM MITCHELL & CHRIS NIEMCZEWSKI
"AS CLOSED-END FUNDS, THESE WOULD BE COMPELLING. BUT THEY'RE *BETTER* — THEY CAN BUY *AND* BUILD...."

Accounts of Sam Mitchell and Chris Niemczewski were reportedly the model of consistency for the 6-1/2 years before they established Marshfield in 1989. But they've done even better in the six calendar years since — outpacing the S&P 500 in five of those years and outperforming it by 2.3% per year compounded for the full six. Also, they've yet to suffer their first down year and seem to have kept the knack of doing their best work in weaker markets.

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WESCO FINANCIAL'S CHARLIE MUNGER
"WHEN WE ARE FINDING LOTS OF OPPORTUNITY, I DON'T THINK ANY OF YOU WILL LIKE IT."

Best known as Buffett's long-time sounding board and confidant, Charlie Munger is also an accomplished investor in his own right. Starting his own investment partnership with Buffett's encouragement, Munger virtually quadrupled the return of the S&P 500 during its life — with a compound return of 19.8% per year before fees and expenses.

Buffett credits Charlie's mind as the powerful force that

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the S&P 500 and TSE 300, respectively — 65% during that two-year period vs. 11% and 32% for those two indices.

Anyone believing (or hoping) that history repeats itself may be interested to learn that Cundill lagged both indices in 1995. Here are Cundill's year-by-year return figures alongside those of the S&P 500 and the TSE Composite. (Performance figures for Cundill Value Fund were provided by Peter Cundill and Associates.)

Period	Cundill Value Fund	S&P 500	TSE 300
1975	+32.2%	+37.2%	+18.5%
1976	+31.5	+23.8	+11.0
1977	+21.1	- 7.2	+10.7
1978	+41.6	+ 6.6	+29.7
1979	+30.1	+18.4	+44.8
1980	+15.9	+32.4	+30.1
1981	+18.8	- 4.9	-10.3
1982	+25.6	+21.4	+ 5.5
1983	+44.1	+22.5	+35.5
1984	+ 6.0	+ 6.3	- 2.4
1985	+22.5	+32.2	+25.1
1986	+ 6.8	+18.5	+ 9.0
1987	+12.9	+ 5.2	+ 5.9
1988	+19.1	+16.8	+11.1
1989	+10.1	+31.5	+21.4
1990	- 9.5	- 3.2	-14.8
1991	+ 5.4	+30.5	+12.0
1992	+ 7.2	+ 7.7	- 1.4
1993	+43.1	+10.0	+32.5
1994	+15.4	+ 1.3	- 0.2
1995	+ 8.2	+37.4	+14.5
1975-95	+18.6%	+15.6%	+12.7%

A perhaps related subplot is his use of futures and put options. In 1992 and 1993, he was short the Nikkei. And his largest exposure on the long side to any country was to the U.S. In contrast, today, he tells us he's *short* the U.S. And his largest exposure at year end was Japan.

For all those reasons and more, we're particularly pleased to bring you excerpts from comments by Cundill and associate Tim McElvaine at the latest annual meeting of Cundill Value Fund and Cundill Security Fund which took place May 7th in Toronto plus conversations with both which took place between July 10th and August 8th. We hope you find their bird's-eye global view and sampling of current bargains as fascinating and valuable as we do.

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MY FATHER THOUGHT INVESTING WAS GAMBLING.
BUT THE WAY *WE* DO IT, IT'S QUITE THE *REVERSE*.

Having a trade helped, but not like my father thought....

Peter Cundill: This is an historic occasion because this meeting is being held on the floor of the Toronto Stock Exchange. And my father was a floor trader on the Montreal and Canadian stock exchanges over a 40-year period — which I think was a record at the time and may still be....

But, in any case, when I was a young man, he encouraged me to become a chartered accountant because, he said, "If you're a gambler like I am, you'll need a trade to be able to fall back on if you blow it in the stock market."

I'd think that the accountancy training was very useful in helping establish the kind of investing that we do which, I would argue, is the *antithesis* of gambling — and, in fact, is low risk....

Screening 20,000 ideas a month helps. But even better....

Cundill: We're up to a six-man research department. I'm a floater. Tim [McElvaine] is in Kingston for the most part. The other four are in Vancouver. We screen approximately 20,000 securities on a monthly basis looking to see what might meet our tests as statistical bargains.

And I imagine that [process] probably gives us a third of our ideas. The other two-thirds come from what has been the global networks that have been developed for me by wandering around for what is now 22 years. And about 75% of our holdings are usually in about 30 names.

We try not to lose. But we don't want to try *too* hard....

Cundill: In our 22-year tenure, we've had one loss. The losses, of course, work against you in establishing decent compound rates of return. And I hope we won't have them. But I don't want to be so risk averse that we are always trying too hard not to lose.

In any case, our methodology should be able to generate consistent rates of return over longer time periods.

MANY HAVE BEEN RESTORED THAT WERE FALLEN
AND MANY SHALL FALL THAT ARE NOW IN HONOR.

Valuations forced us to reduce our U.S. exposure....

Cundill: What we try to do in its most simplistic form is buy a dollar bill for 50¢ in whatever form that dollar bill takes. We tend to seek out — or, perhaps, they're presented to us is the better word — unrecognized, misunderstood and out-of-fashion securities.

We have been doing it on a global basis since our beginnings. But in 1980, 68% of our assets were invested in the U.S., whereas at the end of '95, that figure was down to 12%....

Last year ... was a year of repositioning. The U.S. has almost always been our largest market. But during 1995, valuations in the U.S. became much higher than in the rest of the world. And by year end, we were invested 16% in Japan, 12% in the U.S. — and [the remainder] in Canada, France, Germany and some other countries.

As you know, the Cundill Security Fund, in order to qualify for RRSP purposes, must stay 80% in Canada, but

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it has participation in a number of other countries, too.

We've managed to benefit both ways in Japan.

Cundill: You may recall that we had been short the Nikkei 225 in Japan from 1987 — which served us well for a very brief period during the market crash. However, thereafter, every 90 days, I'd come out into the ring and the Japanese market would knock us down — or *me* down anyway — for an eight count.

But by a combination of patience and obstinacy, we held on. And during the first quarter of 1990, we made up in 90 days all of the accumulated losses we had plus some.

We were essentially short the Japanese market — because the valuations were extreme — until early 1995. And at that time, the Japanese market was around ¥15,000 and the yen was 84 to the U.S. dollar. Fuji Photo, which is a large and important Japanese company, as you all know, was trading below net net working capital, below book value and at five times cash flow. So we moved our assets — basically covered the short position — and went into Japan. We also hedged the yen against the Canadian dollar. And that has been a very satisfactory investment route to follow.

We continue to see substantial risk in the U.S. today....

Cundill: One area that has *not* worked yet — and when you get into overvalued situations, you have to be just as patient as you do on the undervalued side — is the U.S. where even in 1995, we felt that the valuations were getting very high. There's an old investment saying — which I think is a good one: "Valuation defines level of risk. It doesn't help with timing."

And we were penalized last year... [for that reason]. But we continue to believe that there is substantial risk in the U.S. and are proceeding accordingly....

COUNTRIES CAN HAVE MANY VIRTUES,
BUT NONE MORE THAN RIOTS, OF COURSE.

When we saw fire bombs and strikes, we couldn't resist....

Cundill: Also, near the end of the year, we began to see TV accounts of people in France throwing fire bombs and striking and so forth. And that's usually a good time — although, of course, it's not always — to buy securities. As John Templeton points out, you really have to go to the points of maximum pessimism. And so we *did.*

And, thus, our largest holding is Paribas.

Tim McElvaine: Paribas' NAV is easily over 400 francs. It probably exceeds 500 francs. Management feels that they can earn a 10% return on that NAV — which suggests future earnings of about 50 francs a share. Its stock is down significantly from its high. When we started to acquire it, it was 250 francs. And that's the average cost in the Cundill Value Fund.

It's our largest position in the Cundill Value Fund — I'm using April 30th figures — at about 6% of the assets. So at 250 francs, we were paying 60% of NAV and 5 times potential earnings. And no brokerage reports were saying, "Buy Paribas." And that made us feel kind of good.

We still feel very confident in the position. And there were developments today that make it look even better.

Japanese insurers at 40% of NAV vs. 150% in the U.S.

McElvaine: Peter mentioned our activities in Japan. We have a number of holdings in Japan that make up a large part of the portfolio. A couple names you would know are MEI [Matsushita Electric Industrial Company] and Hitachi. Both are industrial concerns that are trading well below net asset value. Koa Fire and Marine is a property and casualty company that trades for about 40% of net asset value — and it's *making* money — compared to U.S. insurers which generally trade at 150% of NAV.

We remain cautiously optimistic about Semi-Tech Global.

McElvaine: And then there's Semi-Tech Global — which is related to Semi-Tech Corp., but is not the same thing. It's really a quasi-Japanese holding company. Semi-Tech Corp. owns companies such as Sansui, Akai and Pfaff and is related to the Singer Sewing Machine Group. Once again, it's cash and securities at a discount. And we remain cautiously optimistic about its future....

WE'LL BUY ANYTHING AT A PRICE —
OIL & GAS, RETAILERS, EVEN NEWSPAPERS.

We'll buy anything at a price — even retailers.

McElvaine: One of the things Cundill Security Fund's done is retailers. Retailing's a tough, tough, tough business. Warren Buffett said, "In some businesses, you have to be smart *once.* In retailing, you have to be smart every *day* — every *second.*" And that means it's a tough business to invest in.

However, the sentiment was so, so negative in the Canadian retailers that we found that the prices outweighed that to some extent. And we bought a number of retailers. Our largest position in Cundill Security Fund, in fact, is in a retailer — Dylex. And in spite of everything you might have seen in the newspaper, we actually own it at a profit. So we'll see how that goes from here.

An oil & gas business at a discount & a retailer for free....

McElvaine: Peter asked me to mention Gendis — which is another holding in Cundill Value Fund. Canadian retailers aren't the most popular things today in the investment world. And Gendis kind of fell into the category of not really being a retailer, but being a *big* retailer.

It has a number of holdings. It has a holding in Chauvco Resources that's worth roughly C$12 a share. It has about a C$800 million retail business — admittedly not the best business in the world, but 800 million bucks worth of sales is 800 million bucks. And the stock trades at C$10 a share. So we figure we're getting the oil and gas company at a discount and we're picking up the retail business for free.

Believe it or not, we even own some *good* businesses....

McElvaine: Another group we have some holdings in is the newspaper group. That seems a little bit odd for a value investor. But we believe that our cost is below what their properties would sell for in an orderly sale. We own

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shares in Southam and Hollinger.

ON JULY 1ST, 1997, HONG KONG REVERTS TO CHINA — AND NEITHER OF THEM WILL BE THE SAME.

We're doing more selling than buying — maybe a *lot* more.

Cundill: In the first quarter, we've probably sold more things (and if you take The Telegraph — which isn't sold yet, but is something that awaits disposition — then we've sold a *lot* more) than we've bought. We've rolled over a number of our [short] positions in the S&P futures. And our cash positions are up by not a lot, but up by some.

So we continue to screen. And there are *some* things to do, but not a huge amount.

On July 1st, 1997, Hong Kong becomes part of China.

Cundill: I did a two-week trip to Japan. I'm going twice a year now because we have a lot of our assets there. And then I went to Seoul in South Korea, Singapore and Hong Kong — which is old hunting grounds for me.

So perhaps I should comment for a second on how I see Hong Kong and its relationship with the People's Republic of China (the PRC) — because Hong Kong becomes part of China in [only about a] year....

What will happen? I think reporting standards, corporate governance and how they do business in China will get *better.* But I suspect corporate governance, accounting and the way one does business in Hong Kong will get a little bit *worse.* But the reality is that on July 1, 1997, Hong Kong becomes a Chinese city. And, as a result, there's a great deal of underlying tension in Hong Kong regarding what will happen.

Two beneficiaries: Singapore and Canada....

Cundill: There have been, and will continue to be, two beneficiaries: One is Singapore and the other is Canada. Although Vancouver is very clearly becoming an Asian city, I think in terms of absolute numbers, at least, the Chinese community in Toronto is even larger.

Interestingly, we probably are having a stronger look at securities in the People's Republic of China than we are in Hong Kong. David Briggs, who was with Nikko Securities and who helped us in doing undervalued securities in Japan and who understands our methodology, has joined us. He has the Asian brief. And he's doing a very good job searching out opportunities for us [there]....

THE 1987 MARKET WAS DRIVEN BY GREED. THIS ONE SEEMS DRIVEN BY MINDLESSNESS.

The 1987 market was speculative; this one is mindless....

Cundill: Returning to a theme, we're outside the U.S. today. And I wrote a note for our internal use which I call "The Almost Definitive Memo on our Short Positions."

I said, "U.S. valuations are moving towards extremes. Overoptimism in early 1987 was speculative greed. This market's dominated by" — although it's an oxymoron — "reckless responsibility." It's a kind of mindless belief that markets will continue upwards in an unbroken stream. However, if you were around in '73 and '74, then you still have a long memory of how that can change.

Also, today's bubble is primarily a *U.S.* phenomenon.

Cundill: But it *is* different from 1987. [At that time, there was] *global* overvaluation. Today, by contrast, valuations ex the U.S. are modest in many cases — like Paribas in France. And there are things to do in almost all jurisdictions — including Canada.

And continuing the excerpt from my memo, "Therefore, buy non-U.S. securities and maintain the short positions in the United States."

But cheaper prices won't protect non-U.S. markets....

Cundill: "But U.S. capital in the form of mutual funds and pension funds dominate global equity markets. So in the event of a severe market sell-off in the U.S., all markets would crack."

I don't think that there's going to be a severe crash or anything like that. However, particularly in the U.S., I think there's an increasing chance that you will have a turndown sometime next year — perhaps even sooner.

The particulars are different, but the prescription's not....

Cundill: On the other hand, I will finish off on the line that I have over the years by saying: "Probably in *all* forms of investing, but particularly in the kind of value investing *we* do, [you need] patience, patience and *more* patience."

WHY DON'T WE BUY IPOS? BECAUSE THEY'RE DREAMS AND WE DEAL TO A CERTAIN EXTENT IN NIGHTMARES.

We've never seen an IPO priced on a Graham formula.

Shareholder: There's an incredible number of IPOs going on worldwide. Does your Ben Graham strategy preclude those because they're all overvalued? Or are there good IPOs in the Cundill-Graham concept?

Cundill: Not usually. Remember that IPOs are usually being hyped. And I don't think ... we've ever seen an IPO priced on a Graham formula....

IPOs tend to be dreams. We deal in nightmares....

Cundill: IPOs for the most part are dreams. We deal to a certain extent in nightmares. But just on that point, a fella named Douglas Eu, a friend of mine from Hong Kong who now manages money for Jardine Fleming and invests in the People's Republic, says that investing there is a nightmare — which, of course, gets my interest. But the guy who runs Jardine Fleming's office in Sri Lanka (because Sri Lanka is actually even worse than the People's Republic) said, "No, no, no. They're *day*-mares."

Internet valuations seem out of whack....

Shareholder: There have been some new issues in the U.S. of Internet search engines like Yahoo, Excite and Lycos. These stocks have a lot of promise, but they don't have a lot of reality right now. How do you evaluate those?

Cundill: You go short the Internet index. And that's what we have been doing to a certain extent — because

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those valuations just seem out of whack.

They remind me of 1983 when the same kind of thing happened. And that particular branch of the share market inevitably falls out of bed. I don't know *when* — which is going back to the comment I made in my formal remarks. But I just have a lot of trouble with it.

We don't think we're the ones with the guts....

McElvaine: In January, someone said to me, "You guys have a lot of guts to be buying Paribas at 250 francs."

I explained the rationale to you before. So I said, "No. We don't have guts to be buying Paribas. The people buying the *internet* stocks are the ones with the *guts*."

I HAVEN'T DECIDED TO CHANGE PROFESSIONS, BUT WE DO PAY MORE ATTENTION TO THE BUSINESS.

We still look to the balance sheet for our margin of safety.

Shareholder: Buffett's partner, Charlie Munger, has been somewhat unkind to money managers...

Cundill: Yeah, but he didn't persuade me to become a plumber.

Shareholder: But he's apparently pulled Buffett away from a pure Benjamin Graham-approach to value investing. And I know that you're a value investor — along with Charles Brandes and John Templeton. Are you a pure Benjamin Graham afficionado or are you leaning towards growth investing as well?

Cundill: I think we're still looking for margin of safety in the balance sheet as distinct from the business.

But we're paying increasing attention to the business.

Cundill: But it's been really interesting to watch. We had a one-day seminar ... about six weeks ago in which Tony Browne — one of the principals of Roxbury who's become a Warren Buffett growth fella — talked about his transformation as he went along.

And we've had a bit of a transformation, too. In the '90-'91 period, you could buy a $1 bill for 50¢, but the business deteriorated. So the $1 bill can also shrink in value. And therefore, we're paying a lot more attention to the business.

The *real* barnburner, of course, is if you can buy the $1 bill for 50¢ and it turns around. Then you get all *sorts* of benefits. And that's happened to us over the years.

I was thinking about this very theme as I was running this morning. I think what Charlie Munger said to Buffett — although Buffett was coming independently to this view — was that if you can buy the business at a multiple well below the rate of growth — and I'm thinking of Coca-Cola — the margin of safety is in the business itself.

That's something we haven't done. But I think we're always studying to try and get it better.

In bad markets, babies get thrown out with the bath water.

Cundill: In a bad market, like the one that happened in the mid-1970's, you got wonderful businesses. You got franchises that were trading below cash that were growing and earning high returns on shareholders' equity.

As you may recall, that was when Buffett really made his bones because he built his liabilities from 1969 to 1974. So he had the cash to be able to make purchases. In bad markets, everything converges [price-wise].

So, yes — we look to the balance sheet first. But we're worrying about the nature of the business more....

WITH SILVER, YOU GET A GOOD INVESTMENT AND AN INFLATION HEDGE THROWN IN FOR FREE.

Below production cost, silver was a value play, too.

Shareholder: I've heard you talk about commodities — which don't quite fit into a balance sheet scenario. And you've talked about silver in the past. I was just wondering if you could give us an update.

Cundill: The silver position has been a long one for us. I think we bought our first position about $4 U.S.... We had a very low cost. And we've seen it go up to $6.50 and then down to about $5.35.

The rationale for our silver purchase was that it was analogous to buying a $1 bill for 50¢. We felt then — and still do, although not quite as strongly — that at $4.40, essentially, silver was trading below its cost of production.

I always thought the cost of production was around $6.50. But there have been a couple of U.S. mines that have gone back into production at $5.35 — Sunshine and Hecla, I think. One of them [Sunshine] may also have its own refinery. So its cost equation may be a little different.

Demand has exceeded supply for five or more years now.

Cundill: Another characteristic of silver has been that the demand for silver, unlike gold, has been exceeding supply for five years now anyway. Some mines have gone out of business. And new mines have begun to produce. Essentially, silver is a by-product. And the supply-demand characteristic seems to be very much in our favor.

[Editor's note: They showed us the figures. And they're actually quite striking. But pages didn't allow....]

Cundill: I'm surprised silver hasn't been doing *better* — [especially since] you're not paying anything for the hedge against inflation. Barton Biggs is quoted in *The Wall Street Journal* about buying gold as an inflation hedge. But I'm inclined to think you're not paying anything for the hedge with silver. Because of the industrial dynamics, you get it for *nothing*.

It's unusual. But we take the stance that, in fact, it is a $1 bill for 50¢. We haven't done anything [in it recently]. I think silver is around $5.42 U.S. But if it got below $5, then we'd probably add to our position.

[Editor's note: It did — and, they inform us, they did (primarily by way of silver futures, incidentally.)]

A GOOD CHANCE OF A CORRECTION IN THE U.S., BUT I DON'T THINK WE'LL HAVE A BIG CRASH.

Markets tend to behave like a swinging pendulum....

Shareholder: [In the 1970s], a stampede of people

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came after real estate and drove the prices and the cost of building materials and labor up. Now you're seeing some people leaving real estate.

Ten or fifteen years from now, might not people decide that they don't want to be stockholders — the way they did with high-tech stocks?

Cundill: You're talking not about demographics, but rather what I would call crowd behavior — because in the real estate boom everybody just piled in almost without thinking about it. At various times — in the late 1960s, for example — the same thing's happened in common stocks.

Graham talked about that. He observed that markets were almost always overpessimistic or overoptimistic — that they usually didn't stay at fair value; that they were very infrequently at what you might call equilibrium value. Almost always, they go from a point of undervaluation to over and back — almost like the swing of a pendulum.

We have a good chance of a correction, but not a crash.

Cundill: [A flight from stocks] is always possible, but I don't think it's terribly dangerous today — because even though you have overvaluations, they're not as extreme as I've seen at other times. But that doesn't mean we won't have it in the future.

You might have one of those periods — and you could go back to the period that we had when we started in 1975 until almost a decade later in 1985 — where there was just a *myriad* of bargains to be bought. And people who'd been beaten up so badly — having had such a bad experience — simply didn't have the courage to come back in.

But do I think we have a good shot at that today? No, I don't. Individual markets and individual components like the Netscapes and so forth may go down. And I suspect we have a good chance of a correction in the U.S. — although not so much in Canada. But I don't foresee a big *crash.*

IN 1987, THINGS WERE EXPENSIVE WORLDWIDE.
TODAY, IT'S PRIMARILY THE UNITED STATES.

OID: At your annual meeting, you said that in 1987, stocks were basically expensive around the world — whereas today, the overvaluation seems to be primarily in the U.S.

Peter Cundill: That's right. We're finding opportunity elsewhere — not that stocks are uniformly cheap anywhere. But there are always some cheap things — even in really expensive markets — as there are in the U.S. today. So you can't just buy a market.

But we can't find very much in the way of bargains in the U.S., whereas there seems to be substantially more opportunity outside the U.S. So you do have to work at it, but they're there.

OID: You also mentioned at your annual meeting that cheapness isn't necessarily protection in the event of a crack in the U.S. market.

Cundill: That's true. If the economic environment deteriorates like it did in 1990 — when it seemed to fall apart right before our eyes — all the asset value in the *world* won't help you.

OID: In the short run, at least. And couldn't you even go one step further and paraphrase the old saying about the U.S. economy — that "when the U.S. sneezes, the rest of the world gets the flu"?

Cundill: That's true. In fact, markets worldwide tend to follow the U.S. market to a remarkable degree. The only time I've seen them not do so was in the pre-bubble days when the Japanese market danced to its own tune. And to a slight extent, it's doing that now. However, I suspect U.S. capital markets are so powerful that we'll continue to see that in almost every market — including Japan.

OID: And your put options and the futures that you're using to establish your short positions are...

Cundill: In the U.S. and nowhere else. If the U.S. market were to falter, I don't think we'd have a free ride. Our securities would probably go down, too. Hopefully, however, our puts would protect us a bit.

OUR BIGGEST COUNTRY IS FRANCE.
AND PARIBAS IS STILL DIRT CHEAP.

OID: Where are you finding bargains today?

Cundill: Well, our biggest country today is France. And our biggest position is Paribas [PM.PA/Fr].

OID: At your annual meeting, you suggested that Paribas was still dirt cheap.

Cundill: According to two analysts, the adjusted book is around FF525-550 per share.

Tim McElvaine: And that's just the sum of the *parts* — the securities marked to market. It's not any attempt to value the business by estimating earnings and giving it an appropriate multiple or anything of the sort.

OID: And you think those estimates are reasonable?

Cundill: We do.

OID: Do you still find it compelling today?

McElvaine: Well, our average cost is about FF270. However, we have paid as much as FF315 per share. And we actually bought some earlier this week.

Cundill: In fact, we're buying it right now at FF300.

OID: That sounds like a yes to me.

Cundill: There's still a very good margin of safety.

OID: I assumed that the opportunity in France came and went with the riots and the elections — although I gather from your annual meeting comments that it's actually even come down a bit lately.

Cundill: A little. The French market has been something of a paradox. French *industrial* shares — the normal concerns — have really been quite strong. So we

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haven't focused on those. The weakness has been in the French banking sector and in the holding companies.

OID: For good reasons or bad?
Cundill: I think they're unpopular for several reasons: First, Credit Lyonnais got into trouble. Second, the banking industry generally is very competitive. And, third, it's very difficult for virtually any company — in most of Continental Europe, at least — to cut costs because of rather draconian labor laws.

OID: Not altogether bad reasons.
Cundill: Maybe not — at least today. However, these holding companies are extremely interesting. A lot of French organizations are run through what I call cascading holding companies whereby one owns 51% of another which owns 51% of another, etc.

And, actually, these holding companies traditionally sold at discounts to net asset value — with the discounts typically ranging from 20% to 50%. Therefore, people say, "Your upside is limited." But that's fine.

OID: Because you're already rich?
Cundill: The upside may not be as limited as they *think*. One of the things that's happening in France — and, to a certain extent, elsewhere in Europe (although, admittedly, it's a very uneven process) — is that corporate governance is coming to town.

OID: Exactly what Chris Browne tells us.
Cundill: And it's coming from a number of fronts. For example, Calpers is making their views known, although I'm not sure how effective they've been thus far. But they're there. And an increasing number of institutional shareholders — including us — have been raising their hands and saying that maybe merger terms or some such are out of whack.

OID: Chris Browne says Tweedy is virtually becoming the Michael Price or Alan Kahn of Italy.
Cundill: We haven't gotten very far yet. It's still a pretty club-like environment in most of those markets. However, the North American practice of listening to shareholder groups is beginning.

OID: So that maybe they'll even begin to factor shareholder interests into the equation?
Cundill: Exactly.

A SMART ACQUISITION, SHARE REPURCHASES
AND TIMELY, FAVORABLE ASSET SALES....

Cundill: I have a long history with Paribas indirectly — going all the way back to my early days. It was founded in 1872...

OID: You really do have a long history with it.
Cundill: Early in my career, I actually worked for a Canadian bank affiliated with it. Paribas was founded as a banque d'affaires — as a sort of businessman's bank. And they created a lot of companies, invested some of the bank's funds and acted primarily as dealmaker — in effect, as one of the early investment bankers — before they developed into a wholesale bank.

But, in 1981, they were nationalized by the Socialists. Then, they were privatized and relaunched — if you will — with a number of strategic shareholders in 1986.

Today, Paribas basically consists of four parts: First, they have the investment bank — Paribas. Second, they own 46% of a specialized financial institution bank called the Compagnie Bancaire — which is also publicly traded. Third, they own 100% of a retail bank — Credit du Nord — which isn't terribly profitable. And fourth, they have a portfolio that was worth about $8 billion at year end 1995.

OID: Based on stock market prices at that time.
Cundill: That's right. And at the end of last year, Paribas took a huge amount of losses. As a result, the bank's estimate of NAV declined all the way from FF493 down to FF438. And its shares got down near FF250 — from FF520 or so in the prior 12-18 months. So they've really come down.

OID: So far, so good. But what about today?
Cundill: Since year end, Paribas' shares have worked their way up to about FF300. And, in the interim, I believe they've paid a net dividend of FF14.

But, meanwhile, they also did a deal with a company called Navigation Mixte — which they owned 33% of already. They bought the remaining 67% at a price that made me quite delighted to be a Paribas shareholder. But I don't think I'd have been so pleased about it had I been a Navigation Mixte shareholder. But it got done.

McElvaine: And in typical French fashion — similar to the Japanese practice of interlocking shareholders — Navigation Mixte was both one of its largest shareholdings and Paribas' largest shareholder. Navigation Mixte's ownership of Paribas shares represented about 12% of Paribas' votes and 8-1/2% of its equity.

So that transaction represented a large repurchase of their own shares at a price we think was even below the low its stock reached last year — at least it was when you net out proceeds of other Navigation Mixte assets that they've since sold.

However, they haven't canceled those shares yet. So for the time being, they're holding it as treasury stock. But we calculate that they effectively repurchased those shares at FF250. So they substantially reduced their capitalization at a significant discount to NAV.

OID: In essence, it was a very positive development and enhanced the value of the remaining shares.
McElvaine: Exactly. Then, the other major thing that happened in the first half of this year is that they disposed of a number of holdings — the largest of which was a company called Poliet. They'll receive the proceeds from that sale over several years, although they'll receive most of it in '97-'98. And that sale should generate some FF3 billion. Plus, they also had several other disposals at prices well in excess of their carrying value.

So I think their restated NAV — and I say I think

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because they haven't released their June 30th numbers — is FF475-500. And we're comfortable with that estimate.

OID: And that's stated book, not the net asset value or adjusted book which you referenced earlier.

McElvaine: That's right.

OID: And the reason why stated book is lower is that you've written up certain assets to market in your estimate of NAV.

McElvaine: That's right. But, again, what accounted for the enormous increase in NAV was the combination of the share repurchases and asset sales I mentioned earlier.

IF PARIBAS COULD EVEN EARN *10%* ON EQUITY, WE COULD MAKE GOOD MONEY FROM TODAY'S PRICE.

McElvaine: So here's a company that was unfocused for most of the 1980s and the early part of the 1990s. And management is doing two things: First, they're disposing of some of their portfolio. And, second, they're taking the proceeds and injecting more capital into their wholesale investment bank.

OID: Nobody's perfect.

McElvaine: In effect, they're getting rid of the secondary assets and focusing on the primary business.

OID: Which you like.

McElvaine: Absolutely. I also like the fact that they've repurchased a significant amount of their stock.

Cundill: Although, as we've mentioned, there is still a little bit of doubt about that.

McElvaine: Incidentally, Paribas' wholesale bank has had extremely volatile earnings — which is what you expect from that type of business. And the question is whether it's worth half of book, two times book or book.

OID: And part of the answer is management.

McElvaine: The *big* part of the answer.

OID: How would you rate management? And what can you tell us about their paper trail?

Cundill: It gets a little complicated. But I think management at the top, like a lot of European bankers, knows what they have to do — they've seen the cost cutting and everything else being done by their American cousins.

OID: And if they weren't prohibited by law and cared more about shareholders, they might even do it, too?

Cundill: Their operating environment is more difficult because of these draconian labor laws. Plus, my sense is that there've always been a lot of fiefdoms in Paribas and a lot of internal politics. So making change isn't easy.

But progress is being made — both at Paribas and elsewhere in Europe. We see an evolutionary process taking place in France — where companies are not only trying to refocus their businesses, but they're also trying to clean up the remnants of interlocking share ownership.

OID: How has that progress translated into returns on shareholder equity?

McElvaine: Over the last four years, Paribas' return on equity has been mediocre at best. But management has kind of set an 8% return on equity as its internal target. And that doesn't sound like anything to write home about, but an 8% ROE would mean earnings of FF45 per share. And with Paribas at FF300, that wouldn't be bad at all.

OID: And in Paribas' year end letter to shareholders, their chairman actually set the target at 10% and said that they were hoping to get it up to 15%.

McElvaine: I didn't realize that. But I like it.

OID: Here's what he said:

"Our ambitions remain unchanged. Over the past three years, our ROE has ranged between 3% and 7% excluding specific items. This is somewhere around the mean for French banks, but we don't regard it at all as a satisfactory level. Our recently announced target of 10% by 1998-99 may seem modest, but it's a first step toward the 15% level which has already been achieved in certain areas and in certain subs."

McElvaine: They actually did set a 15% goal about five years ago, as well. But they have yet to achieve it.

OID: I can certainly relate there.

McElvaine: However, I don't want to discount their management's recent comments — because I think they're a lot more focused today than they were five years ago.

OID: Sounds promising, if unproven.

McElvaine: However, with Paribas at FF300, we figure that we're paying nothing for the operation. So it's all gravy.

OID: Because you're paying less than 55% of NAV.

McElvaine: Exactly.

Cundill: Similarly, an American banker might say, "What are you *talking* about?! If I earned 10% on equity, I'd be out of a *job*."

On the other hand, you're starting from a lower base. So if they were able to get their returns up to 10%, the earnings progression would be pretty good.

OID: They'd become growth companies — and momentum investors would jump on board.

Cundill: Exactly.

AND WE'RE GETTING TAKEOVER POTENTIAL AND ANY EARNINGS EXTRAPOLATION FOR FREE.

OID: You mentioned earlier that Paribas' stock price had declined by half or more from its highs.

Cundill: That's right. In part, that's been because of a severe turndown in the real estate market. What happened in the U.S. in 1990 started happening in 1993 in Europe — and particularly in France, Belgium and Sweden. Actually, it may have even started in Sweden a little before that — because their banks had been remarkably aggressive in

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making loans and buying real estate (in Europe mostly, but in a lot of other places, too).

So the bad times happened *later* in Europe than they did in North America. And I'm not even sure if we've seen the beginning of the end or the end of the beginning.

OID: Winston Cundill. It has a nice ring to it.

Cundill: But Paribas and others have finally taken a whole lot of very hefty provisions. And, in Paribas' case, we think there's not much more provisioning to be done in their loan portfolios — although there may still be some to be done in the real estate they own for their own account. But I'm not even sure about that.

Anyway, I think they're pretty close to being adequately or more than adequately provisioned.

McElvaine: That's what we hear. Of course, you always hold your breath when you say that — especially in a financial institution.

OID: Any thoughts about where Paribas would be fairly valued?

Cundill: Their assets are fine. So that will depend on its earnings. We just figure that if they can get their earnings on some kind of progression and begin to look as if they've slimmed down the business and focused it, I wouldn't think that a FF500 share price would be out of order.

McElvaine: Investment banks' earnings tend to be volatile. And the stock market seems to show constantly that when earnings are volatile in an upward fashion that they're willing to put a nice P/E on those earnings.

OID: In other words, the greater fool theory?

McElvaine: First, Paribas' NAV is significantly in excess of the market price. Second, its management is refocusing the business and concentrating on increasing its return on equity. And, third, its business can earn a substantial amount of money in the right environment. They're not the largest player in Europe, but they're one of the largest. I just saw something recently that ranked them fifth in the underwriting of debt.

Also, the control of Paribas rests in the marketplace.

OID: Meaning?

McElvaine: If people think that Lehman is worth a small premium to book value because it's not controlled and there's, therefore, some takeover speculation, why should Paribas be selling for half of NAV?

OID: Perhaps because of its returns and its domicile?

McElvaine: For now. I'm not suggesting that they'll be taken over — just making a passing observation. Although we're certainly not counting on it, there's an outside chance Paribas could find itself the subject of a suitor. But, again, we're getting that for free.

Therefore, not only are we paying nothing for the investment bank, but we're also paying nothing for the possibility that someone else may actually think it's worth something more than half of book.

OID: It doesn't help to beg. Believe me, I've tried.

NORD EST IS SELLING BELOW NET CASH
AND RIGHT AT 3 TIMES PEAK EARNINGS....

OID: Any others?

McElvaine: Nord Est [NORP.PA/Fr] is an interesting one. It trades at around FF130 per share. And I know you'll be pleased to know that our average cost is around FF138 and that we've paid up to FF140.

OID: A good start. Tell us about it.

Cundill: It's basically a holding company controlled by Paribas — which owns roughly 42% of its 14-odd million shares. Nord Est has sold off a number of its holdings. So it's now left with a packaging business plus cash. And it's trading below net cash. So you get the packaging business for nothing.

OID: And the fundamentals?

McElvaine: We estimate that Nord Est's book value is about FF180 and that its NAV is FF190 as of year end.

OID: What's so exciting about that?

Cundill: Two things: First, it's basically trading at less than net-net — again, with most of that net-net being cash.

OID: And you don't think it always will.

Cundill: Not at all. Second, I talked to the guy at Paribas who has responsibility for the Nord Est file. And he said, "We've done all of the tough work. We're continuing to tidy it up. And sometime in the near future," although he didn't put a time frame certain on it, he said, "we'll try to figure out what we'll do — whether we'll sell it, make an acquisition or dividend out the cash. It's been cleaned up quite a bit already. And by the time we're done, it'll be cleaned up a lot more."

OID: Meaning?

McElvaine: Meaning that Nord Est owns shares in a number of investment companies that will be liquidated during the next couple of years.

OID: And you base that on...

McElvaine: On the fact that Paribas owns about 42% of Nord Est and that this is the type of asset that Paribas has been shedding — i.e., non-financial.

But, actually, we don't have a tremendous amount of information on Nord Est...

OID: You invest that way, too?!

McElvaine: It's not available. However, from what we've been able to determine, totaling the NAV of the investment companies they own plus their net cash gives them an estimated total NAV of FF130 per share.

OID: Which is right at the current share price.

McElvaine: Correct. Then you're left with a

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significant packaging company — Emballage — with about FF2.2 billion of sales in a number of different businesses including manufacturing cardboard and sample cases for perfumes and cosmetics.

OID: Or FF156 per share of sales for free.

McElvaine: Exactly. And aside from that business, Nord Est is extremely liquid. About FF40 is in cash. Another FF10 is in a company that holds some warehouses and industrial sites that will be liquidated over time. And then another FF60 is in various investment companies that we value at net asset value — i.e., what they could be liquidated for today (which, incidentally, is the company's stated intention).

And then they have another FF20 in other assets — although we're not entirely sure what they are. But we've been told that they'll be converted into cash at a price similar to their carrying value.

OID: Gotcha.

McElvaine: And Nord Est's management says that they'd like to use that cash to focus more on the packaging business and to make acquisitions in that area.

OID: Save the negatives for last.

McElvaine: It may not be a negative at all. The guy who is now running Nord Est used to be in charge of Reynaud's international operations. So we're just watching with curiosity. But, again, we own it for free.

OID: And you're hoping management won't prove it to be worth less than nothing.

McElvaine: Yep. Some might say we're betting on this guy's ability to deploy cash in a reasonable manner. And I wouldn't necessarily disagree. That certainly isn't a risk that one should feel particularly comfortable taking.

However, we figure he could overpay by 100% for any businesses he acquires and we'd still wind up with an NAV equal to the current stock price.

OID: There's that good old margin of safety again.

Cundill: Yes.

THERE'S NO SUCH THING AS NORMAL,
BUT THE MATH IS ON OUR SIDE.

OID: Can you tell us anything about earnings or returns historically?

McElvaine: Like Paribas, this is a company in transition. They're taking a cash asset and redeploying it into an operating business. So you have to be careful with drawing too many conclusions from their past results. However, historically, they've earned as much as FF44 as recently as 1992.

OID: They've earned that much?!

McElvaine: They did. But that was a different time. We don't think of that as necessarily being representative.

OID: Could you even ballpark normalized earnings — if there is such a thing here?

McElvaine: There's not, really — because they now have cash and industrial assets. So what will they be able to earn going forward? Well, the stock's at FF130 and the cash is earning 5% today. So they may have earning power of around FF15 today. But once their cash is redeployed, we just think that they'll be able to do a lot better, although how *much* better we can't really say.

OID: It's awfully tough for us to do background work or fact checking on these companies. We don't have remotely the data available for these that we do for domestic firms — even for most very small ones.

McElvaine: Actually, the Street's in the dark, too. But again, in the case of Nord Est, the current price of the stock is more than covered by the current assets. You get the industrial operation for free. They have a shareholder who doesn't want to be there. They're focusing their energies and other assets on their core business. And no one knows anything about it or really cares.

Frankly, what else do you need to know. We've found that to be a combination that tends to lead to good things.

OID: It's certainly hard to argue with you there.

McElvaine: Our downside is protected by the cash — although, of course, it can be subject to piracy or stupidity. And the discount to NAV is substantial. So our upside will come as they evolve into a focused operating business.

In effect, the arithmetic is on your side.

NOW WOULD BE A GOOD TIME TO BUY NET-NETS.
UNFORTUNATELY, THERE AREN'T MANY AROUND.

OID: And Gendis [GDS.A/Can]?

Cundill: It's a net-net — and it's still a bargain. And there are three bets to it: First, Gendis has cash. Second, they have an oil and gas company — Chauvco Resources — with reserves in Canada and Argentina. And, third, its stock price has come down.

McElvaine: And the value of the Chauvco stake alone more than covers the current stock price.

Cundill: That's right. However, the open question is the value of their retail operations and whether they'll be able to turn it around or stop the bleeding.

OID: And the answer?

Cundill: Well, we've actually been buying a lot of these small retailers in Canada — and in the U.S. as well. And the Canadian retail scene is probably generally more difficult — or should I say more *desperate* — than it's been in the U.S. And the U.S. hasn't been easy either.

But the challenge is to identify the survivors. And Gendis is a net-net right now — a classic one, in fact. But it's deteriorating. So there are some question marks.

[Editor's note: FYI, Cundill informed us that their average cost for Gendis had been north of C$12. When we spoke, (and as we go to press,) it was around C$8.]

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OID: What percentage of the time in your experience have net-nets tended to deteriorate — typically?

Cundill: Well, if you're lucky, when you buy them, they'd be beginning to improve. But that doesn't happen all the time.

It depends on the economic environment largely. In 1975, companies were coming out of a bad 1974. So things were getting better. So you were not only buying net-nets, but you were getting good franchises to boot. And, meanwhile, the environment was getting better.

OID: Bill Ruane and Bob Schwerin say the experience positively spoiled them.

Cundill: There was a change in 1990. Economic conditions in all of these really cheap things deteriorated so fast that in many instances where we thought we had a margin of safety, it got eaten up big-time and quickly.

OID: And today?

Cundill: Funnily enough, I think we're in a more benign mode today — which probably bodes well. An awful lot of good things have happened in America.

OID: It sounds like you think this might be a particularly good environment for net-nets.

Cundill: That's right. Unfortunately, there aren't many of them around. However, the retail area has been one of the few exceptions. And I'm not exactly sure why. Maybe there are just too many *stores*.

Let me have Tim tell you about a couple of ideas in that area.

CANADIAN RETAILERS ARE ON THE BARGAIN COUNTER — INCLUDING LE CHATEAU AT ABOUT 2/3 OF BOOK.

OID: What are you finding that's compelling today?

McElvaine: In North America, the things that are *very* interesting are *small*.

OID: That's what we keep hearing.

McElvaine: And there are a *number* of retailers out there that we think we're buying at a very low multiple of earnings. For example, there's Chateau Stores of Canada [CTUa.TO/Can]. Its stock is 70% below its 1994 high of C$17. And then there's Reitman's...

OID: One at a time, please. In any case, I imagine they're down for a reason — and possibly a good one.

McElvaine: The reason why all of these are down is that they have a significant portion of their business related to women's apparel.

OID: That's certainly been a kiss of death in the U.S.

McElvaine: So not only have they gotten tainted by being in retailing, but they've also gotten tainted by being in *women's* retailing. People just didn't want to own these things in the Fall — which is when we bought our positions in most of them.

But one of the ones we bought in the latest quarter is Chateau. It's a Montreal-based retailer of women's clothing. Their target market is aged 15-30. They have 145 outlets across Canada. And they do about C$142 million in sales.

OID: What makes you believe they're a bargain?

McElvaine: Well, Chateau sells for C$5 and change. It has approximately 4.5 million shares outstanding. And it has just over C$8 million — or about C$1.75 per share — of net cash. So, in effect, you can buy the business today for less than C$3.50 per share — or about C$16 million. And, therefore, net of cash, Chateau Stores is selling for less than 10¢ on the dollar of sales.

OID: Sounds like a good answer so far.

McElvaine: And this year, their retail operation looks like it will probably earn about C$7 million — or C$1.50 per share pretax and maybe C85¢ per share after tax.

OID: So that net of cash, Chateau is selling for roughly 4 times this year's earnings.

McElvaine: That's right.

OID: And Chateau Stores' book value?

McElvaine: About C$7.90 as of December 31st.

OID: So it's only selling at about 2/3s of book!

McElvaine: Yeah.

EXCLUDING MISADVENTURE AND TRAGEDY, CHATEAU'S MANAGED A MID-TEENS ROE.

OID: Why so cheap? Is it a dog?

McElvaine: Quite the contrary. Here are Chateau's sales, earnings and returns since 1991:

CHATEAU STORES
(C$millions unless otherwise noted)

Fiscal Year[1]	Revenues	Earnings Pretax	Earnings After tax	Book Value[2]	Return on Equity[3]
1991	147.5	7.8	4.0	21.3	18.8%
1992	150.8	(6.5)	(5.5)	25.3	(21.7)
1993	156.9	8.6	4.5	20.1	22.4
1994	150.3	11.8	7.0	24.9	28.1
1995	159.8	7.8	4.6	31.8	14.5
1996	142.0	3.0	1.5	35.8	4.2
Avg.					11.0%
Avg. excluding 1992					17.6%

[1]Fiscal year ending January 31st.
[2]Beginning of year book value.
[3]Return on beginning of year book value.

OID: So, in effect, it was the lousy 1996 results and the overall pessimism about retailers in general that

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made their stock crater?

McElvaine: That's the way it looks to us. As you see, last year was a difficult one for Chateau. As I mentioned, it was difficult for retailers generally in North America — particularly in women's apparel. And Canadian retailers suffered even more than those in the U.S. However, even though Chateau had a terrible year, notice that they still managed to make money.

OID: Unlike 1992 where they lost over 20% on equity.

McElvaine: That's right. But that was only because they went into the U.S. and lost a ton of money. And they took the write-downs related to that misadventure in 1992. However, those are definitely discontinued operations.

Actually, the fact that they wrote their assets down and renewed their focus on Canada is, if anything, a *virtue* in our book. In any event, it wasn't their core business.

OID: But I understand that they reported losses in 1987, 1988 and 1989. What happened there?

McElvaine: The same thing. They took a write-down in 1992, but their U.S. stores were perennial money losers before that, too.

OID: So do you think there's such a thing as normalized return on equity here?

McElvaine: Return on equity in retailers is particularly hard to peg for lots of reasons.

OID: We noticed.

McElvaine: One reason is that cash is a little like a spring because it goes up and down depending on your inventory position throughout the year. So it's difficult to really know what your net invested assets are.

But aside from the years of their misadventures in the U.S. and last year, they've historically earned an ROE in the teens. And they've even earned that return while they were carrying around much more capital than they needed. So we don't think they're dogs by any means.

OID: Even if they do seem to have a recent history, at least, of nonrecurring problems that recur...

McElvaine: That may be. But, again, net of cash, we're only paying about C$3.50 per share — or about C$16 million — for a business that could earn as much as C$7 million. And that's fine with us. In that case, we don't mind if it's cyclical. We'll just wait it out — or at least we will if we think that the company has staying power.

And because their book value is up around $7.80, if they earn a 15% return on equity, then Chateau would have earnings north of $1.

OID: Actually more like $1.17, but who's counting...

McElvaine: And they'll pay dividends of 30¢ this year. So we're picking up a 6% dividend while we wait.

SHARE BUYBACKS & OPPORTUNISTIC PURCHASES AT 2 TIMES EARNINGS AND LESS THAN 9% OF SALES.

McElvaine: And, incidentally, Reitman's [RET.TO/Can] is similar. It's got about C$11.50 per share in other assets. Our cost is around C$12.50. And the stock is selling for between C$14.00 and C$14.50 today.

OID: But is it still a bargain?

McElvaine: We think so. Reitman's stated book is about C$16 per share. But they have C$7.50 per share, more or less, of cash and marketable securities net of debt.

Plus, they've also acquired a 21% equity interest in NetStar — which operates the Canadian equivalent of the Sports Network — although that's only C$37-38 million or about C$4 per share.

OID: Not to worry. Like they say, C$4 per share here, C$4 per share there, before you know it, it adds up to real money.

McElvaine: Our thoughts exactly. So net of debt, Reitman's has cash and marketable securities of about C$11.50 per share. Therefore, even today, we figure that you're really only paying $3 per share for their business.

OID: Is that good?

McElvaine: Well, they have about 9-1/2 million shares outstanding — although they'll actually be down to about 9 million shares outstanding by year end because they're in the midst of a significant repurchase program.

OID: Generally a good sign.

McElvaine: Yeah. And they've earned between C$1 and C$1.50 per share in each of the past three years.

OID: Certainly, 2 to 3 times earnings sounds good.

McElvaine: And using the estimated 9 million shares that they'll have outstanding by year end would mean that you're paying C$27 million for a retail operation that had C$328 million of sales last year and probably will have sales closer to C$400 million for the fiscal year ended January 31, 1997. So based on sales, once again, you're buying their retail segment at less than 10¢ on the dollar.

OID: Actually less than 7¢ — if you're right about this year.

McElvaine: And their retailing business cash flowed

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about C$7 million pretax in fiscal 1996. And the year before, it made C$15 million. So we're only paying C$27 million for a business that earned about C$7 million last year and C$15 million the year before.

OID: Or two times peak earnings — net of cash anyway — for their business.

McElvaine: And their earnings power has grown since then — because besides repurchasing shares, Reitman's has done other things that endear them to us as value investors. For example, they bought Dalmy's — another chain that was predominantly in women's wear. Dalmy's went bankrupt last fall. And Reitman's bought it out of bankruptcy — out of the Canadian equivalent of Chapter 11. And, in the process, they also picked up a significant amount of tax loss carryforwards.

OID: Might we trouble you to quantify "significant?"

McElvaine: I believe they were about C$30 million. And they acquired another chain the year before — Pennington's — which was larger women's clothing. And, here again, they picked up the sales and the outlets for a very minimal price. They bought them as asset purchases. So they didn't really pay *anything* for the businesses or the tax loss carryforwards.

OID: It's sounding better and better.

McElvaine: And Dalmy's was acquired in February. So it has yet to go through a selling season as part of Reitman's. Therefore, we believe Reitman's is on course to earn much more than the C$15 million they earned three years ago.

OID: That doesn't sound all bad.

McElvaine: So here's a management acquiring competitors out of bankruptcy and otherwise in distress — in any case, paying very little for them — and repurchasing stock at prices that we believe enhance shareholder value. And we receive a modest dividend —about C52¢ this year (for a yield of roughly 3.6%) — while we wait.

A BUSINESS WITH AN AVERAGE ROE OF 30% AT 75% OF BOOK (NET OF LIQUID ASSETS).

OID: It sounds like you'd give Reitman's a high grade for capital allocation. What kind of grade would you give them as operating managers?

McElvaine: Many people would correctly suggest that they're not the most dynamic retailer in Canada...

OID: Only one of their many virtues, I imagine.

McElvaine: Exactly. You don't have to have a wonderful *concept* to have a neat little *business*. In fact, a retailer can be a *very* good business — especially if they're not in the midst of rampant expansion.

There are many segments within the retail industry. Most retail analysts may tend to have a little higher income than most retail customers. So they may be more inclined to like exciting concepts. In contrast, the typical customer might prefer a better price to a flashy store. Or, at least, I think that's true of Reitman's customers.

And I know I certainly prefer it as a *shareholder.*

OID: Speaking of shareholders, what kind of returns has Reitman's earned on shareholder equity?

McElvaine: Their returns within their retail segment are quite high. Here's a breakdown of their sales, earnings and returns in that segment for their last five fiscal years (ending January 31st):

REITMAN'S STORES
(C$millions unless otherwise noted)

Fiscal Year[1]	Revenues	Earnings Pretax	Earnings After tax	Book Value[2]	Return on Equity[3]
1992	298.6	10.1	7.0	21.5	32.8%
1993	317.9	13.3	9.4	14.8	63.8
1994	339.5	14.0	9.7	20.7	47.0
1995	333.3	8.3	6.3	15.0	41.7
1996	349.9	(0.6)	(0.6)	28.6	(2.2)
Avg.					31.7%

[1]Fiscal year ending January 31st.
[2]Beginning of year book value.
[3]Return on beginning of year book value.

McElvaine: As you can see, for the last five years, that segment's return on beginning of year equity has averaged more than 30%.

OID: Wow.

McElvaine: And that's even including 1996 — which was *anything* but typical. Their retail segment nearly achieved break-even even then. It only lost $600,000 in a *horrible* year for the industry in general.

OID: Are those kinds of returns — or anything approaching them — sustainable?

McElvaine: I have no idea. We look at it differently. As of January 31, 1996, Reitman's had working capital of C$34 million, payables of C$27 million and capital assets of C$30 million. So assets invested in that segment totaled about C$37 million. But, as I mentioned, netting out their cash and marketable securities and their stake in NetStar, we're effectively buying it for only C$27 or C$28 million. So we're not even paying book value for the business.

OID: Net of cash, you're paying about 75% of book.

McElvaine: The stock market's appraisal of Reitman's business is less than the net assets it has in the business — as you say, 25% less. Therefore, our returns are higher.

In other words, even if they were only to earn 10% on equity going forward, we'd be fine — because that would be equivalent to someone buying a company at book value that was earning 13.3% on equity.

OID: In the first year at least.

(continued on next page)

CUNDILL VALUE & SECURITY FUNDS'
PETER CUNDILL & TIM McELVAINE
(cont'd from preceding page)

McElvaine: That's right. However, my point is that even though Reitman's return on beginning equity in that segment has averaged more than 30% in the last five years, by *no* means are we counting on its continuation.

THERE'S NOTHING SPECIAL IN THEIR MARGINS.
IN FACT, SOME WOULD SAY THEY'RE *DIS*ADVANTAGED.

OID: Still, how have they done it?
McElvaine: Well, they certainly *haven't* done it with huge operating margins — because over the last five years, their net profit margins have only averaged 2.8% and never exceeded 4.2% for any fiscal year. In contrast, Chateau's net profit margins have been more in the 5-8% range.

OID: What accounts for the difference?
McElvaine: Chateau's apparel is a little less commodity apparel than Reitman's. A Reitman's shopper tends to be somewhat more price conscious. The Chateau shopper is price conscious, too. Only they may be willing to pay up just a bit more.

OID: Is Reitman's a particularly efficient operator?
McElvaine: Reitman's has an enormous presence in a number of malls — which gives them leverage on the leasing side to pull down their costs, on the buying side and on the distribution side. Again, however, both Chateau and Reitman's are mall-based — which some people say is a negative and others say is a plus.

OID: And you?
McElvaine: Well, that will change your cost structure somewhat versus someone like a Wal-Mart...

OID: And cause a higher percentage of sales to go to SG&A?
McElvaine: That's right — although Reitman's actually doesn't break out their statements in a way that you can determine their SG&A or gross margins. However, SG&A tends to be 25-28% of sales for Chateau — versus more like 15% for Wal-Mart. And I'd guess that Reitman's SG&A might be somewhere in the mid-20s.

In terms of gross margins, Chateau's is in the neighborhood of 33% versus around 22% for Wal-Mart. And I'd guess that Reitman's might be in the high 20s.

OID: Does that represent a fatal disadvantage for them long term vis-a-vis Wal-Mart and other more efficient retailers?
McElvaine: That's always possible. But Wal-Mart is much more hard goods-oriented in Canada than they are in the U.S. — although there is talk of them trying to do more soft goods or clothing sales.

But I'd think that a 21-year old fashion-conscious purchaser would be less inclined to drive to a Wal-Mart than to go to one of Chateau's stores where they have the fashions that they're interested in at a reasonable price. Frankly, I worry more about a Sears than I do Wal-Mart.

OID: How do you think Chateau Stores and Reitman's stack up in terms of SG&A and gross margin vs. other mall-based retailers?
McElvaine: I don't think those figures are all that different for Chateau or Reitman's than other comparable, mall-based retailers.

OID: And The Gap isn't eating their lunch the way that I gather that they're eating everyone's in the U.S.?
McElvaine: The Gap takes part of the market. And I don't mean to downplay them as a competitor. But I'm not saying Chateau or Reitman's will become the next Gap. All I'm saying is that they have a neat, profitable little niche today. They're making good money on it. And that's fine.

And the fact is that it tends to be nasty weather-wise up here for longer than many of us would like. Therefore, malls are where people tend to be — at least for five months of the year.

OID: And I thought you guys were out moose hunting...
McElvaine: Only when we're not at the mall.

NO HIDDEN LIABILITIES UP THEIR SLEEVE
AND NO EXCITING (OR EXPENSIVE) GROWTH.

OID: You still haven't told us how Reitman's achieved those returns in its core business.
McElvaine: Let me answer you this way. Reitman's and Chateau have several things in common. First, they're in very fragile businesses.

OID: Fragile in what sense?
McElvaine: One problem with retailers, of course, is that their asset side tends to be fairly weak — because it tends to be only inventory and leaseholds. And, similarly, their liability side tends to contain hidden liabilities — especially the cost of closing stores.

OID: Something Charlie Munger and Bob Goldfarb have discussed in the past.
McElvaine: Therefore, one of the things that we were concerned about was how happy customers were with their stores, and, therefore, how likely they were to close them. If there was any suggestion there might be store closings, we tended to stay away from retailers.

But in the case of Chateau Stores and Reitman's, both were very happy with the stores that they already had.

OID: Although aren't stores virtually guaranteed to become outmoded from time to time — whether it's due to societal changes like where people live or shop, competitive developments or technological changes?
McElvaine: Yeah. But if you're in a situation where a turnaround is underway, you're in *particular* danger. Concept changes in retailing are very difficult to execute — not that people haven't done them successfully. They're just tough. And to do that with a weak balance sheet and some locations you're not comfortable with — well, let's just say that it's usually not very pretty what happens.

OID: And there are other problems with retailers, too,

(continued on next page)

CUNDILL VALUE & SECURITY FUNDS'
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(cont'd from preceding page)

I gather. Leaseholds generally add lots of leverage...

McElvaine: But the flipside is that if the company's happy with its stores, it's like any other leveraged business — although the leverage here may be off balance sheet. If you're happy with your locations and you're continuing to run out your leases, the business takes very little capital and can be an enormous free cash flow generator — especially if it's not expanding.

In part, that's true because even if your inventory can't be financed 100% by payables, it can be financed to a very large degree. And leaseholds may or may not require a lot of maintenance each year. So if you're not expanding, your margins fall through to the bottom line.

OID: Gotcha.

McElvaine: And that's the case with both Chateau and Reitman's. Their sales have been fairly constant the last eight years. So neither of them is a growth company. These are more mature businesses. They continue to add stores and take others off as they fine tune their business.

Chateau's book value, for example, is only up 4% per year in the last nine years. Also, both Chateau's and Reitman's capital expenditures are below their depreciation. So operating earnings are a little higher quality than those of some other retailers — many of whom may be incurring capital expenditures significantly in *excess* of depreciation.

YOU HAVE TO BE SMART EVERY DAY.
FORTUNATELY, THESE MANAGERS ARE.

OID: Albeit if the reinvestment opportunity were right, I suspect that you wouldn't mind capital expenditures well in excess of depreciation.

McElvaine: True. But we trust these managers to make that judgement. And, quite frankly, Reitman's has been doing that by purchasing existing chains in distress as they've been available — and doing it, I should add, in a very disciplined way.

OID: Aren't retail inventories another source of hidden liabilities because they lead to periodic inventory write-downs if they don't catch the latest fad or style just right or if too many competitors catch it, too — especially in women's apparel.

McElvaine: There's no question about it. There are a *lot* of negatives about the business. And, like I said, these are very fragile businesses.

OID: Fragile?

McElvaine: Let me put it this way: I quoted Buffett at our annual meeting about how some businesses only require you to be smart once, whereas in retailing, you have to be smart every single day.

OID: But you can live with those negatives at 2-4 times earnings.

McElvaine: That's part of it. But the other part is that both in the case of Chateau Stores and Reitman's, management owns a significant amount of stock. In the case of Chateau Stores, 2/3s of the stock is owned by Herschel Segal. And in the case of Reitman's, over 50% of the stock is owned by the Reitman family.

So we have significant shareholders there that we're comfortable with who are concerned about things like making sure that inventory is cleared each year and other things like that. Their bonus isn't dependent on any single year's net income. And significant parts of their net worth are tied up in the entire enterprise.

So, in my opinion, the key to Chateau and Reitman's earning above average returns is very, very simple. And that's their management.

OID: So it's in the execution, not the strategy.

McElvaine: That's right. They're really focused — first on their margins and second on their balance sheets. In both cases, these balance sheets are very, very clean. And managing them is one thing Reitman's management does especially well. They don't spend a penny on the stores — whether it's in the decor, the finish or the inventory itself — that they don't absolutely have to spend.

So the returns associated with Reitman's and Chateau are due in no small part to the fact that they have significant shareholders involved in the business. And that's a very important point — or at least it is to us.

OID: It's the swordsman more than the sword.

McElvaine: Right. Because it's a retail business, someone has to be there all the time. I don't think it's based on franchise value. There are very few barriers to entry in the niche they're in. It's a mighty tough business. Certainly, it isn't a business that I would want to go into.

But if I spend any time at night worrying about them, at least I know that Reitman's Jeremy and Stephen Reitman and Chateau's Herschel Segal spend far more time worrying about their solvency then I do — because I'm a lot more diversified than they are.

OID: Misery loves company?

McElvaine: I don't know about that. But I do know that it's comforting to me — especially in this business.

OID: Have both companies' managements treated minority shareholders fairly over the years?

McElvaine: There's been nothing that suggests they've treated people exceptionally, but nothing that would indicate they've been treating people poorly either. Neither one takes a horrendous amount of money out of the company. Most of their money comes via dividends.

WE DON'T MIND A CONSERVATIVE BALANCE SHEET
— ESPECIALLY NOT IN *THIS* BUSINESS.

OID: Earlier, you mentioned Reitman's broadcasting stub — their interest in the Canadian sports network. What can you tell us about it?

McElvaine: Labatt's was taken over about a year ago. And one of the things that its buyers sold off was Labatt's Communications. They sold it to a group that included Reitman's, a member of the Bronfman family, management and Caisse Depot — which is a Quebec pension fund. And

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CUNDILL VALUE & SECURITY FUNDS'
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it included TSN (the Canadian sports channel), 80% of a channel up here that we call The Discovery Channel and a couple of other things.

As a group, they paid C$605 million — including slightly over C$400 million of debt — for a business that we think had operating profits of just under C$70 million.

OID: You <u>think</u>?!

McElvaine: They bought it in August of last year. And that's what operating profits were projected to be at the time. But it's not a public company. So we can't know for sure. It's also a little confusing because ESPN bought 20% of NetStar and got an option for an additional 30% as part of a C$30 million convertible debenture. Therefore, if ESPN exercises its option, Reitman's interest would be somewhat less than 21%.

OID: And I know you're not counting on it. However, do you have any thoughts about its current value and/or its prospects?

McElvaine: Potential strategic buyers have suggested to us that <u>Reitman's</u> paid a very full price. But we've heard that the buyers are quite happy with their progress to date.

We're hopeful that it'll work out. But we're not paying for it. So we won't lose any sleep over it. We just think of it as a little call option.

OID: What about interest rate risk in their marketable securities portfolio?

McElvaine: Not an issue. Their marketable securities are primarily floating rate preferreds — and very short term. So interest rate risk is minimal.

OID: What about <u>credit</u> risk?

McElvaine: They don't disclose the issuers. But most of them are rated P-1 or better, as I recall.

OID: So they're investment grade.

McElvaine: Their objective in their marketable securities portfolio isn't to make any kind of home runs. They're just trying to earn good, tax-efficient rates of return on liquid assets.

OID: Why do they keep so much money around? Is it primarily to avoid double taxation of dividends?

McElvaine: Some observers take the negative view and say, "Why the heck are they doing that? Shouldn't they just dividend it out to their shareholders?" And that's one reason why their stock's come down so much.

OID: It obviously doesn't bother <u>you</u>.

McElvaine: No. From our point of view, they've been doing the right things. Since their stock's come down, they've been willing to use that cash to repurchase stock and to purchase competitors in financial difficulty. And it's their strong balance sheet that's enabled them to do it.

So we have no objection whatsoever to their having an underleveraged balance sheet. A conservative balance sheet generally doesn't bother us — especially in an industry as cyclical as retail. Certainly, in a very different industry — for example, in one without the cyclicality — you might very well argue for a more aggressive financial structure.

IN 1996, EVERYTHING THAT *COULD* GO WRONG *DID*.
WE DON'T THINK THAT'S VERY LIKELY TO RECUR.

OID: You mentioned that Canadian retailers were particularly hard hit among those in North America and that women's apparel retailers were especially hard hit.

McElvaine: That's right. And these were *mall*-based, women's wear retailers to boot — which happened to be *particularly* out of favor.

OID: And to a large degree, I gather still are.

McElvaine: Neither one has moved up since the Fall. So you're right. And both expect business to be significantly better this year than last.

OID: Although <u>Robert Noel</u> tells us that you <u>have</u> to be an optimist to be either a retailer or an entrepreneur, although we think stupidity is the <u>more</u> common trait — at least among investment publishers...

McElvaine: To start a retailer from scratch today, you would indeed have to be an optimist. But to buy an existing, profitable retailer at a price well below the cost of recreating it is quite another story indeed.

OID: But what's to keep 1996 from being the first of many tough years — for the industry in general and <u>Chateau</u> and <u>Reitman's</u> in particular?

McElvaine: Well, anything's possible. But last year saw the convergence of a number of negative factors: First, retailers entered the Fall with above average inventories because of a very weak back-to-school season. Second, a number of competitors' balance sheets were strained already. Third, the consumer was unusually selective in their buying. And, fourth, there was a very nasty price war last year between <u>Wal-Mart</u> and Zellers — which created still *more* price competition, besides pulling traffic away. So they were kind of hit from all sides at once.

OID: And you think those negatives are nonrecurring — at least simultaneously?

McElvaine: That's right. For example, inventories were better going into this year. And one result has been better pricing. Plus, it's hard to imagine a repeat of the pricing problems that happened in the Fall of last year.

Also, again, both <u>Chateau Stores</u> and <u>Reitman's</u> are optimistic that this year's earnings will be better than last year's. However, even if they're not, in both cases, we're confident that they'll be around for the recovery — *whenever* it may come. So if the industry takes 3-4 years to turn around, that's fine with us — because both of these companies are cash flow positive even in *this* environment.

OID: And, in effect, you're purchasing the survivors while there's still blood on the streets...

McElvaine: Exactly. We're getting the retail businesses for very little. And, these two have been very good businesses economically. Of course, I'm not talking

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(cont'd from preceding page)

about whether they add fashion to the world...

OID: That's a different publication, actually...

McElvaine: The nature of the retail business, however — as I've described — forces you to be careful because it doesn't have an enduring quality.

OID: Aside from its negatives, in any case.

McElvaine: So there's a price at which you *want* to own these businesses and a price at which you *don't*. And as long as you don't mislead yourself into thinking that you have something you can hold onto forever, you're fine. You have to be as price sensitive as a shareholder as you might be as a shopper. How's that for a snappy phrase?

OID: Don't give up your day job.

But maybe you have a manager who'll do intelligent things in terms of capital allocation and reward you for holding it a long, long time.

McElvaine: I don't disagree with that on Reitman's. But investors have sometimes valued that highly and sometimes they haven't.

OID: And right now, they aren't.

McElvaine: That's right.

CHINA WAS HOT, BUT NOW IT'S NOT —
TWO MICROCOSMS OF MARKET REALITY....

OID: We see what you mean about Canadian retailers.

But might we trouble you for one more idea?

Cundill: At this year's annual meeting, I mentioned that several companies in the People's Republic of China had listed shares and that they'd gone straight down since.

One of them is Brilliance China Automotive Holdings [CBA/NYSE]. Its subsidiary, Shenyang Automotive, makes mini vans using Toyota assembly and Toyota expertise. And, as recently as 1992, Brilliance was as high as \$34.75. Today, it's trading at \$3-7/8.

OID: Ouch.

Cundill: It's true that its earnings have gone down. However, the net-net — funnily enough — when it was trading at \$34 was \$1.66. Today, with the stock at \$3-7/8, the net-net's \$3.30. It has no long term debt and still has a lot of cash. And at least for now, it's still making money — albeit a lot less.

OID: And Morningstar International Stocks shows its book value as being \$5+ as of December 31st.

Cundill: Yep.

OID: Have you bought this one?

Cundill: We have — and just recently.

OID: Why is it down nearly 90%?

Cundill: Net income in '92 was \$18 million — and now it's down to \$4 million. But, more important, I think, is simply that the PRC was hot and people loved China then. That was when Barton Biggs wrote that wonderful piece about how he loved China.

OID: And the fact that capital expenditures exceeded cash flow the last three years probably doesn't help.

Cundill: Nope.

OID: Although that may not be all that unusual for growth companies in capital intensive businesses — although this one doesn't sound like it's been growing for the last few years...

Cundill: We don't know if it will be a growth company or not. But it meets our tests.

OID: What else can you tell us about Brilliance?

Cundill: Not a lot. If you'd like to get more details, you can get all you want from David Briggs in Vancouver.

OID: Regrettably, pages do not allow...

Cundill: And while we're on the subject of the PRC, you may recall that I also mentioned Douglas Eu at this year's annual meeting as being a valuable member of our intelligence network. Well, we also own shares of his closed-end fund — Jardine Fleming China Region Ltd. [JFC.AX/Aus]. As its name implies, it invests in Asia — mostly in the PRC and Hong Kong — and trades in Australia. And it's currently selling at a 32% discount to net asset value.

OID: And may we ask your cost?

Cundill: I don't remember exactly what we've paid. But our cost is probably roughly where it's trading today. We don't own a lot of it — because it's not a big fund.

But it just seems to me we're buying a portfolio that's partially in the PRC that's probably cheap to begin with. And, then, we're buying it at a 32% discount.

OID: Because of concerns about 1997.

Cundill: I don't *know* why. It just *is*. Interestingly, Eu runs another fund that's very similar that trades on the New York Stock Exchange with basically the same holdings. And, yet, that one often trades at a *premium*.

OID: Which, I imagine, speaks volumes.

Cundill: I think so. But what do *I* know?

OID: Quite a bit if past features are any indication.

Thanks for sharing your thoughts with us again this year.

Cundill: My pleasure.

—OID

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT
(cont'd from page 1)

would have grown to more than *$200* million.

However mind-numbing those figures may be, the manner in which they've been achieved may be even more so. That manner is best described by longtime friend, partner and Berkshire Vice Chairman Charlie Munger. Munger calls Buffett "the Ben Franklin of Omaha" and describes Berkshire as "Buffett's canvas" which he uses to illustrate the value of certain important principles in the most powerful way of all — i.e., by example.

Not on that canvas are some of the common tools of other financiers — hostile takeovers, aggressive use of debt or other buy-low/cash-out-high, LBO-style, get-rich-quick-type maneuvers designed to accelerate the process. Rather, most of the leverage utilized to date has consisted of conservative levels of insurance float plus deferred taxes from their glacial turnover. In fact, their occasional discard has been sufficiently rare that it's as likely as not to raise eyebrows almost as much as their *purchases*.

Buffett carries on the teaching tradition of his late teacher, friend and mentor, Ben Graham, via the book which he says he's writing "on the installment plan" — i.e., his letters to Berkshire shareholders. And that book — according to most knowledgeable readers — may well be the finest example of business wit and wisdom anywhere. Many observers, (including yours truly), believe that a very careful reading (rereading, etc.) of those letters is far more valuable than two years of business school.

Only 18 or 19 years ago, Berkshire's annual meeting was still being held in the employee cafeteria of its National Indemnity subsidiary. And that sparsely attended meeting was regularly punctuated by the recurring sound of soft drinks and other foodstuffs now and again falling from the vending machines surrounding the room.

Having today outgrown every indoor seating facility in Omaha except the Holiday Inn Convention Center, this year's annual meeting attracted 5,000 or so attendees who not only filled the largest room in that facility, but also spilled over into two nearby rooms and a basement room where the overflow crowd watched via closed circuit TV.

Another measure of their popularity is the fact that only cold water from Buffett and Munger themselves (and the issuance of a Baby Berkshire — a B Class of share) could dampen enthusiasm for several funds designed either to consist of Berkshire shares or mimic its holdings. Still another is the publication during the last year or two of several Buffett biographies and the appearance of partner Charlie Munger on the cover of *Forbes*.

We invariably find their insights an invaluable course on what counts in investing, business and human nature. This year's batch was no exception. (Those 5,000 or so attendees didn't travel cross country for nuthin'.)

Just in case you weren't one of those who attended, (or even if you *were*), we're pleased to bring you the following excerpts from the wit and wisdom of Buffett and Munger at this year's annual meeting held on May 6th in Omaha. We hope you find them as enjoyable and valuable as we do.

GOOD MONEY IS MADE ON WALL STREET. THE QUESTION IS HOW IT'S DIVIDED UP.

Good money is made. The question is how it's divided up.

Shareholder: My question is about Wall Street firms in general and how you feel about Salomon at this time.

Buffett: We know more about the securities business than we knew 10 years ago. It's a tough business to manage. There's a lot of money made in the business — throughout Wall Street, I mean — very large sums of money. And then the question is how it gets divided up between the institution and the people there.

You own the stock, but the local surgeon owns the practice.

Buffett: You get to this question: I've often used the analogy that if you're an investor and you get a chance to buy the Mayo Clinic, that is one sort of investment and the local brain surgeon is quite another.

If you buy the local brain surgeon and his practice for $X million, what do you really own? You wouldn't pay any real multiple of earnings because he's going to have this revelation several days later that it's really *him* — not you with your little stock certificate — producing the earnings. It's his reputation. And he doesn't care....

Can you imagine Berkshire Hathaway advertising brain surgery and how much business we'd do? He owns the business even though you have the stock certificate.

At the Mayo Clinic the *institution* has the power....

Buffett: On the other hand, no one can tell you the name of anybody at the Mayo Clinic — unless they happen to live within 10 miles of Rochester. There, the *institution* has the power. It has to keep up the quality and do all the things an institution has to do. But whoever owns the Mayo Clinic has an asset that's independent of the attitude of any one person in the place.

Wall Street has a mix of both. At some companies, the value resides more in the institution — and, at some, it resides more in the individuals.

Management is making progress, but it ain't easy.

Buffett: We have a couple of sensational people running Salomon. They wrestle with this problem as they go along. And they seem to be wrestling considerably more successfully currently than they were close to a year ago.

But it is not an easy business to run and it's not an easy business to predict unless you have a business that's very institutional in character. And there aren't many of those on Wall Street.

SALOMON'S BUSINESS IS INHERENTLY VOLATILE, BUT MANAGEMENT'S FOCUSED ON WHAT COUNTS....

You can see that we aren't wasting much around this joint.

Shareholder: Salomon has experienced quite a lot of volatility in profits. What are your views with respect to Salomon's long-term profitability?

[Editor's note: The shareholder has a heavy accent. And Munger begins to translate the question to Buffett.]

(continued on next page)

BERKSHIRE HATHAWAY'S
WARREN BUFFETT
(cont'd from preceding page)

Buffett: I can see. He can hear. We make a great combination.

Munger: You can see we aren't wasting much around this joint.

Buffett: Salomon's earnings have *always* been volatile — at least during the time I've been around the place. And I don't think that their volatility is likely to disappear.

All that said, we very much like the people at Salomon. Berkshire's done a ton of business with them over the years in a whole lot of different capacities. And they've done it very *well*. So we're high on the firm as a customer. And the firms we like as a customer we think maybe other people will like, too. Generally, we love it — volatile or no.

Accounting emphasizes Salomon's volatility and hides ours.

Buffett: Salomon and other firms of that type mark their securities to market. And those marks go through their income statement — daily, actually, although you see them quarterly.

We mark Berkshire's portfolio to market for balance sheet purposes, but not for income statement purposes — because the rules are different [for insurance companies]. But, interestingly, if we'd done it the way Salomon does, you would have seen *enormous* volatility quarter to quarter in Berkshire's figures for the last 30 years.

I don't think you'd necessarily have seen any down year, but you'd have had swings between a few percent and perhaps 50% or so. And if you looked at us quarterly, you'd have seen a number of quarters of losses — and some great upsurges, too. The volatility would have been *extreme* if it'd all been run through the income account.

But accounting convention doesn't call for running those figures through Berkshire's income account, whereas it does in the case of Salomon.

Salomon's management is focused on what's important.

Buffett: The nature of Salomon's business is such that they will have volatile earnings. The nature of *most* Wall Street businesses is going to lead to volatile earnings. Some Wall Street firms may even follow policies that tend to make their businesses look a little less volatile than they may actually be.

But the real things that count are, first, running it so that the volatility never *kills* you and, second, having a decent return on equity over time. And I think that the people at the top of Salomon are very focused on that.

Munger: I think it's illogical for credit rating agencies to mark down Salomon as much as they do because its earnings are volatile. They're in that style of business. That's their game.

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MANAGED RIGHT, BANKING IS A GOOD BUSINESS.
THE TRICK IS TO AVOID DOING ANYTHING *FOOLISH*.

The advantages of an in-market merger can be dramatic.

Shareholder: Would you lead us through a discussion of Wells Fargo's competitive position since they just effected such a large combination and, perhaps, some discussion of their share repurchase — which is probably as large in percentage terms as any company I can think of today?

Buffett: Wells should repurchase shares if they feel they're purchasing them below intrinsic business value. That's a calculation they make. And you should ask them what their calculus is. That will determine whether their share repurchase program makes good sense or not.

The advantages of an in-market merger *can* be *dramatic*. But sometimes it just causes a bank to do what it should have done anyway. I'm not convinced that the economies come about totally through scale rather than just from taking a hard look at how they run the business.

Bank of Granite required very little scale for its economies.

Buffett: We have in the audience today the CEO of the Bank of Granite located in Granite, North Carolina. That bank earned 2.58% on assets, I believe, in the most recent quarter annualized and had a 33% efficiency ratio.

That bank has $400-500 million of assets. It doesn't need to be $5 billion to get more efficient or anything of the sort. It's so much more efficient than any of those larger banks that had to be put together to get those ratios that it kind of makes you wonder about the underlying rationale. But I'm sure that John Forlines — who runs that bank — just focuses on doing the right things day after day (and he's been focusing on the right things for a lot of years). And it didn't take any in-market merger or anything of the sort to cause him to do that.

Anyone interested in the banking business should get his report — because there's nothing magic about the community of Granite, North Carolina, and he doesn't work under laws that are way different than the rest of the banking industry. And yet he has a record that makes all of the other banks' records look silly.

Gene Abegg did the same thing in our little Illinois bank.

Buffett: And we had a fellow over in Rockford, Illinois in a bank we owned back in the 1970s — Gene Abegg.... Gene ran a bank in Rockford that when the best banks were earning 1% on assets, he earned *2%* on assets. And he did it with way less leverage than anyone else, lower loan losses and a large, ultra-conservative investment portfolio. There wasn't any magic about it. He just didn't do anything that didn't make *sense*.

So there's a lot of room for improvement in the banking business with or without mergers.

Banking's a little like investing. You have to avoid *folly*.

Buffett: There's no magic to it. You just have to avoid doing something *foolish*. It's a little like investing. You don't have to do anything very smart. You just have to avoid doing things that are ungodly dumb when looked at

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT
(cont'd from preceding page)

about a year later — airlines and that sort of thing. That's the trick.

It is not some great crystal ball game where you look into the future and see all these things other people can't. After all, what's complicated about Coca-Cola or Gillette — or Wells Fargo for that matter?

On the record, I'd say that Wells has done an *exceptionally* good job running its bank compared to other big banks. And those two operations put together will be run a whole lot more efficiently than if First Interstate had been run on its own.

We like businesses like banking if the management's right.

Buffett: Banking *can* be a very good business when it's run right — as the Bank of Granite and Illinois National Bank in Rockford prove.

We like businesses like banking if we've got somebody in charge of them that is going to run them right. A fellow named Bob Wilmers runs First Empire — which we have a good-sized investment in. And Bob just runs it right. I don't worry about surprises from Bob or First Empire. If he can grow and it's logical, he'll grow. And if it isn't logical to do something, he'll pass. He has no ego compulsions forcing him into some sort of action....

Wells' move into supermarkets....

Shareholder: Wells Fargo, like most banks, has a very expensive branch system for deposit gathering and servicing its customers. They've also moved more into branches in supermarkets and on-line banking — which seems to have the potential to very significantly reduce their costs relative to their branch system. Would you comment on how significantly you think that's likely to impact their asset gathering costs?

Buffett: You're right. Wells Fargo is the leader in moving into supermarkets. And they have a couple of different formats that they use. Plus, they're a leader in providing on-line banking services.

Unfortunately, in banking, it's a little hard to have any secret formulas. Coca-Cola has [their secret formula] down there in the vaults of what used to be The Trust Company of Georgia and is now SunTrust. But in the banking business, anything you do, your competitors can copy.

Nevertheless, there is an advantage — and sometimes it can be quite a *significant* advantage — in being first and learning more about different distribution methods. And I think Wells Fargo has done a terrific job of learning that. So I think that they have some advantages. However, they aren't advantages that other people can't work at copying and chipping away at.

But it's a good management. And they've done a very good job of seizing on that particular trend in supermarkets. And, as such, they have the potential, perhaps, for having a relatively low cost deposit gathering operation. But every other bank in the world will be looking, though, to see how that works — not only there, but at other banks, too — and to figure out whether they can copy it.

AMEX'S FRANCHISE AIN'T WHAT IT USED TO BE.
THEIR MISSION: TO DIFFERENTIATE THEMSELVES.

Amex either establishes special value or gets commoditized.

Shareholder: Would you comment on the strategy of American Express to deal with its declining market share?

Buffett: Interestingly, American Express backed into the credit card business because they were worried about what would happen to their Travelers Cheque business when they saw Diners Club come along — started by a fellow named Ralph Schneider. They saw the inroads that were being made. So American Express' entry into the credit card business was a reactive move.

And they dominated the field for awhile. Of course, they still dominate the travel and entertainment part of it. But credit cards are going to be a very competitive business over time. So they need to establish special value for their card in some way. Otherwise, it gets more commodity-like. It's not an easy business.

AMEX has a strong franchise, but it ain't what it used to be.

Buffett: American Express has slipped from where they were 20 years ago, obviously, in the credit card business. They may have taken their customer a little bit for granted for awhile. I think Harvey Golub is *very* focused on correcting that and has made some progress. But the credit card business is a very different competitive struggle now than it was 20 or 25 years ago.

They have a strong franchise. But it's not what it was 20 years ago relative to the competition.

FREDDIE MAC IS NOT WITHOUT ITS RISKS,
BUT IT DOESN'T KEEP US UP NIGHTS.

There's no way for Freddie Mac to eliminate risk entirely.

Shareholder: A few years ago, I think Freddie Mac was earning most of its money through guarantee fees and their float. Today, they have a huge balance sheet and a lot of short-term liabilities. Do you think it's more risky now because the spread might go away as the result of some unforeseen event?

Munger: Freddie Mac is probably *slightly* more risky. However, I don't think that they're taking horrible risks. It's still a very good business.

Buffett: I think Freddie Mac's structured its liabilities quite intelligently to handle what the investment world calls "a convexity problem" — which is that the borrower has the option of calling off the deal tomorrow or retaining it for 30 years. And that's a very disadvantageous contract to enter into if you lend money.

They've done quite an intelligent job of attacking that problem by using callable debt and various things. But you can't address a problem like that *totally*. There's no way to set up some model that satisfies that entire risk. So they've done a good job.

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BERKSHIRE HATHAWAY'S
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(cont'd from preceding page)

Greater mortgage retention = greater risk, but only a little.

Buffett: However, formerly, Freddie Mac emphasized just the guarantee of credit and passed all interest rate risk onto the market. Now they retain a higher percentage of the mortgages that come through their hands in their portfolio.

And as Charlie says, the larger the portfolio compared to their guarantee fees — well, you still have the credit risk on the portfolio and you've added a little interest rate risk at the extremes. So it doesn't keep us up nights. However, it's a tiny bit riskier than it used to be.

USAIR'S COSTS ARE A RELIC OF A BYGONE ERA. SO THEY CORRECT THEM OR BECOME A RELIC, TOO.

Either USAir corrects its problems or they correct it.

Shareholder: I'd like to have your comments on the USAir Preferred — which is several quarters in arrears.

Buffett: As I mentioned in this year's annual report, the USAir Preferred looks considerably better than it did 18 or so months ago. As Steve Wolfe, their new CEO, has said, the fundamental problems are there. So they either address and correct those fundamental problems or those problems will address and correct *them*.

Their costs are out of line. Their costs are relics of a regulated, protected environment. And they're no longer in a regulated, protected environment. So far, they've not had any great success in correcting the situation.

Knowing Mr. Wolfe, I'm sure he's focused entirely on getting that changed. And he will need to get it changed. [But] his record has been pretty successful at that.

USAir Preferred is clearly worth a lot more today....

Buffett: So we're a lot better off with our USAir Preferred than we were 18 months ago. But it's still a mistake I made. We'd have been a lot better off, as Charlie has said, if I'd just gone out to a bar that night instead.

Any comment, Charlie? (He doesn't want to comment because it may sound like it was his field.)

Munger: It's plainly worth a lot more than it was last year.

LOW COST ELECTRONIC INFORMATION DELIVERY WON'T JUST CHANGE WORLD BOOK....

Unit sales of print encyclopedias are down significantly.

Shareholder: Do you plan to become a leader in electronic encyclopedias? Or have you considered selling your electronic business and just getting out of it?

Buffett: We won't sell the electronic business. That I can tell you. I'm not very good at some technical stuff. For example, I have trouble turning on a light switch.

But in terms of the bundled product — which is the encyclopedia offered with the purchase of a new computer — that's become a large business in terms of *units*. I'm sure Encarta's sold many, many millions of units bundled with a new computer. But it doesn't necessarily produce a lot of *dollars*.

In the last several weeks, Encyclopedia Brittanica has announced the cessation of the direct distribution of its print product. Unit sales of print encyclopedias in the U.S. have gone down very significantly the last few years — as they have at World Book.

It's not easy to make money in encyclopedias these days.

Buffett: We're in the process of changing — and have already changed in some parts of the country — the distribution system to see what can be made to work, if anything, in direct distribution. There are indications that we may be able to make money in that business with a different cost structure than before. We'll know more about that [soon] — we're not that far off — because we partially changed the distribution system within the last few months.

But it's not easy to figure out how to make money in either the electronic or the print encyclopedia end of the business. We have some ideas in the electronic end that we'll know a lot more about in six months or so. But I don't want to go into any detail about those at present.

We could become the only profitable printed encyclopedia.

Buffett: I have our electronic product myself. It's a first class product. And we have ideas about how to make it even *better*. We've taken a lot of costs out of the print end of the business and we'll be putting some of those into the electronic end. It may turn out to be a workable business for us even though it isn't for anybody else. But the jury is still out on that.

It is not the business it was five years ago. And I don't think it *will* be the business that it was five years ago because the world has changed in some ways since then.

But we will not sell World Book. I will state that unequivocally. We will not sell our electronic World Book. We're in the business to stay. But we are groping a bit to figure out a configuration that will produce decent profits for us and sell a lot of World Books in the process.

We lose some, too — e.g., windmills and Blue Chip Stamps.

Munger: We don't have any way of avoiding declines in some of our businesses some of the time. Blue Chip Stamps once sold stamps at the rate of $120 million a year. Now it's about $200,000 a year. So we lose some.

Buffett: We were in the windmill business many years ago. We *think* about the problems. But there are sometimes industry problems that you can't solve. For example, I was in anthracite coal at one time and street railways, too. So I've seen 'em all.

Implications of electronic data delivery will be far reaching.

Buffett: But World Book is a first class product. And Charlie and I use it. But you can deliver information electronically at a far, far less cost — *unbelievably* less — than you could not that many years ago. The world in many forms will be adjusting to that — and not just in encyclopedias. It effects some of our other businesses, too.

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BERKSHIRE HATHAWAY'S
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So, again, it's something we *think* about. However, it's very unlikely that Charlie and I are going to be smarter than the rest of the world in terms of the electronic world. We're looking for the *obvious* where it's within our capability to do something about it. We're not trying to beat people at their game where we're not very good at it.

PAPERS DON'T HAVE THE LOCK THEY ONCE DID, BUT THEY'RE STILL ONE HELLUVA BUSINESS.

Newspapers still a bargain to readers and advertisers alike.

Shareholder: Not that you can foretell the future, but are you concerned that printed newspapers might go the way of the printed World Book and Blue Chip Stamps?

Buffett: It could happen, but I think it's very unlikely — *very, very* unlikely — down to a few percentage points.... World Book is a different story. It has a reasonable shot at a decent future, but it's not automatic. The newspaper — although it may be configured differently and get a different percentage of its revenue from circulation and advertising and undergo some evolutionary changes — is still a bargain to anyone interested in their community.

And it's still a bargain to a great many *advertisers*. We spend a lot of money advertising in newspapers in our various businesses. Obviously, we feel like we're getting our money's worth. And it works.

Newspapers' position has weakened a bit in recent years.

Buffett: They just don't have the lock they used to have. The circulation of daily newspapers per household has been declining for a long time. And the trends of the last couple of years are somewhat worse in that respect. Also, their ability to price — both at the circulation and advertising level — has weakened a bit in recent years — not dramatically, but it has weakened.

But they started from a position of *extraordinary* strength.

Buffett: At one time, daily newspapers in single newspaper towns were probably as attractive economically as any business you could find. A large percentage of advertisers had very little choice in terms of whether to use them as an advertising medium. People had fewer options in the way of learning what was going on around them other than the daily newspaper. So they started from a position of *extraordinary* strength.

Newspapers are still a bargain and a very fine business.

Buffett: They still have a *very* strong position. And I tried to emphasize that in the annual report. They're still a bargain [to subscribers] at the current price. They give you all kinds of information at a very low price. And they're still a magnificent way for most merchants to reach customers.

But they don't have the *exclusive* advantages in many cases that they had 15 or 20 years ago. Third class mail has become more of an option. People have more ways of obtaining information. As we discussed, information can be processed and delivered electronically at a *far* lower cost than people ever dreamed 20 years ago. So all those things eat away a little bit. But it's still a very fine business.

I don't see anything that will reverse those trends, although I don't think they'll necessarily accelerate either. However, if the only thing you owned was a daily newspaper in a single newspaper town, you'd feel slightly less secure today than you would have felt 20 years ago. However, you'd still be a lot better off than you would be owning virtually any other business....

IF THE BUSINESS AND PEOPLE ARE RIGHT, WE'LL BUY. BUT WE WON'T EXPECT TO MAKE 23.6% PER YEAR.

If historical returns were our yardstick, we'd do *nothing*.

Shareholder: In light of Berkshire's outstanding 23% annual growth in book value per share and the retail industry's 8-9% growth in equity over the last several years, why would Berkshire exchange stock for securities where the growth in net worth of the acquired companies — if they're anywhere *near* the industry average — are one third less? To quote Barnett Helzberg from the annual report, "The diamond business is a very competitive industry."

Buffett: *All* retail is competitive. But both Helzberg's and Borsheim's have averaged a lot better returns on equity than the numbers you cite for the industry as a whole.

But we have *no way* of earning 23.6% on equity in the future. So we don't use our historic average returns as a yardstick for new investments. If we did, we wouldn't make *any* new investments — because we don't know how to make 23.6% in the future.

We do regard retailing as being a very tough business. But we like our companies' records, their market positions and their managements. And when we find a business like that and we feel very comfortable with the people running it, we'll make the deal. But we won't expect to make 23.6% on our money over time doing that.

WHAT ELSE WILL WE DO IN IN INSURANCE? BASICALLY WHATEVER MAKES SENSE....

We were the biggest super-cat insurer the last two years.

Shareholder: What is Berkshire's market share in super-cat insurance? And what's your outlook for growth in that market and market share growth for Berkshire?

Buffett: There aren't any good market share figures in super-cat. A couple of years ago — and last year, I think, too — we had to be the biggest in terms of premium volume. We simply take on so much more than anyone else will. We were getting the calls on big risks — $400 million here and $1 billion on the New Madrid fault a little while ago. Nobody else will be doing that. So we got market share by our willingness to do large volume and by the fact that people knew we would pay subsequently. But while we know that we're the largest, we can't give you any precise figures.

And we know that we're slipping in our share now.

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BERKSHIRE HATHAWAY'S
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However, that makes no difference to us. We would only care if we were slipping in *profitable* markets.

We'll do other things, although we don't know what.

Shareholder: Are there other insurance segments worth expanding into? Or will the focus be on super-cat and auto insurance?

Buffett: This year, we bought a very small company — the managers of which are here. And it's a very fine insurance company. It has a little niche. It'll never be huge or anything of the sort, but it's the kind of business we can understand and we like the people who run it. And we like the position they've achieved in the market. So we're delighted to be in it.

We're willing to think about a variety of things in insurance. But we find that most of them make no sense. Over the next 10-15 years, we'll do other things. It's bound to happen. But I can't tell you what they'll be.

The biggest single thing we'll do in terms of value, though, probably, is GEICO. We'll do other things. But who knows what they might be?

We're now the preferred provider of structured settlements.

Buffett: We have expanded our structured settlement business some since we told you about it a year or two ago. We're now the preferred provider of structured settlements. Those are annuities essentially that are payable to people who are usually the victims of a very bad accident — very severely injured people — whose injuries will probably last for life. So we'll be making payments to people incapable of earning a living and may incur substantial medical bills for many decades — sometimes for 50 or 60 years.

Those annuities are provided by our companies to other insurance companies and to these injured people — usually with the approval of the injured person's attorney. And when the advisors to the injured person think, "Who's going to be around in 50 years to pay money to this person who's been incapacitated?", they frequently — and, in our view, *logically* — think of Berkshire. So we have become much better known in that area the last couple of years.

We have a competitive advantage in structured settlements.

Buffett: It's not a big business and it won't be. But

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it's a perfectly decent business. And it's one where we have a competitive advantage over time.

We don't obtain a competitive advantage with price. We obtain a competitive advantage with the peace of mind that the injured party obtains from knowing that the check will be in the mail 50 years from now. That's the kind of business in which we have some edge.

We'll find other things to do over time. But it isn't like we're looking at any specific area. We're aware generally of what's going on in the insurance business. And we'll be very ready to move when the time comes that we can do something intelligent.

INSURANCE (& REINSURANCE) IS LIKE INVESTING — WAIT FOR THE FAT PITCH (OR ELSE).

Capital has flooded into reinsurance. And rates reflect it.

Buffett: There has been a fair amount of capital — there was a rush of it maybe about three years ago — going into the reinsurance business.... And that is negative for our business — because any capital that's brought in basically will get employed.

We are willing at Berkshire to sit on the sidelines — and we *do*. We'll offer quotes to someone. And, then, someone else will cut those prices substantially if they have a lot of capital and want to keep busy. If you've got a lot of capital in this business or you attract a lot of capital, you will do *something*.

You might *like* to do something smart, but if need be, you'll do something *dumb*. You'll rationalize it so that you'll think it's smart. But you'll do it. You won't just sit there and write to shareholders at the end of the year and say, "We asked you for $300 million last year. We'd like to report that it's still sitting in a bank account at Citicorp."

It just doesn't work that way.... People don't *like* to sit around all day and do nothing. So prices will get cut under certain circumstances. And that's what's happening now.

We have a compact with the folks who run our insurance.

Buffett: At Berkshire, we do have a rule about downsizing on that. We have promised people at all of our insurance operations that we will never have layoffs because of a drop in volume. We do not want the people who run our insurance operations to feel like they have to write $X in order to keep everybody there.

We can *afford* some overhead costing us a little money through lack of using our operation at full capacity — because it isn't that much relative to the size of our insurance operation. What we *can't* afford is people feeling some internal compulsion to keep writing business in order to keep their jobs. So we have a strong policy on that.

If the business falls away in terms of price, we won't be doing business. But we'll be around to do business in a big way when the circumstances reverse.

Insurance is like investing: Wait for the fat pitch.

Buffett: They reversed in the casualty area for awhile in 1985 or so and we did a terrific amount of business. And they reversed in catastrophe reinsurance about four or five years ago and we became very active in that.

We'll have times that are very good for us in insurance. It's a lot like investing. If you feel like you have to invest

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(cont'd from preceding page)

every day, you're going to make a lot of mistakes. It isn't that kind of a business. You have to wait for the fat pitch. And insurance is similar.

If we had a budget for premium volume for our insurance companies, it would be the dumbest thing we could do — because they would meet the budget. They could meet any budget I set out. I could tell an operation that wrote $100 million last year to write $500 million this year — and they would. And I'd be paying the bills for decades to come. So it's very illogical to try and plan 8-10% growth [in the insurance business].

Our reinsurance volume will swing around enormously.

Buffett: GEICO, however, is a different story. They're the low cost operator. And they can, I think, attract business from a huge pool at a very good rate of growth simply by letting people know it's available. So it's a business I see growing under almost *any* circumstance.

But our reinsurance business' volume will swing around enormously based on what competitors are doing. And what they're doing depends to a great extent on how much money they have burning a hole in their pockets.

Today, the market's going one way. But that will change.

Buffett: Right now, it's going in one direction. But it will change — just like investment markets change. I've been through at least half a dozen periods where people think they're never going to get a chance to buy securities at intelligent prices. But it *always* changes.

In this business, people who misprice their policies will pay the price. But the world will still need insurance. And we'll be there.

WE HAVE A PREEMINENT POSITION IN CERTAIN NICHES — AND WE'LL BENEFIT FROM IT AT SOME POINT.

Berkshire has obviously benefited from Lloyd's problems.

Shareholder: There have been some recent news articles on the problems at Lloyd's of London. What effect, if any, do you see Lloyd's problems having on Berkshire's insurance or reinsurance business?

Buffett: I think it's fair to say that Lloyd's problems have helped us. Because Lloyd's had a terrific reputation, it was the *first* stop and, usually, the *last* stop for all kinds of large and unusual risks 20 years ago. And the fact that they've lost some of their luster since then has helped us.

We didn't do anything to contribute to it. But it obviously benefits us competitively when questions develop about an organization that has been a premier player in the industry.

Berkshire has a preeminent position in certain segments.

Buffett: Berkshire probably possesses more capital than all of Lloyd's put together. We've established a reputation for being willing to quote on very large risks very quickly and to do exactly what we say. And it may very well be that in many cases *we* get a call before *they* do now. So we've been a beneficiary — probably, in a fairly good-sized way — from their problems.

It's more difficult for them to make inroads on us now than would have been the case 10 years ago. I don't like to lay it on too strong, but we do have a preeminent position in a certain area of really large scale reinsurance that will be difficult for anyone else to replicate.

And we'll benefit from that position at some point.

Buffett: People may not like our prices. There may not be demand for some of the things we do. But if there is, we're very likely to get some very significant business based on that position. We've seen it some in recent years. And we'll see it more in the future.

DO WE PLAN TO GO INTERNATIONAL IN INSURANCE? WE ARE *ALREADY* — REINSURANCE-WISE & OTHERWISE.

Our reinsurance business is *already* international.

Shareholder: Is there a policy or plan on the part of Berkshire Hathaway to diversify and internationalize their insurance business?

Buffett: Berkshire's reinsurance business is *totally* international. We deal with risks all over the world.... And that's the nature of the reinsurance business generally — although there might be some that specialize by country. We're quite willing to take on risks around the world, although they have to be risks with a large premium. That's the nature of our reinsurance business. We're not in the retail end of the business. But we do that worldwide.

And we'll continue to do it worldwide because primary insurers around the world have huge risks that they need to lay off to someone. Whether they'll pay the proper price, though, is another question. And it may be a little more difficult in a few jurisdictions to do business than others. But it's an international operation.

For GEICO, international markets would be a *distraction*.

Buffett: GEICO has 2-1/2 million policyholders of the 100+ million potential insureds in the U.S. And there is *such* an opportunity here that it would be *diversionary* for GEICO to go into other countries. A firm that was very successful in England introduced a somewhat GEICO-like operation about ten years ago or so and they did very well. They're now encountering more competition and their results are falling off somewhat.

But there's *huge* potential for GEICO in this country. I wouldn't want GEICO's management to be going off in other directions now when there's so much to be done here. Three percentage points on our growth rate here would be $75 million or so of volume which in turn would keep compounding over time. There's too much to do here before we set up some start-up elsewhere in the world.

And there are actually various problems in a lot of jurisdictions to run a GEICO-like operation — although I'm not saying those problems prevail everyplace. There could be opportunities. But the opportunity here in this country is huge. And the management at GEICO is focused.

One thing Coke, Gillette & GEICO have in common: focus.

Buffett: And I *love* focused management. Read the Coca-Cola annual report. You won't get the idea that Roberto Goizueta is thinking about a whole lot of things

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other than Coca-Cola. I've seen that work time after time.

And when you lose that focus — as did both Coke and Gillette, actually, at one point 20-30 years ago — it shows. Two great organizations weren't achieving their potential about 20 years ago. Then they became refocused. And what a difference it makes. It makes *tens of billions of dollars* worth of difference in terms of market value.

GEICO actually started fooling around in a number of things in the early 1980s. And they paid a price for it — actually a very *big* price. They paid a direct price in terms of the cost of those things — because they almost all worked out badly. And then they paid an additional price in terms of the loss of focus on the main business.

That will not happen with the present management. Tony Nicely thinks about nothing else but carrying the GEICO message to the 97-1/2% or so of people who are not GEICO policyholders. And that will work very well for us over time.

We love our international exposure & our companies' focus.

Munger: We are *indirectly* in these emerging markets through Coca-Cola and Gillette. So it isn't true that we're totally absent.

Buffett: International markets account for about 80% of Coca Cola's profits — actually a little more — and 70% or so of Gillette's. We love the international aspects of their businesses. That's a very major attraction.

But the managements of those companies are focused on that. They have distribution systems and a lot going for them over there. But the beauty of it is that they're maximizing what they do have going for them. That was not the case 20 years ago when they grew more by default and they started fooling around with a lot of diversification — which, basically, didn't work that well.

So we like focus. In fact, we *love* focus.

Munger: And by doing it indirectly, as we've done, one can argue that we, thereby, do it a lot better.

Buffett: We won't explore the implications of that.

COST OF INSURANCE FLOAT CAN ONLY BE ESTIMATED, BUT IT LOOKS LIKE IT'S COST US LESS THAN NOTHING.

Our most valuable asset is money we don't own.

Shareholder: You've said your insurance business is probably the most important business you own. On page 12 of your annual report you say, "We have benefited greatly to a degree that has not been generally understood because our liabilities have cost us very little."

Could you describe this a little bit better?

Buffett: Our insurance business provides us with float — which is money we hold that doesn't belong to us. It's like a bank having deposits. The money doesn't belong to it, but it holds the money.

When a bank holds deposits, there's an explicit cost — i.e., an interest rate attached to it — at least on everything except demand deposits [checking accounts]. And then there are the costs of running the system and gathering the money which must also be attributed both to demand and time deposits. So there's a cost to obtaining what they'd call deposits and what we'd call float.

In the insurance business, a similar phenomenon takes place in that policyholders give us their money at the start of the policy period. And, therefore, we get the money paid in advance for the product. Secondly, it takes time to settle losses — particularly in the liability area. If you bang up a fender on your car, it's going to get settled very quickly. But if there's a complicated injury or something, it may take some years to settle. And during that period, we hold the money.

So we have, in effect, something that is tantamount to the deposits of a bank.

Cost of insurance float is by its nature usually an estimate.

Buffett: But whereas it's quite easy to calculate the approximate cost associated with a bank's deposits, in the case of an insurance company's float, you don't really know the cost of that float until all of your policies have expired and your losses have all been settled.

Well, that's *forever* in some cases. You're only making an estimate as you go along of what that float is costing.

But we've obtained our float on very advantageous terms....

Buffett: In the 29 years we've been in the insurance business at Berkshire, it *appears* — you're never certain because you don't know for sure what's going to happen — but it appears that our float hasn't cost us *anything* on average. In some years, we've had an underwriting loss — so that there's been a cost. And in some years, we've had an underwriting profit — so we've had a *reverse* cost. But we've obtained our float on very advantageous terms over the years. And it's important to get it at a low cost.

IT'S NOT ENOUGH TO GET FLOAT CHEAP OR EVEN *FREE* — OR TO GET A *LOT* OF IT. YOU HAVE TO DO *BOTH.*

Equally important, our float has grown and grown.

Buffett: However, fully as important as the low cost — *no* cost, in our case — is that we've *grown* it dramatically. So we've gotten more and more money without any cost attached to it. If we still had the $17 million of float that we had in 1967 at no cost, it would be very nice. Certainly, $17 million of free money is worth something, but it's not worth a ton.

On the other hand, having *$7 billion* of free money — if we can achieve that — is worth a *lot.*

Liability side of our business hasn't been fully appreciated.

Buffett: That growth probably hasn't generally been appreciated fully in connection with Berkshire. Nor has the interplay of how having zero cost money in terms of affecting our gain in value over time been appreciated either. People have always looked at our asset side, but they haven't paid much attention to our liability side.

Charlie and I pay a *lot* of attention to that. It's not entirely an accident that the business has developed in this manner. And we have every intention of trying to make it *continue* to develop in that manner in the future.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT
(cont'd from preceding page)

However, we have competitors out there, too.

Our job is to get lots of float and, above all, to get it cheap.

Buffett: Float per se is not a blessing. We can show you many insurance companies who thought it was wonderful to generate float. And they lost so much money in underwriting that they'd have been better off if they'd never *heard* of the insurance business.

The job is to get it and get it in increasing quantities, but, above all, to get it *cheap*. And that's what we work at.

OUR COMPETITIVE ADVANTAGE IS NOT AUTOMATIC, BUT IF THEY'RE MANAGED RIGHT AND NURTURED....

Our cheap, plentiful float springs from competitive advantage.

Buffett: You achieve that in this business only by having some kind of competitive advantages. You *won't* do it just by having an ordinary insurance company — because an ordinary insurance company is not a good business.

We have it in certain respects because of our *attitude* toward the business. Our financial *strength* gives us certain advantages. And we have it in the case of GEICO because of a very low cost operation. And it's up to us to try and figure out ways to maximize each one of those competitive advantages over time.

We've *built* those advantages. In 1967, we weren't looked at that way in the insurance business. We've built a position of competitive strengths. And GEICO had it without us. But we bought into it over time.

Would I accept $7 billion for our float? The answer is no....

Buffett: So it's a *very* important asset. And you ought to pay a lot of attention over the years to what's happening with that asset — both as to growth and cost. And that will aid you in calculating intrinsic value....

But I will tell you this: We have $7 billion of float presently.... And if I were offered $7 billion for that float and did not have to pay tax on the gain, but would thereafter have to stay out of the insurance business forever — a perpetual non-compete in any kind of insurance — would I accept that? The answer is no.

That's not because I'd rather have $7 billion of float than have $7 billion of free money. It's because I expect the $7 billion to *grow*.

It would have been a mistake — and one I'd have made.

Buffett: If I'd been offered that trade 27 years ago of $17 million for the float we had at that time with no tax to be paid — float for which we'd just paid $8.7 million — in return for us to have gotten out of the insurance business, I might have said yes....

Munger: You *would*'ve.

Buffett: Yeah.

Munger: But he keeps *learning*. That's one of his *strengths*.

Buffett: That's probably true in this case. I'm not sure in other cases. But it would've been a terrible mistake. It would have been a mistake to do it 10 or 12 years ago with $300 million of float. And today, a tax-free payment of $7 billion would not compensate us adequately for giving up the opportunity of being in the insurance business forever at Berkshire — even though it'd be a $7 billion pure addition to equity. So we wouldn't take it. In fact, we wouldn't even *think* about it very long.

So, as Charlie says, that isn't the answer we'd have given some years back. But it's a *very* valuable business.

It's not automatic. But if they're run right and nurtured....

Buffett: It has to be *run* right — as does GEICO, the reinsurance business, National Indemnity and the homestate companies.... And it's not automatic.

But they have the people, the distribution, the reputation, the capital strength and other competitive advantages in place. And, if nurtured, I think they become more valuable as time goes by.

GEICO HAS SOME REALLY BIG OPPORTUNITIES — AND MAY FLOURISH EVEN *MORE* WITH BERKSHIRE.

We have this bias towards things that throw off cash....

Buffett: We've always had an interest in float businesses of one sort or another. Blue Chip Stamps was such a business — until it *disappeared* one day....

We're always interested in businesses that provide cash rather than use up cash. We're willing to have them use cash if what they use it for will produce high enough returns. But we have this bias toward things that throw off cash....

Everybody wants to emulate it, but few even come *close*.

Shareholder: Berkshire has increased the amount of its insurance float by more than 20% per year since 1967. At what rate has GEICO's float grown historically? And what impact will it have on Berkshire's overall float growth?

Buffett: GEICO is a huge plus to Berkshire now.... We owned 50% of it before. And we've benefited from our GEICO investment in a big way ever since 1976. So it's not entirely a new benefit that's coming in.

We paid a good price for it. But it's a *terrific* company. It has outstanding management. And it has a low-cost method of distribution which is *very* difficult to emulate. Everybody wants to have it, but very few come *close* to it. And management's focused on bringing costs down even further and widening that competitive moat.

GEICO may flourish even a bit *more* as part of Berkshire.

Buffett: I personally think from what I see that GEICO's growth rate in the future is likely to be greater than it's been in the past — although it's been perfectly satisfactory in the past. I think that there are some advantages to it being part of Berkshire — in that there are costs attached to bringing new business on the books. And we care not at all about reported quarterly earnings.

GEICO was relatively insensitive to those before. And it's a compliment to say that. But they had *some* pressure on them with respect to reported earnings they won't have as part of Berkshire. And I think there are some really big opportunities in terms of what can be done with GEICO as part of Berkshire.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT
(cont'd from preceding page)

Five years from now, I think you'll be very happy with the fact that we own 100% of GEICO. I think you'll see that as marvelous as it was as an independent company, it will flourish maybe even a bit more as part of Berkshire.

That's not because we bring anything to the party. The management will continue to run it autonomously. But there are some advantages that accrue to it as part of a larger enterprise.

GEICO is doing very well — as I knew it would....

Shareholder: In regards to your purchase of the other half of GEICO, would you comment on your reasoning behind paying a premium above market value and why you instead didn't purchase shares in the open market?

Munger: Well, we couldn't have purchased very many shares in the open market at the quoted price. And given the large number of shares we got, we thought the price we paid was a very satisfactory one.

Buffett: Charlie is 100% right. We also had a restriction that we agreed to almost 20 years ago as to the number of shares that we could own without the consent of the directors and, I believe, the insurance department. So we actually had some special restrictions in place in the case of GEICO. But if we hadn't had those restrictions, we'd have behaved in exactly the same manner.

We didn't think we could buy it any cheaper than that. So we gulped a few times and paid it. I think we'll be happy we did. GEICO is doing very well — and I *knew* it would. So I feel very good about it.

WE DON'T *TRY* TO MAXIMIZE LIQUIDATION VALUE — AND THAT'S NOT THE WAY TO *VALUE* US....

Static value analysis doesn't work in valuing Berkshire...

Buffett: I think to the extent people have made a mistake in the past in valuing Berkshire — and they *have* made this mistake over time (including many commentators and some institutions) — [they've done so by] valuing Berkshire simply in terms of its breakup value....

You could do the same thing with General Electric — an operation that is magnificently run by Jack Welch. But I don't think the way you should look at a business like that is to think about what would happen if they sold each division, paid the taxes and distributed the proceeds. That's tended to be the way many people look at Berkshire — looking at it, in effect, on a static basis.

That's not the way Charlie and I have looked at it. [Berkshire] lends itself a little more to that type of analysis because we have a lot of money in marketable securities. But we have a lot of money in other things, too.

Valuing Berkshire — or *any* business, of course, — involves [projecting out] its stream of cash over many years in the future (in fact, *all* of the years in the future) and discounting them back at an appropriate interest rate....

Book value didn't capture National Indemnity's potential.

Buffett: Berkshire is a *collection* of businesses — some of which we own in their entirety and some in part. And some have very interesting dynamics. For example, we bought two insurance companies from Jack Ringwalt approximately 29 years ago for either $8.4 or $8.7 million.

And if you'd had the foresight at that time to see what would develop out of that insurance business — and *I* didn't — you'd have come to the conclusion that their value to us was going to be far, far greater than the price we paid. They were part of a business which had enormous potential. [As I mentioned,] that's probably been the most significant asset that's been developed at Berkshire. Today, we have over $7 billion of float that's been developed from our insurance businesses.

We couldn't foresee that 25 or 30 years ago. However, it would have been a big mistake to think in terms of the then book value of that business as being representative of its actual value to us over time if it were run right. And that situation probably prevails today.

We haven't run Berkshire to maximize *liquidation* value....

Buffett: Berkshire is a group of, on balance, *very* fine businesses to which we hope to add. Its intrinsic value will be effected by the job we do allocating capital, by the job our managers do running their businesses, and by some items we don't foresee now and perhaps have no control over. But it is *not* measured by the proceeds that we'd receive net of taxes were we to sell each separate business today. And we haven't *run* it that way.

We've run it so we get the use of a lot of capital at very low cost. Between deferred taxes and our insurance float, we have some $12 billion or so on the liability side that we think will carry a very low cost.

And that doesn't show as an asset. But it could be quite valuable. Charlie, do you have anything to add?

BERKSHIRE IS WORTH MORE THAN BOOK TODAY. AND IT'S OUR JOB TO *KEEP* IT THAT WAY.

Value's understated in our book, but reflected in our stock.

Shareholder: Given the large number and dollar size of Berkshire's private businesses recorded at historic cost, shouldn't the multiple of book that Berkshire trades at expand over time to reflect the increases in intrinsic value of the private holdings? And I cite the Buffalo News on the books at essentially zero and GEICO — which will now be on the books for between $3 and $4 billion — as examples of the disparity between intrinsic value and book value.

Buffett: Most of the businesses we own entirely — or where we own 80% or more — are carried on the books at considerably less than they're now worth. In some cases, it's dramatic — although it's not dramatic, I think, relative to Berkshire's $40 billion total market capitalization. However, it's dramatic relative to the carrying price.

When we bought See's Candy for an effective price of $25 million in 1972, it was earning $4 million pretax — and it earned over $50 million pretax last year. When we bought The Buffalo News for $30-odd million, it was making nothing — and now it's making $45 million. And GEICO's worth more than we carry it for because of the accounting peculiarities of the purchase of the first 50%.

Our insurance business is the most dramatic case of a dollar difference between book value and intrinsic value. That number's gotten very big over time. And I personally

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT
(cont'd from preceding page)

think it will tend to get bigger — because I think GEICO will grow and I think our other businesses will do well.

So it is true that our businesses are worth something more than book value — in many cases, *substantially* more — although it is reflected in the market price of our stock.

Book understates value today. Our job: *keep* it that way.

Buffett: Of course, the trick is to take the new capital as it comes along — not from the issuance of the B shares (because that's relatively small compared to the amount of capital we'll generate from operations). But our float will grow from year to year. And our earnings will be retained. So we have to go out and find things to do that will be worth more than book value three or five years from now.

And that's a *job*. And it's a tougher job than it was. But it's kind of *fun*.

Book value, while imprecise, offers a guide to value growth.

Buffett: I don't think you can go from year to year and trace intrinsic value precisely by tracing changes in book value. We use changes in book value as a very rough guide as to movement [in intrinsic value]. And there have been certain annual reports where I've said that our intrinsic value has moved more than the proportional move in book value and others where I've said I thought it was roughly the same.

So I don't think you can stick some multiplier on it and come up with a precise number. However, I do think that it's a guide to movement in value.

A LESSON IN DISCOUNTED CASH FLOW ANALYSIS.
FIRST AND FOREMOST, STAY IN YOUR CIRCLE....

Discount rate? We think in terms of long-term Treasuries.

Shareholder: To determine a company's intrinsic value, you say you project out its owner earnings for a number of years and then discount them back at prevailing interest rates. How much of a premium, if any, do you demand when you discount them back? For example, today, with long-term Treasuries around 7%, at what rate would you discount back the owner earnings of Coca-Cola?

Buffett: We're asked that question a lot. And we've answered it to some extent in our past annual reports.

For our discount rate, we basically think in terms of the long-term government rate. We don't think we're any good at predicting interest rates. But in times of what seem like very low rates, we might use a little higher rate.

And cash is cash — whatever its source....

Buffett: We don't put the risk factor in per se — because, essentially, the purity of the idea is that you're discounting future *cash*. And it doesn't make any difference whether that cash comes from a *risky* business or a *safe* business — or, perhaps, I should say a "so-called" safe business.

The value of the cash delivered by a water company that's going to be around 100 years is no different than the value of the cash derived from some high-tech company, if any, that you might be looking at.

We don't go below a certain threshold of understanding....

Buffett: It may be harder to make the estimate [for the high tech company]. Therefore, you may apply a bigger discount when you're all through with your calculation.... Or you may decide that you can't estimate it at *all* — which is what happens to us with *most* companies....

But we believe in trying to stick to businesses where we think we can see the future reasonably well — obviously, you never see it perfectly — but where we think we have a reasonable handle on it. We don't go below a certain threshold of understanding.

Fudge factors for uncertainty are mathematical gibberish.

Buffett: We want to stick with businesses we think we understand quite well and not try to have the whole panoply with all different kinds of risk rates because, frankly, we think that would just be playing games with numbers.

I don't think you can stick numbers on a highly speculative business where the whole industry's going to change in five years and have it mean anything when you get through. If you say, "I'm going to stick an extra 6% on the interest rate to allow for that", I think that's nonsense. It may *look* mathematical, but it's mathematical *gibberish* in my view....

WALL STREET REPORTS DON'T HELP.
ANNUAL REPORTS, ON THE OTHER HAND....

I'd like to see what the manager thinks about the business.

Shareholder: I know that you read lots of annual reports. And I think I know what you're reading for. But would you share that with us? And are there any further disclosures you'd like to see companies make in their financial reporting or see the SEC require them to report to their shareholders?

Buffett: The main thing is what they *can't* mandate in annual reports — I like to know as much as I can about the person running it, how they think about the business and what's really going on with it. I would like to have a report identical to what I'd like to receive from my partner if I owned half of a company and I were away for a year. It would tell me what had taken place the past year and what he saw coming up. That is what I think the purpose of the report is.

The SEC mandates a lot of information. And *some* of it's helpful. But there's an *intent* behind the annual report: If it's a sales document, I'm less interested. And I don't see any way to mandate the kind of report I'm talking about. But that's what I'm looking for.

To understand our companies, I study their competitors.

Buffett: If I'm thinking about investing in a specific company, I try to size up their business and the people running it. And as I read annual reports, I'm trying to understand generally what's going on in all kinds of businesses. If we own stock in one company and there are eight others in the industry, I want to be on the mailing list for the annual reports of the other eight because I can't

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WARREN BUFFETT
(cont'd from preceding page)

understand how *my* company is doing unless I understand what the *other* eight are doing. I want perspective on market share, margins, the trend in margins — all kinds of things....

Over the years, I've found reading a lot of reports quite useful in terms of making business decisions at Berkshire. If we own all of a business, I want to own shares in all of its competitors just to keep track of what's going on. I want to be able to intelligently evaluate how our managers are doing. And I can't do that unless I know the industry [context within] which they're working.

Wall Street reports haven't helped. But *annual* reports....

Buffett: It's *amazing* how well you can do in investing really with what I'd call "outside" information. I'm not sure how useful inside information is. But there's *all kinds* of "outside" information around as to businesses. And you don't have to understand all of them. You just have to understand the ones you're thinking about investing in. And you can. But no one can do it *for* you.

In my view, you can't read Wall Street reports and get anything out of them. You've got to get your arms around it yourself. I don't think we've *ever* gotten an idea from a Wall Street report. However, we've gotten a *lot* of ideas from *annual* reports. Charlie?

Where it all begins and ends....

Munger: It takes a long *time* to read an annual report — even if the business is a comparatively simple one. If you're really trying to understand it, it's not a *bit* easy.

Buffett: Yeah. On average, in a business we're really interested in — where we know what to skip to some extent and what to read — we'll spend 45 minutes or an hour on a single annual report. If there are six or eight companies in the industry, that's going to be six to eight hours. And then there are quarterlies and a lot of other [material]....

The way you learn about businesses is by absorbing information about 'em, deciding what counts and what doesn't and relating one thing to another. That's the job.

You can't get that by looking at a bunch of little numbers on a chart bobbing up and down or by reading market commentary, periodicals or anything of the sort. That won't do it. You have to understand the businesses. That's where it all begins and ends.

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IF YOU'RE IGNORANT OR JOB SECURITY IS YOUR GOAL, YOU SHOULD OWN *EVERYTHING*. OTHERWISE....

If you're not ignorant, it's *crazy* to own 40-50 stocks....

Shareholder: I'm very interested in your policy on diversification and how you concentrate your investments. I've studied your annual reports going back a good number of years. And there've been years when you've had a lot of stocks in your portfolio and others when you've had a few or no more than seven....

Buffett: We like to put a lot of money in things we feel strongly about. And that gets back to diversification. We think diversification, as practiced generally, makes very little sense for anyone who knows what they're doing.

Diversification serves as protection against ignorance. If you want to make sure that nothing bad happens to you relative to the market, you should own *everything*. There's nothing wrong with that. It's a perfectly sound approach for somebody who doesn't know how to analyze businesses.

But if you know how to value businesses, it's *crazy* to own 50 stocks or 40 stocks or 30 stocks, probably — because there aren't that many wonderful businesses understandable to a single human being in all likelihood. To forego buying more of some super-wonderful business and instead put your money into #30 or #35 on your list of attractiveness just strikes Charlie and me as *madness*.

Modern finance theory has no utility — job security aside.

Buffett: It's conventional practice. And if all you have to achieve is average, then it may preserve your job. But it's a confession in our view that you don't really understand the businesses you own.

It's *amazing* what has been taught over the years in finance classes about that. Charlie?

Munger: What he's saying is that much of what is taught in modern finance courses is *twaddle*.... You cannot believe this stuff — like modern portfolio theory.... I have great difficulty understanding its cause even though I'm something of a student of dementia.

Buffett: That's why he hangs around me.

Munger: And they classify dementia along some theory structure of models. But modern portfolio theory follows a type of dementia I can't even *classify*. Something very strange is going on.

Buffett: It has no utility. It will tell you how to do *average*. But I think almost anybody can figure out how to do average in the fifth grade. It's just not that difficult. [Modern portfolio theory is] elaborate. There are lots of little Greek letters and all kinds of things to make you think you're in the big leagues. But there is no value added.

Munger: Maybe the elaborateness explains why there's so much dementia: If you believe what Warren says, you'd teach the whole course in about a *week*.

Buffett: The high priests wouldn't have any edge over the lay people. And that never sells well.

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BERKSHIRE HATHAWAY'S
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(cont'd from preceding page)

You aren't going to *find* 50 Coca-Colas. They don't *exist*.

Buffett: The great personal fortunes in this country weren't built on a portfolio of 50 companies. They were built by someone who identified one wonderful business.

Coca-Cola's a great example. A lot of fortunes have been built on that. And there *aren't* 50 Coca-Colas. There aren't *20*. If there were, it'd be fine — you could own a lot, diversify like crazy among that group and get results that were the equal of owning the really wonderful ones. But you're not going to find [that many].

Three wonderful businesses are safer than 50 typical ones.

Buffett: And the truth is you don't need to. A really wonderful business is very well protected against the vicissitudes of the economy and competition over time. And I'm talking about businesses that are resistant to effective competition. Three of those will be better than 100 average businesses.

And they'll be *safer*. There's less risk in owning three, easy-to-identify, wonderful businesses than in owning 50 well known and big businesses. Bad things won't happen to those three. That's one of the characteristics of a wonderful business.

If my own family's fortunes for the next 30 years were dependent on the income from a group of businesses, I can assure you that I'd rather pick *three* businesses from those we own than own a diversified group of *50*.

Personally, I wouldn't mind even *more* concentration.

Buffett: On a personal basis, I own *one* stock. But it's a business I *know*. And it leaves me very comfortable. So do I need 28 stocks to have proper diversification? Nonsense. [Even] within Berkshire, I could pick out three of our businesses that I'd be very happy if they were the only ones we owned and I had all my money in Berkshire.

I love the fact that we can buy more than that and that we keep adding to it. But three wonderful businesses is more than you need in this life to do very well. Find three wonderful businesses and you'll get very rich.

IF THE BUSINESS AND THE MANAGER ARE RIGHT, YOU SHOULD PROBABLY *FORGET* THE QUOTE.

By definition, a great company will *stay* great....

Shareholder: You said that three great companies could last you a lifetime. One thing that struck me, however, is that you seem to wait until wonderful businesses get pounded down and then you bet big on them — like American Express and Disney at one time.

I have capital to invest.... And I've identified three great companies: Coca-Cola, Gillette and McDonald's. If I want to invest for 20-30 years or more, is it better to wait for a year or two to see if one of them stumbles or just buy 'em today and stay with 'em...?

Buffett: I won't comment on the three companies you've named. But, by definition, a great company is one that's going to *remain* great for 30 years. If it's only going to be great for three years, then it ain't a great company.

So you really ought to invest with the idea that if you were going to take a trip for 20 years, you wouldn't feel bad leaving the money with the company — with no orders with your broker, no power of attorney or anything — and you knew that when you came back that it would still be a terribly strong company.

I'm not sure mortician-style investing would be so great.

Buffett: So if you've identified great companies, unless you find the price really offensive, I think it's better just to own 'em. We could attempt to buy and sell some of the things we own that we think are fine businesses. But they're too hard to *find*. We found See's Candy in 1972. And here and there, we get an opportunity to do something. But they're too hard to find.

So to sit there and hope you buy 'em in the throes of some panic — to sort of take the attitude of a mortician waiting for a flu epidemic or something — I'm not sure would be a great technique.

The main thing to do is to find wonderful businesses.

Buffett: It may be great if you inherit — Paul Getty inherited money at the bottom in 1932. He didn't inherit it — he actually talked his mother out of it.... And he benefited enormously by having access to a lot of cash in the early '30s that he didn't have access to in the late '20s. So you do get some accidents like that. But that's a lot to count on.

And if you start with the Dow at X and you think it's too high and it goes to 90% of X, do you buy? And, if so, and it goes to 150% of X, you never get the benefit of those extremes anyway unless you come into some accidental money at some particularly favorable time. So I think the main thing to do is to find wonderful businesses.

You'll probably learn more from Phil than you will from me.

Buffett: Is Phil Carret here? There's the hero of investing. He's 99. He wrote a book on investing in 1924. And he's done awfully well by finding businesses he likes and sticking with 'em and not worrying too much about what they do day-to-day.

I think there's going to be an article in *The Wall Street Journal* on Phil on May 28th. I'd advise you all to read it. You'll probably learn a lot more from it than you will from this meeting. It's that approach to buying businesses....

If the business & manager are right, then *forget* the quote.

Buffett: Let's just say there *was* no stock market. And the owner of the best business in your home town came to you and said, "My brother just died. He owned 20% of the business. And I want somebody to go in with me and buy that 20%. The price looks a little high maybe. But that's what I think I can get for it. And if you want to buy in...."

If you know and like the business and you like the person and the price sounds reasonable, I think the thing probably to do is to *take* it. You wouldn't worry about how it's quoted — because it wouldn't be. I think people's investment would be more intelligent if stocks were quoted once a year. But it isn't going to happen.

You don't want to spend your life waiting for flu epidemics.

Buffett: If you come into some added money at a

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time when something dramatic's happened... We did well back in '64 because American Express ran into a crook. We did well in 1976 because GEICO's managers and auditors didn't know what the loss reserves should have been the previous couple of years.

So we've had our share of flu epidemics. But you don't want to spend your life waiting around for 'em.

OUR BUSINESSES ARE FAR MORE PREDICTABLE. I WOULDN'T WANT THE JOB OF DISPLACING THEM.

Our businesses tend to be *far* more predictable than most.

Shareholder: You have said that you like franchise companies — companies that have castles surrounded by moats that are predictable five to ten years down the road. However, aren't businesses like See's Candy and your furniture, jewelry and shoe businesses all businesses that are hard to predict five to ten years down the road?

Buffett: I think they're *far* easier to predict than most. I think I can come closer to telling you the future of virtually all of our businesses — and not just because we have them — than if I took the Dow 30 (excluding the ones that we own) or the first 100 companies alphabetically on the New York Stock Exchange. I think ours are *way* easier to predict.

Ours tend to be driven by fundamental things, be fairly simple and have a rate of change that's not fast. So I feel pretty comfortable.

My guess is that we'll have very few surprises.

Buffett: When you look at Berkshire five years from now, I think that the businesses we have now will be performing pretty much as we anticipate at this time. I hope there are some *new* ones and I hope they're *big*. But I don't think that we'll have had lots of surprises.

My guess is that we'll have had *one* surprise, although I don't know what it'll be. That *happens* in life. But there won't be a series of them.

I wouldn't want to have to try to displace our businesses.

Buffett: On the other hand, if we were to go out and buy a base metals business, a typical retail business or an auto business, I'm not sure I'd know where we'd stand in the competitive pecking order five or ten years from now. I wouldn't want to try and displace See's Candy, for example, or the Furniture Mart. That would not be easy.

So I don't think we'll get lots of surprises from our present businesses, but the key is developing *more* of them.

IF YOU'RE RIGHT ABOUT THE COMPANIES, YOU CAN HOLD THEM AT SOME PRETTY HIGH LEVELS.

As Bill Gates says, it's illogical to hold things at *some* price.

Shareholder: Berkshire owns stock in several companies called "permanent holdings". In the early 1970s, we had a two-tier market — with one-decision stocks selling at 50-60 times earnings. If that were to reappear, would Berkshire's companies still be "permanent"? Or is there a price for everything?

Buffett: There are things we *think* there's no price for — and we've been tested sometimes and haven't sold 'em. But my friend, Bill Gates, says that it has to be illogical at some point. At *some* price, you *have* to be willing to sell something that's a marketable security — forgetting about our controlled businesses.

If our companies sell at P/Es of 60-70, keep an eye on me.

Buffett: I doubt if we'll ever get tested — and there are only a couple of them in that category. Actually, there's — well, I won't comment on that....

We really have a great reluctance to sell businesses where we like both the businesses and the people. So I don't think I'd count on seeing many sales. But if you ever attend a meeting here and they're at 60-70 times earnings, keep an eye on me. Charlie?

The main problem with the two-tiered market wasn't *price*.

Munger: The so-called "two-tier market" created difficulties primarily because a lot of companies were called Tier 1 when they really weren't. They just *had* been Tier 1 at some time. If you're right about the companies, you can hold them at pretty high values.

Buffett: You can hold them at *extraordinary* levels.

We'd rather just pretend the stock market doesn't exist.

Buffett: They're too hard to *find*. You're not going to find businesses as *good*. So then you have to ask, "Am I going to get a chance to buy the same business at a lot lower price or am I going to buy something that's *almost* as good at a lot lower price?"

And we don't think we're very good at doing that. So we'd rather just sit and hold the business and pretend that the stock market doesn't exist.

Buy & hold strategy has worked way better than I expected.

Buffett: Actually, it's worked out way better for us than I would have predicted 25 years ago. A fair amount of good fortune has flowed out of it that I really didn't expect.

Munger: There you're demonstrating your *trick* again of still learning. A lot of people regard that as *cheating*.

WHY SHOULD WE BET ON THINGS WE *DON'T* KNOW WHEN WE CAN BET ON *SIMPLE* THINGS?

Why haven't we bought J&J & Microsoft? We didn't *have* to.

Shareholder: Both of you have addressed my question in annual reports and at previous meetings here. And it has to do with investing in a few great high technology stocks. I know your answer's been that if you don't understand it, [then don't buy it]. But with your performance, I can't really believe that both of you don't understand most high technology questions.

And I'm thinking not only of Microsoft, but also of Pfizer and Johnson & Johnson. All three companies have already proven that they not only have a great product, but proven management over 10 to 15 years and great market

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share in businesses which aren't easy to get into. And I frankly don't see a big difference in P/E ratios between Coca-Cola or Johnson and Johnson and Pfizer — both of which are very powerful companies....

Munger: If you have something you think you understand that looks very attractive to you, we think it's smart to do what you understand. If we'd been *unable* to buy companies that fit our slender talents, we well *might* have been in the Pfizers and the Microsofts and so forth. But we've never had to resort to it.

We don't sneer at it. For people with more talent, it might be a wonderful course of action.

We generally believe change is likely to work *against* us.

Buffett: We generally look at businesses and believe that change is likely to work *against* us. We do not think we have great ability to predict where change is going to lead. We think we have *some* ability to find businesses where we don't think change is going to be very important.

For example, at Gillette, the product is going to be better 10 years and 20 years from now than it is today. You saw those ads going back to the Blue Blade and all of that. The Blue Blade seemed great at the time. But shaving technology gets better and better.

And you know that Gillette — although they did have that little experience with Wilkinson in the early 1960s — is going to be spending many multiples of the money on developing better shaving systems spent by anyone else. You know that they have the distribution system.

And they have the believability. If they bring out a product and say that it's something men ought to look at, they *do.* And a few years ago, they found out that they had the same believability with *women* in the shaving field. They wouldn't have that same credibility someplace else. But in the shaving field, they have it.

Those are assets that can't be built. And they're very hard to destroy.

We want to understand where a business is going....

Buffett: So we think we know in a general way what the soft drink industry or the shaving industry or the candy business is going to look like 10-20 years from now.

We think Microsoft is a sensational company run by the best of managers. But we don't have any idea what that world is going to look like there in 10 or 20 years. Now if you're going to bet on somebody that is going to see out [into the future] and do what we can't do ourselves, then I'd rather bet on Bill Gates than anybody *else.* But I don't *want* to bet on anybody else. In the end, we want to understand *ourselves* where we think a business is going.

Change may be opportunity, but it scares the *hell* out of us.

Buffett: Wall Street loves to say that if a business is going to change a lot that it represents great opportunity. But they don't seem to think it's a great opportunity when Wall Street *itself* is going to change a lot, incidentally.... Well, we don't think it's an opportunity at *all.* It scares the *hell* out of us — because we don't know how things are going to change.

We're looking for things that aren't likely to change.... For example, we think we have a pretty good idea how people chewed gum 20 years ago and how they're likely to chew it 20 years from now. We don't see a lot of technology going into the art of the chew.

If we don't *have* to make those decisions, why *should* we?

Buffett: And as long as we don't *have* to make those other decisions, why in the world *should* we? There are all kinds of things we don't know. So why should we go around trying to bet on things we don't know when we can bet on *simple* things?

[Editor's note: He hears a smattering of applause.]

Buffett: I see that shareholders *like us* sticking with the simple ones....

WHENEVER YOU FIND A TOM MURPHY IN A DECENT BUSINESS, BET VERY HEAVILY.

The jockey's important, but we still look to the horse.

Shareholder: You've discussed wonderful businesses. And one of your criteria is good management. Would you discuss how you decide whether you have a good manager?

Buffett: We look for people who know their businesses, love their businesses, love their shareholders and want to treat them as partners.

But we still look to the underlying business. The *really* great business doesn't *require* good management. That's a terrific business. On the other hand, the *poor* business is one that can only succeed or even *survive* with great management.

And if we have somebody we think is extraordinary, but they're locked into a terrible business — and we've been in terrible businesses — the best thing you can do, probably, is to get out of it and into something else.

The manager selection process doesn't ensure quality.

Buffett: But there's an enormous difference in the talent of managers in American business. The CEOs of the Fortune 500 are not selected like the 500 members of the American Olympic Track and Field Team. And you don't have the uniformity of quality in the top management of American business that you get in the American Olympic team in any sport. You do get some very able people — and some terrific people.... But you get a lot of mediocrity, too.

We prefer to bet on proven managers.

Buffett: I think in some cases, it's fairly identifiable who has done an extraordinary job. And we like people who've batted 350 or 360 in terms of predicting that they're likely to bat over 300 in the future.

If some guys says, "I batted 127 last year, but I have a new bat or a new batting coach" — or some management consultant's supposedly come in and told him how to do it — we're very suspicious. We don't like banjo hitters who proclaim they can somehow suddenly become power hitters.

When the manager and the business are right, bet heavy.

Buffett: And then we try to figure out what their

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(cont'd from preceding page)

attitude is toward shareholders. That isn't uniform either throughout corporate America. It's *far* from uniform.

We still want them to be in good businesses, though. I'd emphasize that. I gave the illustration of Tom Murphy in the annual report. No one could top his ability or integrity in terms of the way he ran Cap Cities for decades. And you could see it in 50 different ways. He was thinking about the shareholders. And he not only *thought* about them, but he knew what to *do* to forward their interests. And when it came to building the business, he only built it when it made sense and was in the shareholders' interest — not for his ego [or self-interest].

They're not all Tom Murphys. But when you find 'em and they're in a decent business, you want to bet very heavily — and not make the same mistake I made by selling out once or twice, too.

DISNEY HAS ITS ADVANTAGES AND ITS CHALLENGES — AND EISNER IS EQUIPPED TO HANDLE BOTH.

Eisner understands what Disney is all about.

Shareholder: How would you define Michael Eisner's circle of competence?

Buffett: He has proven himself very good at understanding what Disney is really all about. You could look to the predecessor management — between Walt Disney and Michael Eisner. They didn't really do much with Disney in those years.

What's special about Disney? And how do you make it more special? And how do you make it more special to more people? Those are the things you want to do.... And you have wonderful ingredients to work with when you're working with something like Disney.

One of the nice things about the Mouse — he has no *agent*.

Buffett: And going back to my comments about the Mayo Clinic and brain surgeons, one of the nice things about the Mouse is that he doesn't have an *agent*. The Mouse is *yours*. He's not in there renegotiating every day or every month saying: "Look how much more famous I've become in China." If you own the Mouse, you own the Mouse.

And Eisner understands all of that very well. He's been very skillful in terms of how he's thought about it.

It's very hard *not* to step outside your circle of competence.

Buffett: I worry about *any* manager — it has nothing to do with Michael Eisner — but Charlie and I worry about *ourselves* getting outside of our circle of competence. And we've done it. It is very tempting. It's probably part of the human condition — in terms of hubris or something.

As Charlie says, if you're a duck floating on a pond and it's been raining and you're going up in the world, after awhile, you think it's you and not the rain — that you're *some* duck. We all succumb to that a little bit.

But I think Disney, Coca-Cola and Gillette are very focused and our operating units are very focused. And I think that gives us a *huge* advantage over managers who are getting a little bored and decide they better fool around with this or that to show just how talented they really are.

Eisner has the right stuff — which is good. He *needs* it.

Munger: Eisner is quite creative and he distrusts projections. And that is a very good combination to have in the motion picture business.

Buffett: Yeah. Charlie used to be a lawyer for — what was it — Twentieth Century Pictures?

Munger: Yes.

Buffett: And he saw a little bit of how Hollywood operated. It kept us out of buying any motion picture stocks for 30 years. Every time that I would go near one, he'd regale me with a few stories of the past.

It's a business where people can trade other people's money for their own significance in their world. And that is a dangerous combination. If I can buy significance in *my* world with *your* money, there's no telling what I'll do.

Munger: Part of the business reminds me of an oil company in California controlled by one individual. And people used to say about it, "If they ever *do* find any oil, that old man will steal it."

In the motion picture business, there's only about *half* of the normal commercial morals.

Even Disney's shareholders have made money.

Buffett: We're not applying that to Disney.

Munger: No.

Buffett: Disney has done an extraordinary job for its shareholders. They make real money out of movies. Most movie companies make money for everybody associated with it, but not a lot gets stuck to the shareholders.

A PRETTY GOOD TRADE NAME, A TERRIFIC MANAGER & OIL FIELDS WHERE THE OIL KEEPS SEEPING BACK IN.

The most important person at Disney by *far* is Eisner.

Shareholder: I wonder if the negative surprise might not come from Disney because it seems to me that they've been coasting up until very recently on the efforts of a person who's no longer with the company — Katzenburg. He's one of those rare geniuses like Spielberg that has his finger on the pulse of the American people. They don't come along every day in Hollywood. And it, therefore, might be a very different company now....

Buffett: Katzenburg is a real talent. But I'd say that by far — by *far* — the most important person at Disney in the last 12 years or whatever has been Michael Eisner. If you know him and what he's done, there's no one [else like him].... Frank Wells did a terrific job in conjunction with Eisner. But Eisner has, in effect, been the Walt Disney of his tenure. He knows the business, he loves the business and he eats, lives and breathes it. He has been, in my view, by far the most important factor in Disney's success.

We know that there's going to be plenty of competition.

Buffett: They face competition. The big money is in animated films and everything that revolves around that —

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from films to parks to character merchandising. So it's a circular sort of thing that feeds on itself.

And there's going to be plenty of competition in that. You've seen what MCA and Universal are going to do with theme parks in Florida. And you know what DreamWorks is going to do in animation. And now you've got new technology in animation through Steve Jobs. So there are a lot of things going on in that field.

It's called share of *market*, but it starts with share of *mind*.

Buffett: But the question is 10 years from now, what place in the mind of billions of children around the world and their parents will Disney and its characters have relative to the characters owned by other organizations — because it's all about share of mind. It's called share of *market*, but it starts with share of *mind*.

I prefer Disney's hand and its manager by some margin.

Buffett: And it's a competitive world. So people will be fighting for it. But I'd rather start with Disney's *hand* than anyone else's by some margin. And I'd rather start with Michael Eisner *running* the place than anyone else by some margin.

That does not mean it can't become a much more competitive business. People look at the video releases of *The Lion King* and salivate: You sell 30 million copies at whatever it may be — $16 or $17 — and you can figure out the manufacturing costs. Well, it gets your attention. And it gets your competitors' attention, too.

But if I thought that the children of the world were going to want to be entertained 10 or 20 years from now and I had my choice of betting on who is going to have a special place — if *anyone* will have a special place — in the minds of those kids and their parents, I think I'd rather bet on Disney. And I'd feel *particularly* good about betting on them if I had the guy who's done what Eisner has done over those years presiding in the future. Charlie?

It's like an oil field where the oil keeps seeping back in.

Munger: I think it helps to do the simple arithmetic: Suppose you have a billion children of middle to high income 20 years from now. And suppose you could make $10 per year per child after tax. It gets into some very large numbers.

And I don't know about your children and grandchildren, but mine want to see Disney. And they want to see it over and over and over again. They don't want to see Katzenburg — in terms of the trade name.

Buffett: It's a pretty good trade name. When you think about names around the world, it's very hard to beat the name Coca-Cola; but Disney has a very, very big name.

And Charlie's point about kids wanting to see them over and over again.... It's kind of nice to be able to recycle *Snow White* every seven or eight years to a different crowd. It's kind of like having an oil field where you pump out all the oil and sell it and it all seeps back in every seven or eight years.

IGNORING THE COST OF CAPITAL IN INCENTIVES
IS LIKE MAKING AN INTEREST-FREE LOAN.

The *best* businesses are the ones that don't *need* capital.

Shareholder: In your letter to shareholders, you say you reward management in your wholly-owned companies at a high rate when they release capital to you and that you charge them a high rate when they need capital. Would you elaborate on that?

Buffett: Some of our businesses don't need capital at all or need so little that it doesn't make sense to build it into a formula. Those are the *best* businesses, incidentally, because it means that to double the size of the business, you don't need any more capital. Those are really wonderful businesses. And we have a few of those.

Charging for capital is simpler than capital budgets, etc.

Buffett: But when our businesses do produce capital, we could have all kinds of complicated systems including capital budgeting groups at headquarters and do all kinds of things. But we just figure it's simpler to charge people a fair amount for the money and then let *them* figure out whether they really want to buy a new splitter or whatever it may be in their business.

The rate *should* get managers' attention, but not *too* much.

Buffett: It varies a little — depending on the history of when we came in, the interest rate when we bought it, etc. But we generally charge people something in the area of 15% for capital in their compensation arrangements.

And 15% pretax — depending on state income taxes — is only 9% to 9-1/2% after tax. So you could say that that isn't even *enough* to charge people. But we find that 15% gets their attention. And it *should* get their attention. But it shouldn't be such a high hurdle rate that things that we want to do don't get done.

Ignoring cost of capital is like making interest-free loans.

Buffett: Our managers, incidentally, expect to be managing their businesses for a long, long time. So we don't worry about them doing something that works for them in the next year that doesn't work five years out where they don't make longer plans — because they see themselves as part owners of the business. But we want them to be owners with a cost attached to capital.

We think it's awful, frankly, how businesses reward executives with absolutely *no* regard for the cost of capital. [But that's exactly what they're doing when they grant] a fixed-price option for 10 years. Just imagine giving somebody an interest-free loan for 10 years. You're not going to *do* it.

If a company's retaining a significant part of its earnings and giving out a fixed-price option, they could do nothing with it except put it in a savings account and make some money off it. So we like attaching a cost of capital.

Options shouldn't be *better* because the stock's *cheaper*.

Buffett: For example, let's assume we had options for me and Charlie at Berkshire. That's not going to happen, but it would not be illogical since we have responsibility for

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the whole place. We could have some kind of compensation arrangement that worked with respect to how the whole enterprise fared that would make sense for the two of us.

It *wouldn't* make sense for the rest of our managers, incidentally, because they work on specific units. And they should have compensation arrangements that apply to those units. But assume we had it for the two of us.... The fair way to do that would be to have an option at not less than present intrinsic value.

Forget market price — because the notion of the more depressed your stock price, the better your option price doesn't make any sense. So we would have it at not less than intrinsic value.

And then we'd have our option price step up each year.

Buffett: Then we'd have them step up yearly based on something related to our cost of capital — because why should we get free use of shareholders' capital? And, in that way, we could work out a fair stock option.

That would be a perfectly appropriate way for us to be compensated — although, again, we won't do it — [because it would] involve an issuance at an initial price of not less than intrinsic value and incorporate carrying costs.

And then we'd be in a position still not *totally* analogous to shareholders because we wouldn't have the same *downside* you have. But at least we'd have the carrying costs that you have of ownership.

So we don't mind paying our managers to give us money.

Buffett: So, at Berkshire, we work that through into our unit compensation plans by having a cost of capital.... And if people give us money, we should be able to figure out a way to earn something better than 15% pretax with it. That's part of our job. So we will pay them to give us back money.

Munger: We really have a more extreme system — and, that is, the executives can buy Berkshire's stock in the market for *cash*.... It's a very old-fashioned system. It doesn't take any lawyers, compensation consultants or anything. Most companies that have done it that way have done very well. I don't know why it doesn't spread more.

Buffett: People say they want their managers to think like shareholders and try to compensate them so they will. Well, it's pretty easy to *think* like a shareholder if they *become* one.

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Munger: Yeah.

Buffett: Then they think *exactly* like a shareholder. It's not some huge psychological hurdle to get over.

TEST FOR SHARE REPURCHASES IS SIMPLE.
ONLY IT'S NOT SO SIMPLE TO *APPLY*.

It's easy to *talk* about intrinsic value. But *figuring* it....

Shareholder: You've indicated that one thing you like in companies is a willingness on the part of management to repurchase its own shares. I wonder if you would talk for a minute about your own frame of reference on repurchases when it appears that the current price of a stock is rich in relation to its intrinsic value.

Some have said that with the right company, ongoing repurchases of stock should be made irrespective of price. How do you think it pencils out when the current price of a stock is rich in relation to its intrinsic value?

Buffett: If you're repurchasing shares above ... intrinsic value, you are harming your shareholders — just as if you *issue* shares *beneath* that figure. That's a truism.

The tough part, of course, is coming up with the [correct] intrinsic value.

Coke's repurchases weren't at such a high price after all.

Buffett: A good example is Coca-Cola. I think a number of people who didn't understand Coca-Cola or who thought mechanistic methods of valuation should take precedence really misjudged the value of that company and its stock repurchases. A number of people — because they looked at book value or P/E — thought Coca-Cola was repurchasing shares at a very high price.

People who understood Coca-Cola's business well — [including] management — understood and have been very forthright about saying so over the years that by repurchasing their shares, they're adding to the value per share for remaining shareholders.

We're better off because they bought shares at what looked like high prices. We thought [people who thought those prices were high] were wrong at the time. And I think now it's been proven.

We like our share of wonderful businesses to be intensified.

Buffett: Our ownership of the Coca-Cola Company probably went over 8% in the last three or four months. And we had a second purchase at one point. But our percentage interest in the Coca-Cola Company has gone up *significantly* through their repurchases.

And [that's happened in other] companies we own shares in. For example, our interest in GEICO went from 33% or so to 50% over a 15-year period simply through repurchases. And we benefited *significantly*. So did every other shareholder, I might add, who stayed with the company. We benefited in no way disproportionately. But that was a very wise action on their part.

There, too, they were usually repurchasing shares at twice book or more. And you could have compared it to other insurance stocks and said, "That's too much to pay." But GEICO wasn't *comparable* to other insurance companies. It was a very different sort of business. And they were very wise, in my view, to be following that course of action.

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We probably value wonderful businesses higher than most.

Buffett: So if a management wishes to intensify our ownership of a wonderful business by repurchasing shares, we applaud. We favor using funds that are generated by a wonderful business to make it even more wonderful by repurchasing shares if those shares are below intrinsic value.

So if you're trying to decide on the wisdom of share repurchases or share issuances, I urge you not to think in terms of book value, P/Es or any little model. [Instead], pick businesses you can understand and then think what you'd really pay to be in those businesses. What counts over time is whether the repurchases are made at a discount from that figure.

However, there's a lot more to intrinsic value than book value and P/E ratios. Anytime anybody gives you some simplified formula for figuring out intrinsic value, forget it. You have to understand the business.

And I would say that if it's a really wonderful business, we probably come up with higher intrinsic values than most people do. Over the years, Charlie and I have developed enormous respect for the power of a really outstanding business. We recognize how *scarce* they are.

RETURNS TODAY AREN'T AS HIGH AS THEY LOOK.
BUT I CAN'T SEE RETURNS *NEAR* 20% LONG TERM.

Returns in corporate America aren't as high as they look....

Shareholder: In the mid-'70s, you wrote an article on how inflation swindles the equity investor and said that the average return on equity in corporate America was likely to be 12-13%. Last year, the average was more like *20%*. Have the laws of economics been repealed or modified? And, if not, what sort of calamities might occur as we revert to the mean?

Buffett: I've been surprised by returns on equity. There was a good article in *Fortune* about two issues ago — in the Fortune 500 issue, whenever that was — that discussed the question of return on equity. It made some good points about how the introduction of post-retirement health benefits onto the balance sheet tends to swell subsequent equity returns. They lower the denominator of total equity employed.

To the extent GM sets aside many billions of dollars of reserves for post-retirement health benefits, that tends to make its returns look a lot better than it did in the past when it wasn't even recognizing those costs and, therefore, showed an equity much larger than its true equity.

Also, there's been a lot of big bath accounting — with write-offs and the like.

Share repurchases have helped, too.

Buffett: And we've had situations like Coke, for example, where they would not have repurchased stock 25 years ago. So if they'd been following the policies of 1970 or 1975, they would have piled up more equity. Therefore, their return on equity would be *far* less than it is today.

Coke really doesn't *need* equity. Therefore, it can earn *extraordinary* returns and very large dollar sums. So that also impacts the figures some.

I don't expect returns to average even *near* 20% long term.

Buffett: So some things have happened like that. And counting those, I don't think it's gotten to 20%. But it's certainly higher than I anticipated when I wrote the article. It has surprised me how high returns have been.

All in all, under *any* system of accounting, I don't think 20% returns from American industry are in the cards. It would seem *very* extreme to me in a world like today's for returns on equity to average *close* to 20% over time. Charlie?

Munger: I agree. And I think that consolidation and the successful companies like Wells Fargo buying in stock has had a huge effect, too. I don't think it's actually gotten that much publicity.

Obviously, we had a long period of real growth and so on. And I think that on average, business *has* earned higher returns on equity. But I think a whole lot of things have combined to goose the results. And I don't see how it could go much farther.

WE COULDN'T CARE LESS ABOUT THE STOCK MARKET.
WE'RE JUST TRYING TO FIND WONDERFUL BUSINESSES.

It's tough to make money even shorting *obvious* frauds.

Shareholder: Are you concerned about the rising valuations on the NASDAQ market where companies sell at multiples of revenues instead of multiples of earnings?

Buffett: We don't pay much attention to that. Throughout my and Charlie's careers in investing, there have *always* been hundreds of cases or thousands of cases of things that have been ridiculously priced including phony stock promotions with the gullible being led to believe things that just can't come true. That kind of thing's always gone on and always will. And it doesn't make any difference to us.

We tried shorting some of those a few times in the innocence of our youth. But it's very tough to make money shorting even the *obvious* frauds. It really is. And there *are* obvious frauds. It's not so tough to find them. And it's not tough to be right over 10 years. But it's very tough to make money shorting them....

We wouldn't care if Coke and Gillette *delisted* their stocks.

Buffett: But we aren't trying to predict markets and never will. We're trying to find wonderful businesses. The fact that part of the market is screwy is unimportant to us.

We don't look at indices of stocks in general or P/Es, price-to-sales ratios or anything else. We really just focus on businesses.

In fact, we don't *care* if there *is* a stock market. Would we want to own the 8% of Coca-Cola or 11% of Gillette that we do if they were just going to delist the stock and not open it again for 20 years? That'd be fine with us. And if it went down on the news, then we'd buy *more* of it. What we care about is what the *business* does.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT
(cont'd from preceding page)

BERKSHIRE HAS BEEN LOVINGLY CONSTRUCTED SO AS NOT TO *REQUIRE* CONTINUING INTELLIGENCE.

A fate worse than death....

Shareholder: Many people would characterize Berkshire as a one-man company — with all due respect to Charlie. Many of us in this audience here, I'm sure, are retired or semiretired. And it's not unthinkable that *you* might want to retire...

Buffett: It's unthinkable.

Shareholder: After all, it wouldn't be the *worst* thing in the world.

Buffett: That would be the worst. I think death would be second.

Berkshire's not something that ends at *all* with my death.

Shareholder: I was thinking of something we might want to do to protect our sizeable investment. I've owned Berkshire since the Blue Chip Stamp days. Anyway, we could put in a stop order, take out an insurance policy, or ask Charlie to masquerade as you once you've moved on. But none of those seem like very attractive options. And I'm very serious now.

How would you respond to the question of a stockholder who's really concerned about Berkshire being a one-man show?

Buffett: First of all, Berkshire's *not* a one-man show. It's a *two*-man show in terms of capital allocation. There's no question about that. But it's run by many managers who do an outstanding job and don't need any guidance from Charlie or me as they go along.

But I'll die with all of my Berkshire stock, essentially. And that stock will be held either in the family or in a foundation depending on the order of death for a long time thereafter. So no one is more concerned about the issue of subsequent management than I. This is not something that ends at *all* at my death. And it doesn't end with the Buffett family or the Buffett Foundation. So it's a subject that Charlie and I have both thought about.

We'll use the GEICO model.

Buffett: It's always struck me as terribly illogical the way that property/casualty insurance companies are run — because here they have this important investment side. But in virtually every company, the investment side has been *subservient* to the underwriting end. They're dominated by the underwriting side of the business.

GEICO set up a co-CEO arrangement some years back where, first, Bill Snyder and, subsequently, Tony Nicely ran the underwriting end of the business and Lou Simpson ran the investment side.

And those are two very different functions. The same person doesn't fit both functions in most cases. It's a rarity when the same person does. [So GEICO's solution is] quite a logical one. It's been run that way for some years. It has worked very well that way. And it *still* works that way....

It won't take a genius. It will take a certain sensitivity....

Buffett: But Berkshire is slightly different. It uses a variant of it. At Berkshire headquarters, you essentially need someone overseeing [everything] — but not meddling in it too much — making sure you have the right managers and that you're treating them fairly. So you need someone on the operating side. And then you need someone on the investment/capital allocation side.

Then, besides allocating capital, the other thing we do is identify the managers and, hopefully, make it attractive for them to stay.... But it doesn't require a 150 I.Q. or anything to do that. It *does* require a certain sensitivity as to why people get up in the morning and why they want to do what they do.

Our successors are designated now and will be always.

Buffett: And it depends on when it happens. Charlie's a little older than I am. But when I'm not around, it's likely that it will be broken into a two-person function again — although not exactly in the way Charlie and I function. It's logical that there will be someone in charge of investments and capital allocation. I mention Lou Simpson's position in the annual report because he *is* younger than I am. Then there will be someone in charge of operations. And we have that person in the organization now.

I don't know what the situation will be when I die — because it could be in 20 *minutes* or 20 *years*. So I can't specifically name the individuals — although we have the individuals *now* for both of those functions. And we'll have the individuals for the same functions 20 years from now, although I don't know whether they'll be the same people....

You can see how vital I am to this place.

Buffett: But you have to get away from the idea that it's a one-man show. We have some very good businesses. Nobody's buying See's Candy because they think I'm sitting in some office in Omaha. And no one's buying a GEICO insurance policy because my name appears as chairman or CEO. The businesses are marvelous businesses. They'll continue to do very well.

There will be a capital allocation problem then — just like there is now. And there will be the problem of keeping good managers in place and treating them fairly — and that's a solvable problem.

But right now we have 33,000 people working for Berkshire out there as we speak. And I'm sitting around watching movies about myself. So you can see how *vital* I am to the place. And that's the future as seen from Kiewet Plaza. Charlie?

No continuing intelligence is required. That's by *design*.

Munger: If you run your mind through all the assets, you will quickly decide that there are large momentums in place that would continue.... Is Coca-Cola going to suddenly stop selling because some manager is dead at Berkshire Hathaway? Are people going to stop buying Gillette razor blades? Is GEICO suddenly going to stop being intelligently run? Is the Nebraska Furniture Mart going to start trying any less hard?

So the existing assets, you could argue, have been *lovingly* put together so as not to *require* continuing

(continued on next page)

BERKSHIRE HATHAWAY'S
WARREN BUFFETT
(cont'd from preceding page)

intelligence at headquarters.

But there *would* be a disadvantage in that I think it would be unreasonable to expect a successor to be as good at making new investments as Warren's been in the past. Well, that's just too damned bad.

Buffett: You notice his sympathetic ear....

LOU'S DONE A TERRIFIC JOB AND WILL IN THE FUTURE.
ONLY NOW HE HAS ANOTHER STRING IN HIS BOW.

Lou's done a fabulous job and will continue to do so.

Shareholder: One of the things that makes Berkshire unique is the high percentage of assets it has in equities as opposed to fixed assets. At year end, GEICO looked like a typical insurance company with four times as much in fixed assets as in equities. Over time, will GEICO have the same composite as Berkshire on the asset side?

Also, how are asset allocation decisions being made at GEICO after the merger as compared to before the merger?

Buffett: Investment decisions at GEICO — which has about $5 billion of marketable securities — have been made, are being made and will be made by Lou Simpson. Lou has done a fabulous job of running the investments at GEICO since about 1979. And we're lucky to have him.

There are *very* few people who I will let run money in businesses that we have control over, but we are delighted in the case of Lou. It's one in a thousand or something. Lou has done a terrific job and *will* do a good job.

Before GEICO became part of Berkshire, it had limitations.

Buffett: And one thing we offer him is the ability to do whatever he wants with those assets. Before GEICO became part of Berkshire, he didn't *have* that ability — because there were certain ratios that were understandably necessary for GEICO to maintain. As a stand-alone entity with its net worth of $1-1/2 to $2 billion doing $3 billion of business, it would have been inappropriate for him to take on a configuration beyond a certain point in equities. So he was constrained by the nature of the business and its capitalization.

Now Lou can do whatever he *wants*....

Buffett: Now, that constraint no longer applies. So he can do whatever he *wants* with that $5 billion.

If he does certain things, we'd need to provide backup to GEICO so that their policyholders would be protected under the most adverse of circumstances. But that's no problem. We could do it by quota share or reinsurance. We could do a lot of things. We could just guarantee their obligations. We're in a position to do that.

We haven't yet because it hasn't been necessary. But if Lou wanted GEICO to be $5 billion in equities and it made sense, we'd arrange things so GEICO policyholders would be every bit as secure as if they were operating with the most conservative of investment portfolios.

Lou did great under the old system. He may do better now.

Buffett: So Lou has another string in his bow now. And there may be a time when it gets used. He did great under the old system And he may do even better under this system.

Munger: That's a very shrewd question. You're to be complimented.

Buffett: That means it's something we thought about. You *are* to be complimented....

IF YOU HAVE TO USE A PENCIL AND PAPER,
THEN IT'S TOO CLOSE TO THINK ABOUT.

First and foremost, I recommend *The Intelligent Investor*....

Buffett: In terms of investment books, obviously, first and foremost, I recommend *The Intelligent Investor* — with Chapters 8 and 20 the ones you really should read. All of the important ideas in investing are in that book. There really are only about three ideas — and two of them are emphasized in those two chapters:

One idea is to think of investing as owning a business and not as buying something that wiggles around in price. And the second idea, which ties in with the first, is about your attitude toward the market. It's covered in Chapter 8. Having the proper attitude toward market movements is an *enormous* help in investing.

And the final chapter is on margin of safety — which means not to drive a 9,800 pound truck over a bridge that says it has a capacity of 10,000 pounds. Go down the road a little and find one that says "Capacity 15,000 pounds".

And Phil Fisher's books & John Train's *The Money Masters*.

Buffett: I'd also recommend the first two books that Phil Fisher wrote back around 1960 — *Common Stocks and Uncommon Profits* and his second one — *Paths to Wealth Through Common Stocks*. Those are *very* good books.

And I think John Train's *The Money Masters* is an interesting book.

If we have to use a pencil and paper, it's too close....

Buffett: Can you think of any others, Charlie, that we want to tout?

Munger: I don't know. We have such a fingers and toes-style around here. Warren often *talks* about these discounted cash flows, but I've never seen him *do* one.

Buffett: Some things you only do in private, Charlie.

Munger: Yeah. If it isn't perfectly obvious that it's going to work out well if you *do* the calculation, then he tends to go on to the *next* idea.

Buffett: That's true. It's sort of automatic. If you have to actually do it with pencil and paper, it's too close to think about. It ought to just kind of *scream* at you that you've got this huge margin of safety.

CHARLIE'S WORKING ON SOMETHING —
AND IT PROBABLY INVOLVES MOLE RATS.

Two *marvelous, powerful* books that helped me *unlearn*....

Shareholder: Are there some worthwhile books that

(continued on next page)

BERKSHIRE HATHAWAY'S
WARREN BUFFETT
(cont'd from preceding page)

you could recommend to us?

Buffett: Charlie, what are you reading these days?

Munger: Well, I'm almost ashamed to report because I went back and picked up the part of biology that I should have picked up 10 or 15 years earlier. And if any of you haven't done it, it's a total circus what they've figured out over the last 20 or 30 years in biology.

Dawkins' *The Selfish Gene* and *The Blind Watchmaker* are *marvelous* books. He's a famous Oxford Darwinian biologist — and a very good writer. And there are words in those books that are entering the English language — they'll be in the next Oxford Dictionary.

These are powerful books and a lot of fun. I had to read *The Selfish Gene* twice before I fully understood it. There were things that I believed all my life that weren't so. It's wonderful to have those experiences. We always say, "It isn't the *learning* that's so hard, but the *un*learning."

Buffett: Yeah.

If you read Dawkins' books, you won't be so dumb....

Munger: I'm totally nuts about those Dawkins books. But that's because until quite recently, I was educated in a manner that was disgracefully bad. Here this huge and powerful synthesis had come along since I took high school biology — and I'd missed the important part of it.

And when people like Dawkins introduced me to it, I was *dumbstruck*. I mean I can't imagine having any intellectual interests and not being totally *nuts* about Dawkins if you've never been through the so-called modern Darwinian synthesis.

If any of you haven't done that, you're very, very lucky: (A) You won't be so dumb in your future years if you work at it. And (B) it's a lot of fun to wade through....

That stuff is *very* important.... And it's not totally unrelated to investing.... It demonstrates the power of a big idea which accounts for a lot of observations. That kind of synthesis, of course, has been very helpful to the Berkshire Hathaway group over the years.

We may be seeing mole rats at next year's annual meeting.

Buffett: I made the mistake of taking Charlie up to Microsoft in December. And he became friends with Nathan Myhrvold [Microsoft SVP of advanced technology]. They're corresponding back and forth with increasing fervor and enthusiasm about mole rats. And they copy me on all these communications. So I get to see this flow back and forth on the habits of mole rats.

I really haven't found a way to apply it at Berkshire. But I'm sure Charlie's working on something. He's gotten very interested in biology lately.

[Editor's note: We understand that prior to joining Microsoft, Myhrvold worked with Prof. Stephen Hawking on research in cosmology and quantum theories of gravitation at Cambridge.]

Something had to go and not sleeping, eating or Berkshire.

Buffett: I've always liked reading biography. But the computer's changed my life. I now find myself playing bridge on the computer about ten hours a week. And, unfortunately, I didn't want to give up sleeping or eating — or Berkshire. So the reading has been kind of light.

IF YOU'RE OUT SELLING THE FUTURE,
IT MAY BE *BETTER* TO FORGET THE PAST.

I spoke about great, big models of considerable generality.

Shareholder: In your worldly wisdom speech, you talked about a hundred or so models we ought to have in our heads. I'd like to know the most useful models on industry consolidation, product extension, vertical integration and any models which explain the special cases when it makes sense to invest in retailing stocks....

Munger: I'm glad to answer such a modest question.

I spoke about having a hundred models in your head. But those are all great big models of considerable generality that are useful over and over again. When you get into what's going to happen in industrial consolidations, retailing stocks and so on, you're down into very complex *sub*-modeling. And I'm not up to all those sub-models.

Wall Street tends not to learn — which is to its *advantage*.

Buffett: But we're up to a few. We take the general models and plug them in. And sometimes the light goes on and sometimes it doesn't. But if it does, they can be quite useful.

You do see repetition of certain business patterns and business behavior. And Wall Street tends to ignore those, incidentally. Wall Street really doesn't seem to learn business lessons for very long. It may not be to their *advantage* to learn. That would probably plug right into Charlie's model.

Munger: You bet.

Buffett: If you're out selling the future, it may be *better* to forget the past — if you get paid on selling it and not on betting your life on it in some way.

When we say we think long term, we mean *l-o-n-g* term.

Buffett: One situation at Berkshire that really is somewhat different than that of many companies is that we assume — unfortunately, it's an error — that we'll be around forever. So in our insurance business, we figure that we're going to be here to pay every claim and we're *not* going to retire at age 65 and hand it over to someone else. So there wouldn't be any sense in playing games in accounting because it would catch up with us later on.

In many businesses, I'm not sure that they have quite the same time horizon. They do at Coca-Cola and they do at Gillette. But many companies — more than you'd like, I'm afraid — are thinking about what kind of little pictures they can paint for the next four quarters. And that's easy to do.

We think that we're going to be around a lot longer than four quarters. So that's not an option for us. We really run Berkshire as if in the year 2050 or something, someone's going to look at it and say, "How'd it work out?"

—OID

MARSHFIELD ASSOCIATES' SAM MITCHELL & CHRIS NIEMCZEWSKI
(cont'd from page 1)

Here are the year-by-year performance figures for Marshfield Associates since June 30, 1989 when it began accepting individual accounts. Prior performance figures are the equity-only returns of Justin Asset Management — where Niemczewski was chief investment officer and Mitchell was director of equity research. (All figures have been provided by Marshfield Associates.)

Year	Marshfield Total Return[1]	S&P 500 Total Return
1981	+14.0%	- 4.9%
1982	+ 5.0	+21.4
1983	+26.8	+22.5
1984	+14.0	+ 6.3
1985	+23.1	+32.2
1986	+24.7	+18.5
1987	+10.4	+ 5.2
1988	+11.3	+16.8
1989[2]	+27.7	+31.5
1990	+ 0.4	- 3.2
1991	+34.3	+30.5
1992	+11.8	+ 7.7
1993	+10.5	+10.0
1994	+ 4.8	+ 1.3
1995	+34.9	+37.4
1981-95	+16.5%	+14.8%

[1] Returns shown are after all fees and expenses.
[2] Prior to June 30, 1989, the performance figures are those of Justin Asset Management.

While we always enjoy Marshfield's letters and have shared a couple of them with you in past editions of *OID*, we found the latest one particularly intriguing. In it, Mitchell and Niemczewski mentioned having recently made two "bets on the capital allocation skills of people whose judgement we greatly respect ... [with] a long, distinguished record of building asset value ... at a discount to ... a conservative estimate of book value."

They then laid out certain additional special situation aspects which made them more intriguing still. Of course, we had little choice but to pick up the phone and see if we couldn't persuade them to share them with you. And, we're pleased to report, here they are.

The excerpts which follow were selected from a series of conversations with Mitchell and Niemczewski which occurred between July 20th and August 7th. They required more than a little bit of work on our part and theirs to bring them to you in a way that, we hope, is at once clear and comprehensive. While they may nevertheless require more than a little work on *your* part, too, we hope and trust that you'll find the exercise worthwhile.

A TERRIFIC PAPER TRAIL AND LOTS OF OPPORTUNITY AT WELL BELOW MARKED-TO-MARKET BOOK VALUE.

OID: In your latest letter to your clients, you say that you've taken half positions in several securities. Does that mean you're half convinced or...

Chris Niemczewski: I'd say we *are* half convinced. We're growing our business at a pretty good pace — up from zero to half a billion dollars in less than five years. And a lot of our new accounts are still 100% in cash. If we were rigid about price at this point and stocks were to stay at current valuations, then we might only get them 20% invested during the first year. And, frankly, it's hard to keep clients that way. Most people who hire us would be distressed if we were just 20% invested.

Sam Mitchell: We're taking a chicken's position in businesses we want to own long run because we figure that this market could very easily go from *somewhat* overvalued to *very* overvalued. And we don't want new clients to get left at the station. But Chris and I feel very strongly that with few exceptions, we don't see bargains.

OID: Client distress and business considerations aside, what would you buy with that 20%?

Niemczewski: We like to have 15 positions in an account — with positions being about 7% each. Today, we'd buy full positions in Fund American, White River and Salomon and half positions — of about 3-1/2% each — in Wells Fargo and American Express.

OID: Three positions of 7% each and two positions of 3-1/2% each totals 29-1/2%. But you said that you'd only be about 20% invested. What are we missing?

Mitchell: We're money managers. So we round down to be conservative.

OID: Get that out of your system right now, please.

Niemczewski: Also, Fund American and White River take awhile to buy. In fact, today, not all of our clients yet have even half positions. So that 25-28% invested is only a theoretical figure. Unless we want to bid it up, we can't buy enough.

OID: Then, we're particularly grateful to you guys for sharing them with us. And before you rethink it...

Niemczewski: Actually, we were just doing that before you called...

OID: Well, it's a darn good thing we called now. What's your investment rationale with Fund?

Mitchell: Our basic hypothesis with Fund American is, first, that there's a great deal of ferment and opportunity in certain segments of the insurance industry; and, second, we can't think of a better way of playing that than with Jack Byrne. The institution he's building — this family of niche, specialty property and casualty insurance companies — is really quite exciting. And so are the returns that we think the company can earn over time.

Niemczewski: Yet its stock is trading at a price below where most of the *bad* insurance companies trade.

Mitchell: We're paying less than *stated* book value —

(continued on next page)

MARSHFIELD ASSOCIATES'
SAM MITCHELL & CHRIS NIEMCZEWSKI
(cont'd from preceding page)

which was $86.92 as of June 30th — and *well* below conservatively *marked-to-market* book value.

OID: I'll drink to that.

Mitchell: But Fund American isn't earnings driven. Because it's book value-driven — and will continue to be so — it won't make your readers rich overnight. However, over a decade or more, I believe it *will* make them rich. You might say that it's a get-rich-slowly stock.

OID: That's OK. I can't afford more get-rich-quick ideas — at least until I finish paying off the other ones...

Mitchell: We believe that Fund American will earn upwards of 15% on its capital. And, again, we're buying it for less than book. Therefore, over a long period of time, we believe that we can earn 15%+ on our clients' money. And we like that because we think it's a very doable goal. In contrast, if you buy something for 2 times book or more, they have to do a whole lot better to even justify the price — much less earn 15% — on *your* cost.

As a general rule, I don't like saying that returns are highly probable...

OID: Then never go into publishing...

Niemczewski: But the odds here seem mighty high. If you look at the niche companies in this business — at the people who are focused both on the underwriting side and the investment side — I think you'd conclude that 15% really isn't that much of a reach. Certainly, people like this ought to be able to do it.

Mitchell: That's right. And that 15% isn't counting the ability of Byrne and his institution to invest the money they don't need for reserves in equities. That's part of the secret of the returns he's achieved over time. So we don't think 15% is a stretch target for Byrne. Over his career, we understand he's compounded book 21-22% per year. And we're buying all of that for below book.

So we think it's a great deal in absolute terms, but especially in *this* market.

OID: And I get the impression that Byrne agrees — since they've been buying back shares now and again.

Mitchell: You could say that. Between December 31, 1993 and March 31, 1996, fully diluted shares were reduced from 10.7 million to 8.7 million.

Niemczewski: And that's before the latest tender — during which they bought back another 130,000 shares.

OID: And I gather that their shares outstanding have declined all the way down from 58 million in 1988.

Mitchell: That's right.

(continued in next column)

FUND AMERICAN IS STARTING TO TAKE SHAPE
AS A FAMILY OF SPECIALTY, NICHE P&C COMPANIES.

OID: Then tell us about it, please.

Mitchell: As you know, Jack Byrne's involvement with this company dates back to 1985. That's when he was appointed chairman of Fireman's Fund — which was then a subsidiary of American Express. He was brought in to improve their subpar returns. However, he concluded that he couldn't get the kind of returns that he wanted with the company configured as it was.

So he decided to break it up. And on January 2, 1991 Fund American Enterprises Holdings — the new name for what was left of the old Fund American Companies — sold Fireman's Fund Insurance. And, basically, all that was left then was a 97% interest in a mortgage banking company — Source One — plus a portfolio of equities and other investments totaling about $736 million.

OID: And today?

Mitchell: Today, Fund American [FFC/NYSE] is evolving from a hodgepodge of passive investments plus Source One into a family of specialty niche property and casualty companies. Its passive investment portfolio, for example, has declined from 52% of assets at December 31, 1993 to about 28% at March 31st — and even less today. Likewise, at its carrying value, Source One has declined from 48% of assets at December 31, 1993 to 32% at the end of the first quarter.

OID: So it's starting to take shape. Like Byrne says in his latest annual report, "1995 was a year we applied a box of Crayolas to the pencil outline of Fund American."

Mitchell: Exactly. And their balance sheet is relatively complicated — although, we manage to simplify it some. Incidentally, these are first quarter figures because they haven't yet published their updated balance sheet figures for the second quarter.

First, Fund American has $89 million in what they call "Common Equities" — $67.4 million of which consists of 11 million shares of San Juan Basin Royalty Trust. And then the other $21.6 million consists of dribs and drabs of other unspecified equities.

OID: We're with you so far.

Mitchell: Next, they have "Fixed Maturity Investments" of $143 million in medium-term instruments in a mix of corporate and municipal bonds.

Then, they have "Other Investments" totaling $98.7 million — including 718,000 shares of White River — which, in effect, is a spin-off from Fund American that's run by a long-time Jack Byrne colleague. Incidentally, they appear to have closer to 1 million shares. But 200,000 or so of those shares have been set aside for options to officers.

Also included in that $99 million are 600,000 shares of Mid Ocean plus options to buy another 388,140 shares at $16.67 each, mortgage loans of about $24 million and dribs and drabs of another $20 million.

OID: Why aren't Mid Ocean and White River included in the "Common Equity" category?

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MARSHFIELD ASSOCIATES'
SAM MITCHELL & CHRIS NIEMCZEWSKI
(cont'd from preceding page)

Mitchell: There are restrictions on their salability. However, the restrictions on Mid Ocean ended in July. And the restrictions on White River end in December.

So if our math is correct, they have $330.7 million in all of what they call "Total Passive Investments."

Again, we've simplified it some. Their balance sheet as of March 31st shows them having $561.2 million of "Total Investments." But we think it's clearer to allocate their short-term investments to their operating subsidiaries.

OID: We're still with you.

Mitchell: Next, they carry their equity in Source One at about $295 million. As you probably know, it's one of the country's largest mortgage banking companies. Plus, it's a low cost, high quality servicer.

Unfortunately, that's a very tough business. And it hasn't been earning the kind of returns they'd like. Another drawback is that Source One has only originated fixed-rate loans — which we think is crazy. But their president recently resigned. And their results do appear to have improved in the second quarter. But we'll just have to wait and see what happens.

Meanwhile, we get the impression Fund American thinks it would make more sense as part of a bigger entity with more capital than opportunity. They say that they'll either increase returns by leveraging it up or they'll sell it.

They came close to selling it to Mellon for $65 million above their carrying value. But we're just assuming that they get the $295 million that they're carrying it for.

OID: And you think that's likely.

Mitchell: We do. But we're not saying it's a certainty. Next, White Mountains Holdings has net assets of about $258.3 million. And that $258.3 million, incidentally, is net of White Mountains' fixed income investments because I cranked them into Fund American's passive investments. Again, we play around with their balance sheet to make the analysis as simple as possible.

OID: We do the same thing. Only, we do it for drama...

Mitchell: Finally, there's $26 million of goodwill. So that gives you $910 million of total assets.

OID: And liabilities?

Mitchell: They have parent debt of $202 million. So that leaves $709 million of shareholder equity. And as of March 31st, there were 7.67 million shares outstanding. But Byrne has warrants to buy 1 million shares at $25.75 per share. So factoring in the exercise of those warrants and options to other employees for another 3,000 shares, we come up with 8.675 million shares fully diluted.

And, again, that's before their most recent tender.

FSA COULD BE A REAL SLEEPER. BUT ITS VALUATION IS *ABSURDLY* LOW.

Mitchell: Next we make adjustments to book for the excess of market value over book of two of their assets:

FUND AMERICAN
Simplified Balance Sheet[1]

	($mil)	($/share)[2]
Common Equities	89.0	10.26
Fixed Maturity Investm'ts	143.0	16.48
Other Investments	98.7	11.38
Total Passive Investments	330.7	38.12
Source One	295.0	34.01
White Mountain Holdings	258.3	29.78
Goodwill	26.0	3.00
Total Assets	910.0	104.90
Less Parent Debt	202.0	23.29
Shareholder Equity	708.7	81.69
Warrant & Option Proceeds	25.8	2.98
Adjusted Equity[3]	734.5	84.67
Excess of market over book[4]		
Of FSA Stake	25.6	2.95
Of Other Public Issues	24.6	2.83
Adjusted Book Value	784.7	90.45
Tax Liability[5]	15.3	1.76
Breakup Value After Tax	769.4	88.69

[1] All figures as of March 31, 1996 — except for publicly traded assets and prices of assets based thereon.
[2] Assuming 8.675 million (fully diluted) shares — including warrants & options for 1.003 million shares.
[3] Equity upon exercise of all warrants and options.
[4] Values of publicly traded securities & asset values derived therefrom based on prices as of 7/19/96.
[5] Assumes sale of publicly traded securities with gain taxed at 28%.

Apparent math errors due to rounding.

First, taking their publicly traded issues and adjusting them to current prices adds $2.83 per share to book value. And that's using the current stock price for White River, not our valuation — which is much *higher*.

Second, Fund American owns both shares and options in Financial Security Assurance (FSA) — which we think is a *terrific* little company. It's one of the top three or four insurers of municipal bonds and asset-backed instruments — credit card receivables and so forth — along with AMBAC and MBIA.

Plus — and this is *important* — they're the *pioneer* in securitization technology outside the U.S. Securitization, of course, dramatically reduces intermediation costs. And the technology is still pretty new outside the U.S. So these guys have what we think is huge market potential there.

OID: It's certainly hard to imagine otherwise — although whether FSA gets its share is less obvious.

Mitchell: Why *wouldn't* they? They have first mover advantages. Also, in their niche, they're as low cost and as good at analyzing credits as anyone in the business.

(continued on next page)

MARSHFIELD ASSOCIATES'
SAM MITCHELL & CHRIS NIEMCZEWSKI
(cont'd from preceding page)

Therefore, I think it's fair to expect them to get their share.

Fund American owns a whole bunch of FSA. And, here again, it gets somewhat complicated. As of May 16th, Fund American owned 3.46 million of FSA. Plus, they have options to buy additional shares. For example, they have options for 1.893 million shares — say 1.9 million shares — at $26.40 per share and 667,000 shares at $23.50 from U.S. West through 1999. Then they have options to buy another 2 million shares from FSA at $30 through 2004.

And what gets tricky...

OID: Gets tricky?!

Mitchell: I told you it was complicated. However I think you'll find the exercise to be a very rewarding one. As I was saying, what gets tricky is valuing these options and comparing what the options are really worth to how they're being carried today on Fund American's books.

OID: How many shares does FSA have outstanding?

Niemczewski: Approximately 31 million.

Mitchell: It's a *very*, very nice little company.

OID: Although it doesn't really sound all that little. What's FSA's current stock price?

Mitchell: About $27. But, for our analysis, we're using prices for the publicly traded pieces as of July 17th. Fund American values options essentially as follows: First, they discount the strike price at the interest rate for Treasuries of similar maturity. Then they value the option by taking the excess, if any, of the stock price over the discounted strike price and multiplying that figure by the number of shares under option. Finally, they tax effect the result by assuming 35% is paid to taxes.

However, the long and short of it is that we think FSA's stock price is too low and that Fund American is carrying those options on their books at a price that's ridiculously low. Since Fund American owns more than 20% of FSA, they're deemed to have a controlling interest. Therefore, under accounting rules, they *have* to throw its current stock price out the window for purposes of valuing the options. They can't use it.

OID: Interesting.

Mitchell: Therefore, Fund American is forced to take the spread between FSA's unadjusted book value — which is $24.67 — and the options' strike price to determine their valuations. So what that means is that even if FSA goes from $26 to $50, there would be no impact whatsoever on Fund American's valuation of those options.

OID: Wow.

Mitchell: In our valuation of those options, we use the same assumptions as Fund American except that instead of using book — which is what they *have* to do — we use FSA's current stock price.

OID: And what assumptions do you make about the stock price going forward?

Mitchell: We just did it in a very simple-minded way. We just assumed that FSA's stock price would stay where it is out to 2004.

OID: That sounds conservative, all right.

Mitchell: Obviously, that's absurd. Even our very conservative revaluation of their FSA position adds another $2.95 per share to Fund American's valuation.

And this little deal is a perfect example of the way Jack Byrne works and why you see all these little pops in book value come out of nowhere from time to time.

Even to calculate FSA's adjusted book, you'd have to add their unearned premium reserve and the present value of their future installment premiums and then deduct their deferred acquisition costs and tax effect that figure. And for purposes of internal valuation of FSA, Fund American and FSA say that they do that. And even that number for FSA as of the end of 1995 was north of $31.

OID: So, in effect, their current book is understated.

Mitchell: That's right. In a nutshell, we're saying that these options will do nothing but go up in value. And we value them using the current stock price. But, again, even *that's* crazy — because FSA is a nice little company which *itself* can earn 15% on equity over time. So we think it's *easily* worth north of $30 per share. And we think FSA could be a real sleeper.

Niemczewski: Exactly. So, as you can see, the options aren't valued in a way that reflects reality. And there are quite a few boxes here that we could open up and explore.

OID: I noticed...

Niemczewski: They lowball everything they can. So the question is how many of these boxes you want to open and adjust up.

Mitchell: That's exactly right. So we estimate that Fund's marked-to-market book is probably north of $90.

And that's excluding any premium for Source One. And Fund American damn near sold Source One to Mellon for about $65 million — or roughly $7 per share before tax — in excess of their carrying value. Also, they're suing the operator of San Juan Basin Trust for allocating $67 million of excess costs to the trust. So if these issues were to work in Fund's favor, that could add another $14 to $15 pretax — which would bring its adjusted book up close to $100.

Niemczewski: Without any trouble.

IT'S MUCH MORE THAN A BOOK VALUE STORY.
IT ALSO HAS VERY EXCITING GROWTH PROSPECTS.

Mitchell: But the key to whether Fund American is a great investment long run is whether they can take advantage of opportunities in the specialty property and casualty insurance business. And Fund American's vehicle for doing that is called White Mountains Holdings.

OID: I assume you realize we only have 64 pages...

Mitchell: White Mountains Holdings has five pieces: (1) FSA — which we just told you about, (2) Folksamerica, (3) Main Street America, (4) Valley Group and (5) White Mountains Insurance.

The strategy of Byrne and Tom Kemp — who is the

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(cont'd from preceding page)

CEO of White Mountains — is to assemble a collection of regional and/or specialty property and casualty niche insurance companies.

And they never, never, *never* overpay. They walk *away* from deals rather than overpay.

OID: One of the finer virtues....

Mitchell: Also, they have a cult-like attitude about keeping their combined ratio below 100. And finally, they invest in common equities to the maximum amount appropriate. For the vast majority of insurance companies, equity investments represent only about 5-10% of their investment portfolio — which is a de minimus amount. But that's not the case with a Jack Byrne company.

Of course, you have to be sure that the people investing the money have what it takes — because you get into trouble very quickly if they don't. However, we believe that's *unquestionably* the case with these guys.

OID: Time will tell.

Mitchell: Their long-term goal for return on equity is Treasuries plus 600 basis points after tax — which today comes to a little less than 15%.

So if this were only a book value story, then it would be interesting, but it wouldn't be dynamite. But we think the institution that Byrne is building is much, much more than a book value story. We think that it also has some very exciting growth prospects.

In part, that's because Fund American shareholders enjoy the benefit of a great capital allocator in a business that he knows very, very well where ferment is currently creating lots of opportunity.

For example, they recently bought a 50% interest in Folksamerica — the parent of Folksamerica Reinsurance which is the nation's 16th largest multi-line broker-market reinsurer — for $80 million. And that deal is a wonderful example of Byrne's dealmaking ability. Just listen to this:

Fund American wrote a check for $80 million to Folksamerica. Folksamerica's book value is $160 million±. So they paid roughly book value for their investment — which was $11.03 per share.

OID: So it doesn't sound like they paid up.

Mitchell: Never. And Fund American's investment was in the form of a preferred on which they earn a yield of 6.5% — which is over $5 million per year. Plus, they get 10-year warrants to buy 6.92 million *more* shares at the same price. Think about it. For no cost and no premium, they get 10-year warrants exercisable at today's book value. That is a my idea of a great deal.

OID: Sounds like it.

Mitchell: Oh, yeah. It was so good I had to call up the company and verify it before I could believe it. You'll never see these warrants in Fund American's financial statements. But they're there, all right. And that's why you have to go through a Jack Byrne company carefully — because he has all of these little things popping around.

OID: And to think he looks so wholesome and folksy...

Mitchell: So, again, one of the reasons why we think Fund American is going to be an outstanding investment is that we're getting a great capital allocator and dealmaker in a field he knows really, really well.

OID: And you're not under public relations retainer or related — by marriage or otherwise?

Mitchell: Sadly, no.

GIANTS ARE RETREATING TO THEIR FORTRESSES AND LEAVING POOLS OF OPPORTUNITY IN THEIR WAKE.

OID: What's going on in the insurance market that makes a strategy of buying these little regional specialty insurers a good idea?

Mitchell: As you know, the big dinosaur property and casualty companies have been losing their shirts on environmental liabilities, social inflation, product liability, malpractice and so forth. So a lot of the big guys are sitting there with these long-tail liabilities with no idea of what they're in for. But, if you start up a new company, you don't start with a ball and chain around your foot because you don't have all of these long-tail liabilities that you really don't know how to value.

OID: You get to build them yourself.

Mitchell: Right. But to use an old football analogy, at least you don't start at 4th and 15. Therefore, KKR [Kohlberg Kravis Roberts & Co.], Sandy Weill and other smart people have been getting into the property and casualty insurance business on the theory that they can cut costs, get out of many lines of business, tighten up underwriting standards and maybe make a decent living.

And that means opportunity — because it allows regional insurers to increase their market share — primarily by being closer to the insureds. So, in effect, really good insurance business is available because the giants of the industry are retreating to their fortresses. The glaciers are receding and leaving pools of opportunity in their wake.

As a result, the insurance agents are getting orphaned as the big insurers are moving further and further away. In response, the agents are consolidating and looking for good service. That's why White Mountains Holdings created White Mountains Insurance.

Obviously, the whole basis of the insurance business is intelligent pricing of risk.

OID: The successful insurance business anyway.

Mitchell: That's right. Therefore, underwriters have to know the local marketplace well so they can price risk. And our hypothesis is that Byrne's operations over time will do a more intelligent job of pricing risk.

OID: Both because they're local and because of what you referred to as their cult-like insistence on keeping their combined ratio below 100.

Mitchell: That's right. But there's another reason. And that's a company White Mountains acquired called Valley Insurance.

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(cont'd from preceding page)

OID: Complicated is fine. But enough is enough...

Mitchell: Valley Insurance is a P&C insurer that's done extremely well. However, they're also a leader in image technology. And over time, we believe image technology has important implications in terms of competitive advantage. It allows an insurer to convert a piece of paper into an electronic file fast and efficiently. What that means is that the insurer can build a work flow system where it can move product through the system without having to move the paper files.

That means — and we think this is really important — that underwriters can be located *anywhere*. Specifically, they can be located close to where the insureds are. Therefore, an underwriter can be in the local community whereas the backup support — data storage, number crunching and so forth — can be centrally located. And that's just the reverse of what the leviathans are doing.

So they're getting economies of scale in the processing at the same time they're staying close to their insureds. And that's also the way to optimize results from their risk management — because you minimize your costs and maximize your ability to correctly price risk.

OID: Interesting.

Mitchell: So the Fund American network, if you will, has the makings of what could become an enduring competitive advantage. Whether that happens or not, who knows? But if you're betting on horses, these are the ones to bet on. And we're sure not paying much for our ticket.

A MARRIAGE MADE IN HEAVEN: MAIN STREET AMERICA NATIONAL GRANGE AND LOCAL COUNTRY INSURERS.

Mitchell: Another really interesting wrinkle — and the final piece of White Mountains — is a one-third interest in something called Main Street America. It's a downstream, stock subsidiary of National Grange Mutual. And the important word here is "mutual."

OID: I thought it was "complicated."

Mitchell: Main Street America has a quota share agreement with National Grange whereby they get 40% of the property and casualty insurance business that National Grange Mutual writes. In other words, for each $1 of insurance premiums that National Grange writes — most of which, by the way, is written to small businesses and so forth — Main Street America writes 40¢ of it.

And we believe that Fund American's investment in Main Street America is a great way of benefiting from the consolidation going on out there among literally hundreds of small, mutual insurers around the country. A.M. Best has increased its rating stringency over time. And they're telling many of them that they have to have more capital — that they have to have more surplus per $1 of premiums they write. And, of course, they can't *get* the capital.

OID: I can certainly relate. But why not?

Mitchell: Because they're mutuals — which are owned by the policyholders.

OID: But can't they just retain the capital they need — assuming that they're writing profitable business in the first place?

Mitchell: They probably could — given time. However, I'm not sure Best would leave their ratings intact in the interim. So they're looking for a faster alternative. And the alternatives a mutual has to raise money quickly are quite limited. The best way for them to do it is to merge with a stronger mutual.

OID: Gotcha.

Mitchell: Therefore, many small, country mutuals with good books of business are coming to National Grange to get capital.

So both Fund American and National Grange say that they see a terrific opportunity to merge smaller mutuals into National Grange. And, again, one of the things that National Grange is doing to get the capital that it needs is the 40% quota share deal with Main Street America that I mentioned earlier.

OID: Because, in effect, by writing 40% less business, they need 40% less capital.

Mitchell: Actually even *less*. A.M. Best allows a look-through to a stock subsidiary for purposes of assessing capital strength. So National Grange, in effect, can count the capital of Main Street America for the purpose of getting and keeping a rating. And with their surplus strengthened, National Grange is more attractive as a merger partner — especially to the weaker mutuals.

OID: Very interesting.

Mitchell: Incidentally, there's also a trend underway of consolidation at the insurance *agency* level. The average agency is growing larger, too. We understand that the little ones are finding out that they don't have what it takes — in terms of systems and scale and so forth — to compete.

So we find it encouraging that larger agencies are finding it attractive to do business with National Grange. The evidence of that, by the way, is that the average size of the agency National Grange deals with has increased by 45% over the past five years.

Incidentally, its goal is to be #1 or #2 in personal lines in each agent's office. Again, the agents are finding that the big insurance companies — the dinosaurs, the goliaths — are increasingly retreating back to the home office. So they're not providing agents with the level of service and

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support they'd like. And the folks at National Grange concur with Fund American management that it presents an opportunity for them to capitalize on.

And the arrangement is a win/win for *everybody*. The mutual that joins National Grange is now part of a better capitalized entity. National Grange can grow its premium base, but stay within the permissible surplus ratio by downstreaming premiums. And Main Street America — and, indirectly, obviously, Fund American — acquires premiums at no cost.

And, over time, as Fund American puts more capital into Main Street America in order to support its premiums — it will eventually own more of it. So it's a heck of a deal for all concerned.

OID: If it's decent business, anyway.

Mitchell: So there's the opportunity. Honestly, we don't know how to quantify it. But we *do* know that there are a lot of little country mutuals out there that can be merged. And, obviously, National Grange should be able to cut their overhead and otherwise improve their operations.

ULTIMATELY, YOU'RE BETTING ON BYRNE & CO.
AND THAT'S A BET WE'RE VERY COMFORTABLE WITH.

OID: However, is Main Street America — and, possibly Fund American — taking 100% of the risk legally or practically — for 40% of the premium?

Mitchell: I don't think so. Fund American owns 33% of the stock of Main Street America. So it would be like *us* owning it.

OID: But aren't they forced to serve as the backstop for any folly they do or watch them go down the tubes — tainting Fund American's reputation in the process.

Niemczewski: If you're asking whether they're subject to suffering from some huge systematic blunder, the answer to your question is an unequivocal yes. Therefore, we've satisfied ourselves as best we can that the people running Main Street America and National Grange are Fund American's kind of people.

We're ultimately betting here — and there's no way to assure you that we're right — that the management team at Fund American has done its due diligence.

Mitchell: Your point's absolutely correct. The only way to answer it is to judge whether Byrne, Kemp, etc. have used good judgement in terms of the people they're in business with. There's not another damn thing you can do. And that's why culture is so important.

OID: On that score, I happen to be a big fan of Byrne. But I'm not familiar with his paper trail — aside from his decade or so at GEICO and, to a lesser extent, the decade or so that he's been at Fund American.

Niemczewski: Although, in all fairness, you're talking about 20 years right there.

OID: Not to worry. If he's as good as you say he is, he'll overcome his youth and inexperience. However, during his reign at GEICO, didn't they diversify outside of their core auto insurance business...

Mitchell: I understand that they did get killed when they strayed outside their core line. But I believe they entered those lines before his watch — although I honestly don't know for sure. But one thing you have with almost every insurance company is a paper trail. And there's the triangle chart showing subsequent reserve development.

OID: Although I wasn't able to find Fund American's.

Mitchell: Theirs is very hard to find. But if your question is whether he's made any underwriting mistakes along the way, I'm sure he *has*. Nobody's perfect.

But we've studied Jack Byrne's accounting and talked with people who've worked with him for two decades. And, without exception, everyone tells us that when you see a Jack Byrne balance sheet, it's a strong balance sheet and the reserves are properly reserved. So, based on history, I'm confident that their reserving — like their accounting — tilts towards conservatism.

OID: Good answer.

Mitchell: Plus, he owns 21% of the company. So he's not that concerned about the near-term stock price, but he's very concerned about the growth of book value. Therefore, there are grounds for a lot of confidence that he won't be under-reserving.

OID: Because, in effect, he'd be lying to himself.

Mitchell: Exactly. Also, this company is very much in a state of flux. They've sold the insurance business with the long history and are beginning initiatives that generally don't have very much in the way of history to show. However, I've never seen a Jack Byrne company ever have high and rising cumulative deficiencies.

What killed the big guys was incentive-based bias — to use Charlie Munger's terminology. Their incentives were based on growing *premiums*. They didn't give a damn about *profitability* because they weren't owners.

OID: Like Buffett said at Berkshire's annual meeting, his insurance team could meet any volume goal he set. But shareholders would be left holding the bag.

Mitchell: Exactly. All I'm saying is that the key is to find a CEO and a management team that thinks in terms of balance sheet discipline and underwriting discipline — not growing the business just to build an empire, but rather to grow it profitably. I keep coming back to culture because it's critical to long-term success here. And we are *very* convinced that they have that.

Then, we think that if you combine that discipline with buying stocks with funds not needed for policyholder reserves that over time you have a very high probability of earning a 15% return on your capital.

So to sum up, first, we think we're buying this thing for well below fair market value today. Second, we believe its reinvestment opportunities and opportunities for growth are as good as any we see in the insurance area. And, third, we have a terrific capital allocator in our camp who owns 21% of the stock.

So we like those odds — especially in *this* market.

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MARSHFIELD ASSOCIATES'
SAM MITCHELL & CHRIS NIEMCZEWSKI
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WHITE RIVER HAS IT ALL: A GREAT BUSINESS, A GREAT MANAGEMENT AND A CHEAP PRICE.

OID: And I gather that you believe White River [WHRC/NASDAQ] is also a compelling bargain today?

Mitchell: Absolutely.

OID: In a nutshell, why?

Mitchell: We believe that White River's valuation conservatively estimated is north of $70.

OID: With the stock at $50, why is that compelling? Isn't the idea to find 50¢ dollars?

Niemczewski: Well, we're looking for three things: a great business, a great management and a cheap price. And this is one of the very few things we've seen recently that combines all three.

Mitchell: Actually, in all fairness, when we wrote our last letter to clients, it was right at a 50¢ dollar.

OID: I hope you're not suggesting for one minute that we backdate our issue...

Niemczewski: Are we violating the 50¢ dollar rule? Maybe. But when we tell you about this company, I think you'll understand why. We've paid as little as $30.50 and up to $45. But we still think it's a compelling value today.

OID: So you'd establish a full position at $50?

Niemczewski: Oh, yeah.

Mitchell: Definitely.

Niemczewski: Also, our valuation may be a bit on the conservative side. We tend to be more conservative in our valuations than most.

Mitchell: And White River's management is more conservative still. For example, their book value at March 31st was $38.62 per share. But that's after having written down the carrying value of what we believe is their most important asset — their stake in a company called Infovest — from its $38 million cost to $7 million. So their book is understated right there by about $31 million — which, based on their 4.9 million shares outstanding, is roughly $6 per share. So that adjustment alone would increase their adjusted book to about $45 per share. And we believe that stake's worth *at least* $80 million *more* than they paid — which is another $16 per share.

OID: I hope it's less complicated than Fund American.

Mitchell: In some ways, it's a complicated analysis, too. And that's one reason why its stock is cheap.

OID: You really know how to hurt a guy. Could you tell us the back-of-the-envelope version?

Mitchell: Since you rarely care about the details, that shouldn't be a problem. Here's how we value it:

THEN, CROSS TIMBERS LOOKS UNDERVALUED. SO WE JUST VALUE IT AT TODAY'S STOCK PRICE.

Mitchell: White River has $27.82 per share of cash and cash equivalents. They also have passive securities — some common stocks — including 2.7 million shares of Cross Timbers Oil [XTO/NYSE] plus some dribs and drabs of other things. And at current prices, all told, those equity holdings add up to about $13.89 per share.

OID: What can you tell us about Cross Timbers?

Mitchell: As you may recall, Fund American had a heck of a lot of energy investments way back when.

Well, the guy running Cross Timbers is just terrific at doing in oil and gas what Jack Byrne does in insurance — he just buys oil and gas reserves on the cheap and runs a low cost production operation. To give you some idea of what I mean, since this company went public in 1993, their per share reserves have increased 75%.

OID: And you have to like the fact that they recently announced a share buyback — although I also see that their chairman just recently retired.

Mitchell: That's right. But we don't see that as a negative. The new chairman is a co-founder of the company with the retiring chairman.

Cross Timbers' strategy is very simple. They focus on buying high quality, long-life reserves — usually from the majors like Mobil, Exxon, etc. One of the majors may have a field that once held 100 million barrels and is now down to only 2 million. So it's not economic for them to apply modern technology to these odds and ends.

However, it *is* economic for Cross Timbers.

OID: Why?

Mitchell: Cross Timbers has extremely experienced people. And they know how to increase production and lower production cost per barrel. Their finding cost is as

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WHITE RIVER
Simplified Balance Sheet

	$(mil)	$/share[1]
Cash and equivalents	136.1	27.82
Securities	67.9	13.89
Northwest Preferred[2]	15.0	3.07
Northwest Common[2]	34.9	7.14
Infovest Preferred	37.5	7.67
Infovest Common	84.5	17.25
Total Assets	375.9	76.87
Liabilities	8.3	01.70
Breakup Value Pre tax	367.6	75.16
Tax Liability[3]	9.1	1.87
Breakup Value After Tax	358.5	73.29

[1]White River has 4.891 million shares outstanding.
[2]Based on its 21% pro-rata interest in NWA Partners. Preferred has $39.5 million face value.
[3] Assumes sale of NWA stake and securities with gain taxed at 28%.

Apparent math errors due to rounding.

MARSHFIELD ASSOCIATES'
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low as anyone's. Their average acquisition cost is about $5 per barrel. But they typically add 60% to proven reserves in the fields they acquire at about $2 per barrel. So that reduces their cost to about $4 per barrel.

The point is that these guys will acquire properties that have been under-managed by the majors for years simply because the majors haven't found them big enough to fool with. And they'll increase production by managing them properly. As a result, they can buy reserves cheap — in effect, by picking up the crumbs that the majors don't want anymore and making a good living off those crumbs.

OID: And how is it being valued today?

Mitchell: Today, Cross Timbers is selling at $22. But in our valuation, we use its price as of July 19th — which was $26 — although we think it is selling below economic value.

White River's chairman, Gordon Macklin, thinks Cross Timbers is quite undervalued on an asset basis. And it looks that way to us, too. When we do the math, we come up with $36 per share based on their 1997 reserves. And if you assume that they add no reserves subsequent to December 31, 1995 — which is clearly ridiculous — then you'd come up with a valuation of about $24 to $25. However, that's clearly a crazy number.

OID: Which would seem to suggest that you would consider between $22 and $26 crazy, too.

Mitchell: That's certainly the *minimum* valuation — although, here, again, we're using prices as of July 19th — at which time Cross Timbers was selling at $26 per share. But, actually, we reach our $24-25 valuation using very conservative assumptions.

Niemczewski: They're in fact *extremely* conservative. We assume an average selling price of crude oil of $22. And you might wonder what's so conservative about that. Well, we assume that price prevails for the next *15 years*. So there's lots of upside in our price estimate.

OID: From inflation, if nothing else.

Niemczewski: That's right.

Mitchell: There are three ways that I think the assumptions are conservative: First, as Chris mentioned, we assume a static price of $22 for oil for 15 years. Second, we assume a 15-year life in these fields — and they may be able to do better than that because they have historically. And third, we assume a straight line reserve depletion rate. But we suspect they may front load their production when it's to their advantage. Therefore, the present value of their fields might be higher than we've calculated.

OID: You guys would never make it in the high stakes world of newsletter publishing...

Mitchell: And we use an after-tax margin of 44%. We use that because the professional reserve estimators who estimate their cash flows for proved reserves assume 44% margin. So we thought that was probably a reasonable number.

OID: Although because of the relatively economic way that they acquire reserves, you figure their margins could be higher?

Mitchell: Oh, *yeah*. And I say that both because of their relatively low costs and because the figure is an average margin, not an incremental margin. So as they add reserves, their margins should increase.

OID: And the average finding cost for other companies in the industry is well above their $4 per barrel cost?

Mitchell: Among U.S. companies? Oh, *yeah*.

OID: But isn't White River selling Cross Timber?

Mitchell: They are. So the natural question is, "Why?" Well, I asked them the same thing. And their answer wasn't altogether clear to me. Their basic reason seemed to be that they realize their expertise is in the area of financial services and that they think they'll eventually be able to put their cash to work in a good deal.

OID: Sounds sensible enough.

Mitchell: However, I believe that they may think that Cross Timbers is reasonably to slightly undervalued, but not *grotesquely* undervalued. And, therefore, they're saying, "We'll just liquidate it over time." And that's what they're doing. But it's not the most liquid thing in the world.

OID: And you'd like our subscribers to help by...

Mitchell: Not at all. It looks to us like Cross Timbers is a pretty good value. But, again, we just value it at its current stock price. To make White River work investment-wise, we don't need to be optimistic at all about Cross Timbers. All we have to do is satisfy ourselves that its valuation is reasonable to slightly undervalued.

OID: And you're satisfied there.

Mitchell: Very much so.

[Editor's note: It appears to us that White River may be selling its Cross Timber shares for another reason — namely, to avoid being characterized as an investment holding company. (See White River's 1995 Annual Report and 10-K.)]

WE'RE NO FAN OF THE AIRLINE INDUSTRY — AS OUR NORTHWEST VALUATION DEMONSTRATES.

Mitchell: Then, White River has a very interesting investment in Northwest Airlines through NWA Partners — which was put together by Richard Blum in 1989. He got the Northwest Airlines shares for basically nothing. And, obviously, the reason he got it at the price he did was because it was about to go bankrupt.

White River owns roughly 21% of NWA Partners — which owns 4.7 million shares of Northwest common stock. Therefore, valuing that common stock at its July 19th price of $35-3/8 per share, White River's 21% pro rata interest is worth $34.9 million — or $7+ per White River share.

In addition, NWA Partners owns 1,727 shares of Northwest Airlines Series B Preferred with a par value of $50,000 per share — or $86+ million in par value. So

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White River's 21% pro rata portion would have a face value of slightly over $18 million at par.

Incidentally, the Preferred accrues dividends at 8% through August 1998 and aren't paid until the Preferred is redeemed in 2003. Therefore, besides its $18 million face, White River's pro-rata portion of the Preferred should also have accrued dividends of roughly $13 million.

OID: So including accrued dividends, White River's share of the Northwest Preferred is about $31 million.

Mitchell: Correct. Again, Northwest is supposed to start paying the 8% dividend currently in September 1998. But we just assume it isn't paid until 2003. And we take the sum they'll receive at that time and discount it back to its present value using a discount rate of 15%.

OID: Which sounds like a relatively stiff rate.

Mitchell: It is. But we think it's reasonable given Northwest's current financial position, etc. So, doing that, we value those preferred shares at $15 million. And, once again, dividing that $15 million by White River's 4.9 odd million shares, there's another $3 per share.

OID: Gotcha.

Mitchell: Incidentally, it looks to us like White River's total pro-rata cost for their common and preferred stake was only $987,000. So they got both for basically nothing. It was an unbelievably good deal.

OID: If your valuation is even remotely reasonable, we'd certainly have to agree. We'd be talking about a 50-bagger in only about 7 years...

Mitchell: Now White River management will say — and correctly so — that you can't value their interest at 100% of its current market value because the transfer of the common stock is restricted. It's restricted by the terms of the LBO until June of 1997.

Also, NWA Partners has a 10-year life ending in 1999. And it's extendable at the option of the general partner for an *additional* two years. So White River management would say, "Gee. We're locked up. So we better assign it a big liquidity discount."

But we're valuing it, I believe, as a long-term investor should — discounting the preferred back to present value by giving it a rather major haircut.

OID: Certainly, going from $31 million to $15 million doesn't sound like a little off the top.

Mitchell: We aren't fans of the airline business. But it looks to us that for at least the next two or three years — absent fuel going through the roof — yields per seat mile will enable them to earn reasonably decent returns.

OID: In fact, I understand that the industry has just been through the worst downturn in its history.

Mitchell: We don't pretend to be airline analysts. But based on the balance between supply and demand and enhanced safety needs raising the barrier to entry, we think that the industry may enjoy a few years of reasonably decent performance. So we think our valuation may actually prove low.

Plus, we think there's a decent chance that someone — whether it's KLM or someone else — will *buy* Northwest.

OID: If it's still around. And how likely is that? I see Value Line says it earns its long-term interest 2.4 times and gives it a B rating for financial strength.

Mitchell: That may be generous. The biggest uncertainty for Northwest right now is its spat with KLM. Basically, KLM wanted to buy more of Northwest than Northwest's management wanted them to buy. And that created lots of hard feelings and, in fact, appears to have put the whole alliance at risk. I don't know what's going to happen there. However, I can't believe Checci and Wilson would be so stupid as to destroy value out of pique.

The code sharing arrangement through which they tie into each others' reservations and route flights through each others' systems is working and continues to be a big success. Plus, they just reported excellent numbers. However, they got dragged down along with everyone else by the TWA crash. In reality, however, Northwest stands to be a prime beneficiary of any troubles that TWA might have.

OID: In any case, you're valuing White River's pro-rata interest in Northwest's common shares at $35 million and their preferred stake at $15 million — which is $7 and $3 per White River share, respectively.

Mitchell: Exactly. And adding that to the value of White River's cash and securities gets us to $52 per share — which net of their $1.70 of redeemable preferred stock brings our valuation up to $50.

INFOVEST HAS A COMPELLING SERVICE
— AND A CLIENT LIST TO MATCH.

OID: But I gather that you didn't invest in White River as a play on Northwest Airlines.

Mitchell: Correct. And here's where it starts to get very interesting. If you look at White River's balance sheet, you might say, "Sam, you're out of your mind. These guys have a lot of debt. What are you doing?!"

But White River actually doesn't *have* any debt. They consolidate Infovest for reporting purposes. So they incorporate Infovest's debt on their balance sheet. But they don't owe a *penny* of that debt themselves.

White River owns 52% of Infovest's common. Plus, they own Series C and Series D Redeemable Preferred. And, again, if you were to simply value the common shares at White River's cost — which is $38 million — you'd add another $6 per share to White River's valuation. However, we think it's worth quite a bit more than that.

So let me explain what Infovest is, how we value it and why we're excited about its prospects.

OID: I thought you'd never ask.

Mitchell: Infovest's CCC Information Services subsidiary offers several claims-related services to insurance companies. The first of these is called Total Loss — which is a local market valuation service for vehicles. And why is that important? I may be the only person you've ever interviewed who's actually sold used cars.

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OID: Or, at least, the only one to admit it. But don't worry. We've even had attorneys and brokers...

Mitchell: Incidentally, lest your readers become alarmed that you've gone too far in terms of lowering your standards, I hasten to add that this was over 25 years ago.

However, typically, insurance companies value cars based on the Kelly Blue Book or the NADA Book. And the valuations are *squirrely*.

What Infovest has done — and, by the way, it isn't easy to duplicate — is to hire people to go around local area by local area to get actual transaction prices for used cars and put those transaction prices on their database. So that's product #1.

OID: Gotcha.

Mitchell: Then, product #2 is EZEst — which is a collision estimating system. It uses a nationally recognized source of collision estimation data — the MacLean Hunter database. They use it pursuant to a non-exclusive licensing agreement to come up with the repair cost of cars that have been in a smack up.

And, finally, their third product is EZNet — which is a really terrific product. It's a 24 hour loss reporting service which enables insurance companies to do assignments, appraisals and appraisal supplements — in other words, they can contact body shops, service shops, independent adjusters and so forth — all on line.

OID: Why is that so terrific?

Mitchell: Because they've basically created an electronic network for claims adjusting. The benefits are tremendous improvements in claims adjuster productivity. Whereas they might typically have been able to handle only *5* claims per day before, with EZNet, they're generally able to do *12*.

Incidentally, there's another important advantage, too. Obviously, the better your data — the more real it is — the less chance there is of fraud. So the insurance company protects itself and improves customer service. You're well aware of the deals that go on where somebody smacks up their car, goes to the body shop and the body shop says, "It's really only going to cost you $800. But we'll write it up for $1,000 and split the difference."

OID: Actually, we weren't. That's a new one to us.

Mitchell: Let me tell you — when I was in the car business, I ran the get-ready department. And I never did that. But I had a hell of a lot of customers come to me and say, "What can you write it up for?"

OID: Wow.

Mitchell: However, the *key* thing is that thanks to Infovest, the insurance company's customer knows that they're getting a fair replacement cost for their car, not something out of a book where the data may be old or nonspecific to the locality of the customer.

So it reduces fraud, increases the productivity of claims adjusters and leads to a far more satisfied customer.

OID: Which sounds like it might equalize the playing field — at least a bit — for smaller insurers vis-a-vis the Progressives, GEICOs and Allstates of the world.

Mitchell: That's true. But GEICO's a happy client.

OID: Really?!

Mitchell: Yeah. GEICO knows these guys well. And it's not just GEICO. The top *20* insurance companies are their clients.

OID: Not bad.

Mitchell: They have about a third of the market. And ADP and Mitchell have about a third each.

AND INFOVEST SEEMS TO BE GAINING SHARE.
IN THEIR OWN WORDS, THEY'RE "KICKING BUTT."

Mitchell: But we're told that CCC is increasing its share — that they're up to 11,359 software "nodes" — which is a 24% increase over the last year.

OID: You said they have about a third of the market, but that the top 20 insurers are already clients. How, exactly, can that be? And if the top 20 firms are already clients, where does their growth come from?

Mitchell: First, those are old market share figures — dating back to 1995. Also, I imagine that many of those top 20 companies don't exclusively use Infovest.

I'm told that their primary market is growing rapidly, although I can't give you an exact figure. The total claims adjusting market is relatively static. But what Infovest is doing is replacing today's paper claims processing system with an electronic network that operates in real time or something very close thereto. And I've already told you about some of the serious problems of the former and some of the compelling advantages of the latter.

OID: Please don't think I wasn't listening...

Mitchell: Two or three insurance companies to which we've spoken are telling us — and a year or so from now, we'll know if they're right — that Infovest's software is really very, very good.

OID: ADP's product isn't comparable?

Mitchell: Infovest just recently came out with Pathways — which is an upgraded software package that makes their services more efficient, faster, more up-to-date and easier to use.

And from our conversations with people in the insurance industry, we've been told that the early response to Pathways has been extremely positive and that it's qualitatively superior to the other products on the market. So we think they'll gain market share as a result of their superior technology, superior network, etc.

What's going on — to quote the company — is that CCC is "kicking butt". They just got a big contract from Progressive — which fired ADP.

OID: Fascinating.

Mitchell: And then they got another contract from Nationwide which fired Mitchell.

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OID: Just in case any investment banking recruiters happen to read this interview, let me ask you — do Infovest's services have applicability internationally?

Mitchell: I think they do. However, I think it would be stretching it to spin a story on that account. After all, there's so much market here in the U.S.

OID: We can do it the easy way and let you spin away or the hard way and put words in your mouth...

Mitchell: In that case, *sure* it does. *Of course*, it does. — because we're talking about a very much improved way of handling transaction costs pertaining to auto accidents.

However, Chris and I would be too embarrassed to spin an international story.

OID: Then those comments won't go beyond our pages — journalists' honor.

IGNORING THE SIZZLE AND VALUING ONLY THE STEAK, WE VALUE INFOVEST AT $25 PER WHITE RIVER SHARE.

OID: What's the background of Infovest's developers? And how did they hook up with White River?

Mitchell: They were insurance people with an idea for a better mousetrap. They were excellent technically, but they ran into cash flow problems. And the way White River wound up with their stake is that the founders were about to go bankrupt...

OID: There seems to be a recurring theme here...

Mitchell: It's the same, old story. They had lots of growth and ran out of cash because they underestimated how long it would take them to start generating positive cash flow. They spent their seed money developing the software, testing it, setting up the network, etc. Obviously, with this kind of product, you have to set the network up and get the software working right before you earn a *dime*.

OID: Not so unusual.

Mitchell: So they ran out of money. And the banks were about to call their loans when White River came along and bought their stake.

OID: And the remaining stake was retained by the founder/managers.

Mitchell: Correct.

OID: A recent news story mentions plans for an IPO by Infovest in the third quarter. What can you tell us there?

Mitchell: Not much. The prospectus is supposed to be out shortly. And I understand White River isn't selling any shares at this point. But I don't have the details.

OID: Is it your sense that White River would like to keep this thing long term or that they want to sell it?

Mitchell: If they could get an absurd price for it — 40 times earnings or 15-20 times cash flow (which is the figure that some of the investment bankers have been throwing around) — then they might let it go. If they did, we'd have to add another $20 or so to the valuation.

OID: A security analyst's work is never done.

Mitchell: But you should keep in mind that we're not doing any projections of free cash flow in our valuation. We're just saying, "Here's what we think it's worth today without assuming much growth."

So we think we're being quite conservative.

Niemczewski: But to answer your question, I believe White River intends to *keep* Infovest.

Mitchell: That's right. They do. Bob Marto, White River's CEO, said at their annual meeting this year that if somebody offers them an absurd price that they'll think about it. But, absent that, they say that they just have a terrific little company — a real gem — with good management, financial controls and proper financing in place and a bright future ahead of it. And it's our impression, at least, that the guys at White River are very straight shooters.

OID: And how do you value it?

Mitchell: For the year ended December 1995, Infovest had $115 million in revenue. And we figure it ought to do maybe $130 million this year. I'm guessing because they won't tell me exactly what they're doing. But their operating income was about $11 million in 1995. And if they continue to grow at their first quarter pace, it could be $16 to $20 million or more this year.

So 10 times operating income — and we've been told that the investment bankers think they could bring it out for considerably more — might be a reasonable valuation today with nothing, in effect, on the come. And that would give it a value of something around $200 million. And other people we've spoken with suggest similar numbers. Nobody comes up with lower ones.

OID: And you're estimating private market value, intrinsic value or what?

Mitchell: Intrinsic value. We're not factoring in any kind of IPO premium, private market value or anything of that sort. And, two or three years from now, we're hoping that it'll be worth much more than that.

OID: Tell me something I don't know.

Mitchell: We could very easily spin a story that could justify a much higher price. This is just the easy, conservative way to do it.

In our valuation, we don't net out Infovest's debt — which totaled $34-odd million as of December 31, 1995. But, frankly, we think we're lowballing their valuation by that much or more because we're not factoring in anything for the kind of growth that we're told their Pathways software is generating.

So netting out White River's the $37.5 million worth of preferred from our $200 million valuation, we value Infovest's equity at about $162.5 million.

OID: For 100% of Infovest's equity.

Mitchell: Right. And, again, White River owns 52% of that equity. So we estimate that their equity in Infovest

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is worth about $84.5 million. And when we add back their $37.5 million worth of preferred, we arrive at a total value for White River's stake in Infovest of about $122 million — although, again, we believe it could be sold for much more.

Then, dividing Infovest's total value by White River's 4.9 million shares, that comes to roughly $25 per share — $8 of which is represented by Infovest's preferred and the remaining $17 by way of their equity.

OID: And added to the $50 subtotal from before, there's your $75 valuation for White River.

Mitchell: You've got it.

OID: Although the figures we've discussed are pretax.

Niemczewski: *Most* things are. So are Coca-Cola's.

OID: That's a good point. And I guess they don't have to sell Infovest. But what about taxes resulting from the sale of their securities and their stake in NWA?

Mitchell: These guys generally do whatever benefits shareholders. They basically paid nothing for their stake in Northwest. So it's at least as likely as not that they ultimately spin it off to shareholders rather than sell it.

But they will incur taxes on the sale of Cross Timbers and some of their other securities. Again, those securities were worth $67.9 million as of July 19th. And White River's cost was $35.4 million. So applying a 28% capital gains tax to the estimated gain of $32.5 million, the tax due on sale would be approximately $9.1 million — or $1.87 per share.

Obviously, we're both engaging in false precision here. But all we're concerned about is being roughly right. And we think our White River analysis holds up just fine there.

OID: So netting out that tax liability, you wind up with an estimated valuation of $73 per share.

Mitchell: You've got it.

MARTO IS A VERY GOOD DEALMAKER —
RIGHT OUT OF THE JACK BYRNE MOLD.

OID: You mentioned earlier that White River had the key things that you look for — i.e., a great business and a great manager at a great price.

Mitchell: That's right.

OID: And when you say great business, I gather that you're not talking about the airline business...

Mitchell: No. We're talking about Infovest. I think it's a terrific, little growth vehicle hiding among the thicket of White River.

OID: And the great manager?

Mitchell: Bob Marto is a very, very good dealmaker right out of the Jack Bryne mold — in that he won't overpay for anything. And just take a look at their record. This management has a long record of being able to spot bargains and buy 'em cheap. Marto has been under Byrne's tutelage. And he's done a terrific job.

If you were to look at White River and Fund American as a closed-end fund put together by people who really know financial services and who know how to invest, I don't see how anyone *wouldn't* find it compelling. But, in fact, I think it's better than a closed-end fund because they're also excellent operators. These guys know how to *build* insurance companies, not just *buy* 'em.

OID: It sounds like all roads lead to Jack Byrne here.

Mitchell: What Jack Byrne has done is to build a cadre of people who share his philosophy. They're people he's trained who've been with him a long time. And they know in their bones how to do what he does.

He's got a lot of 'em at Fund American plus Marto at White River.

OID: What can you tell us about Marto's paper trail?

Mitchell: In part, we're relying on a member of our advisory board who worked with Jack Byrne at GEICO and who's known all of these people for a long time.

But Marto joined Fund American in 1985. So he was there awhile. He was Treasurer from 1985 to 1989, CFO from 1989 to 1990 and EVP and CFO from 1990 to 1993. So he's a Jack Byrne protege. And we're told by people who have worked with him over the years and know him that he's first rate.

OID: You said that Byrne owns 17% of White River?

Mitchell: That's right — 17.1%. But Fund American also owns 20.8% of White River. And Byrne owns 21% of it. So he effectively owns slightly over 20% of White River.

OID: And Marto?

Mitchell: Marto owns 6.4% of White River.

Mitchell: And we know that Byrne shows his deals to Marto as well as to Fund American.

OID: Is White River engaged in financial services?

Mitchell: They owned an advisory firm at one point. But it was really insignificant to their business.

OID: So that they really are a holding company today, plain and simple — or, at least, plain.

Mitchell: That's correct. White River is evolving towards a financial services company defined broadly — not specialty property and casualty insurance per se. And they're having trouble finding acquisitions in those areas that will meet their return objectives.

OID: Because most of the financial services area isn't offering the same opportunity that you describe as existing in the insurance area?

Mitchell: It's hard to find good niche deals. But they're not going to pay up for these businesses. If they can't find the right property at the right price, then they'll return the money to shareholders. That you know.

For example, when we started buying White River in late 1993, they had 6.1 million shares outstanding. And, obviously, there's a liquidity issue. But even given how few shares they have outstanding, they're still willing to buy back shares. And they've reduced their shares outstanding from 6.1 million to 4.9 million since.

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Incidentally, in 1995, they bought back $20 million worth of shares. But in the first quarter of this year, they bought back much less — only about $500,000 worth.

OID: With their stock between $36 and $39, anyway.

THEY'VE COVERED THEIR DOWNSIDE, TOO. AND BYRNE TAKES THESE THINGS *PERSONALLY*.

Mitchell: Which, of course, gets to the question of whether or not White River has a cheap price.

OID: You noticed.
Mitchell: Again, using our valuations, White River's pieces all told are worth $70-75 today. And the big kicker is Infovest — which we think has a very bright future. And, while we can't prove it, we can say that its cash flow is improving very significantly.

OID: It sure sounds like it.
Mitchell: So I hope you'll agree that our valuation of their Northwest Airlines' stake is reasonable, that their Cross Timbers is worth the current market price or more and that our valuation of Infovest is *clearly* conservative.

Also, when we value companies, we usually estimate future cash flows and some future terminal value and discount those figures back to their present value. We're not doing that at all with Infovest or White River. Admittedly, it would be difficult to do with Infovest — because it doesn't have a long operating history.

OID: Don't think of it as difficult. Just think of it as an opportunity to exercise your imagination.
Mitchell: Exactly. But if we were to value Infovest on a discounted cash flow basis, I think we'd come up with *seriously* higher numbers than we have here.

OID: Teasing the editor won't help.
Mitchell: Therefore, I'm personally inclined to believe that our valuation is low by a considerable amount.

Niemczewski: The discount to intrinsic value here is as good as anything else that we see out there today. Actually, I think it's a lot *better* than anything else we see.

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Mitchell: I think that's fair.

OID: That, too, shall pass.
Mitchell: Plus, because of the way Byrne and Marto have structured it, they've really covered their downside. And because I know you'll ask, let me go ahead and tell you what can go wrong.

OID: Changing the subject won't help, either.
Mitchell: What could go *wrong*? Northwest Airlines' return to health turns out to be a 360 instead of a 180 — although I think that's unlikely. Another would be that contrary to everything Chris and I have been told, Infovest turns out to be worthless.

OID: But even if Infovest and Northwest proved to be worthless, you'd still have $40 of cash and securities.
Mitchell: And that's unrealistic for several reasons. First, it's highly unlikely that Infovest would be worth zero. That's certainly very hard for me to imagine.

OID: They might still have some used computers?
Mitchell: It might not grow. But you have to remember that White River has $37.5 million worth of cumulative preferred — which is a senior security. Therefore, unless you assume that Infovest goes belly up, even there you're being a little conservative.

OID: Good point — in which case, there's your $48.
Mitchell: More or less, that's right.

WHITE RIVER
Estimated Value

	Estimated Value ($/share)	Worst Case[1] Value ($/share)
Cash and equivalents	27.82	27.82
Securities	13.89	13.89
Northwest Preferred	3.07	--.--
Northwest Common	7.14	--.--
Infovest Preferred	7.67	7.67
Infovest Common	17.25	--.--
Total Assets	76.87	49.38
Liabilities	1.70	1.70
Breakup Value Pre tax	75.16	47.68
Tax Liability	1.87	1.87
Breakup Value After Tax	73.29	45.81

[1] Assuming Northwest stake and Infovest common turn out to be worthless.
Apparent math errors due to rounding.

Niemczewski: This isn't a Ben Graham special where you buy it dead and it's not. This isn't Northwest Airlines in 1989 — something that's being run horribly today and somebody else has to take it, shake it up and fix it.

White River's a lot cheaper than other businesses that we generally want to own, with management we trust and hold in very high regard where we have confidence in their ability to run it well. We don't see very many things that

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look *remotely* as cheap.

Granted, there are some rotten things out there that someone could turn around trading at a cheaper price. But that's not what we do.

OID: Darn. We were kinda hopin' to get rich quick — or solvent quick, anyway...

Niemczewski: My own experience with stocks like White River is that they rarely get fabulous P/Es, but that you make your money as they grow their intrinsic value.

Of course, if Infovest were to successfully go public, people might not think of White River's stake in Infovest as something with a carrying value of $8 per share.

Mitchell: So the hidden value might all of a sudden become more apparent.

BYRNE'S A CLOCK BUILDER, NOT A TIME TELLER.
HE'S BUILDING MUCH MORE THAN A ONE-PUFF CIGAR.

OID: What else could turn these ideas into a mistake?

Mitchell: First, you shouldn't own White River or Fund American unless you're prepared to put it away for a decade or longer — because neither has much liquidity. We believe our clientele can handle that. And *we* can, too — because we really are long-term investors. But that is *definitely* a negative.

OID: Anything else?

Mitchell: Well, it's generally very tough to get money out of an insurance company. It's a challenge to upstream free cash to the holding company from the subsidiaries. Right now, there's a lot of intercompany debt that they'd like to replace with third party debt. And that's a challenge.

If they can't do that, it would reduce their returns over time. But I think they *will* be able to do it. They've certainly been able to do it in the past.

What else could turn Fund American into a mistake? Well, if we're wrong about Source One and they can't sell it or improve it — well, there's $295 million of their assets.

OID: Which is $34 per share of uncertainty.

Mitchell: But we're betting that they'll either sell it for what they have in it or more or fix it so it earns its cost of capital. But we don't have high expectations there.

OID: And, again, you're just assuming that they sell it for what they're carrying it for.

Mitchell: That's right. Also, the mergers between the mutuals and National Grange is relationship-driven. And National Grange is well regarded by these mutuals, while Fund American and Byrne, in turn, are well regarded by National Grange. And their relationship is primarily with Byrne. So, should he blow away, there could be a problem.

OID: Although that's certainly hard to imagine.

Mitchell: Agreed. Also, if and when Fund American sells Source One, they should have around $35 of cash. And White River has $28 per share of cash today. So it's always possible that they could invest it stupidly.

Niemczewski: But if you look at the deals they've done — not only in their passive investments, but even more so in their active investments — we think it's obvious that they have some real imagination...

OID: Nobody's perfect.

Niemczewski: Infovest and Folksamerica come to mind. They're doing deals that look to us, at least, like they have long-term prospects in excess of the returns typically available in the insurance business.

Mitchell: In no case so far has either Fund American or White River gotten anything other than very good prices on its acquisitions. So we think that they're very unlikely to invest stupidly.

Niemczewski: Especially since one of the most attractive aspects of Fund American and White River is Byrne's involvement. We know he takes what happens with both companies very personally.

Mitchell: Absolutely. At Fund American's annual meeting, someone asked Byrne, "What's the bear case? Why are people selling Fund American. It's been weak."

And he said, "They think I'm over the hill." And he said it with plenty of passion and fire.

OID: He's not?

Mitchell: One thing I don't worry about is their age. Byrne is 63 and Marto is 50.

OID: What do you worry about?

Mitchell: Once Byrne retires, their deal flow could slow to a trickle. But he's built an organization of first-rate people who've been with him a long time and who share his philosophy and discipline. Obviously, they don't have his brand name. But we think he's building an institution that will last. So we don't worry about *much*.

Have you read the book, *Built to Last?*

OID: Let's leave my ignorance out of it...

Mitchell: It says there are institutions and there are institutions. What separates an outstanding institution that earns very high returns long term from a lousy one? It's the organization's culture, its values and its people.

We think Byrne is a clock builder, not a time teller. We're making the argument, (and it's unprovable, unfortunately,) that Byrne didn't build this thing and that he didn't excel at Travelers, GEICO and Fund American entirely on his own. He created an institution and incorporated certain values: underwriting discipline, investing for total return, strong balance sheet, being the low cost operator, and thinking like owners.

We're arguing — and if you don't buy it, you won't buy our case for Fund American — that the kind of people, culture and incentives they have is exactly what you want in a first-rate, high return specialty insurance company.

Jack Byrne won't be there forever. On the *other* hand, we believe that the institution he's built *will* be — because it has the right ingredients for long-term success. The people are first-rate. We're extremely impressed with the quality of the team he's building and their focus on what's important. We're not saying there's another Jack Byrne waiting in the wings. However, we do have conviction that

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MARSHFIELD ASSOCIATES'
SAM MITCHELL & CHRIS NIEMCZEWSKI
(cont'd from preceding page)

he's building much more than just a one-puff cigar.

THE PICKINGS OUT THERE ARE MIGHTY SLIM
— FINANCIAL SERVICE COMPANIES ASIDE.

OID: Financial stocks seem to dominate your buy list. What do you make of that?

Niemczewski: Financial companies tend to have several attributes that we like: First, Wall Street seems to find them hard to understand.

OID: However ironic that might be.

Niemczewski: There's almost a systematic inability or unwillingness for Wall Street to differentiate between financial businesses earning very different returns. Take Morgan Stanley and PaineWebber, for example. Although they earn very different returns, you'd never know it from the difference in their valuations.

OID: I believe Shelby Davis and his father before him have observed that the best financial companies are growth companies in disguise — that they aren't priced like growth companies, but, in fact, that's exactly what they are.

Mitchell: These things have historically traded at a discount to the market. However, the return on equity for well managed financial service companies is almost always higher than those of the S&P 500 as a whole. And, sure, we'd like to get an expansion in the P/E multiple or the price-to-book. However, if we buy businesses that generate high returns over long periods, then we really don't *care* — because everything else will take care of itself.

Niemczewski: We bought Morgan Stanley in 1990, for example, at a 5% premium to book value. And it's OK with us that their stock sometimes gets up to 2 times book. But what we really care about is how fast Morgan Stanley *grows* its book. As long as they can keep growing it as fast as they have historically and as long as their valuation is within some reasonable range, we don't care.

Mitchell: In other words, an upward revaluation would be nice. But we don't need it to get our returns.

OID: Paraphrasing George Michaelis: In the short run, what dominates your returns is the price you pay; but in the long run, it's what you own.

Mitchell: That's exactly right. Also, the market seems to be operating under a major misconception — which is that these companies are interest rate-driven, plain and simple. Therefore, when interest rates go down, they go up and vice versa.

But most good financials sterilize interest rate risk. And we don't think that the market understands that. We're very wary of big, global generalizations. But if you look at the drivers of the financials we own, for example, they're very different. The drivers of insurance-related financials, obviously, are very different from the drivers of a Salomon. And Salomon's drivers are very different from those of Wells Fargo. So we think glomming 'em in together obscures more than it elucidates.

OID: Although, generally speaking, don't the same factors that hinder one financial company tend to hinder most of them?

Mitchell: I think that's true.

OID: For example, don't the same things that lead to higher credit losses for American Express tend to do the same to Wells and, often, be the same ones that hit portfolios and slow customer activity at brokers, investment banks and mutual fund companies?

Niemczewski: Absolutely.

Mitchell: That's true. In fact, Deryck Maughan has said that volatility is their friend. But he also said that one of the things that killed 'em in 1994 was people getting so panicked that they were like deer in the headlights. So their trading volume went down. Salomon is sort of like a chemical plant: Its fixed costs are very high. Therefore, what you're saying is true.

Niemczewski: And we do worry about volatility. Every once in a while — as in the second half of 1990 — anything financial just gets taken apart. And, therefore, we tend to set limits on how much concentration any portfolio can have in financials. It's a pretty big limit — close to half, in fact.

Mitchell: But that's really more a short-term issue. Although we can and will get hammered in the short run — even for three or four quarters — long run, we believe that the values are there.

SALOMON EARNS $5 IN THE FIRST HALF
— AND NOBODY SEEMS TO CARE....

OID: Speaking of volatility, you said earlier that you'd also make Salomon a full position?

Mitchell: That's right. In fact, just last week, we put together trade tickets to buy Salomon for new clients without a full position.

OID: You guys really are contrarians.

Niemczewski: We've been quoted enough about Salomon — much to our long and everlasting regret.

OID: I can't imagine anyone having that sentiment...

Niemczewski: In fact, I'm quite sure that anything we say about Salomon today will be something that we can look back on with regret six months or so from now.

OID: You and me both.

Niemczewski: Sam and I have probably had more and longer battles over Salomon than anything else that we've ever owned. And I've been deeply skeptical at times for reasons that you can no doubt imagine.

OID: There's no need to brag...

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MARSHFIELD ASSOCIATES'
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(cont'd from preceding page)

Niemczewski: Like everyone, we've heard the story on risk management before. Again, I've been the *skeptic.* But *I'm* actually starting to believe.

OID: You think a good, long vacation might help?
Niemczewski: What's making me feel better today is that there seems to be some clear, empirical evidence that they've finally got it right.

And what's *not* to like? We like to see improving fundamentals and a stock price the same or lower. And Salomon's stock price at year end was around \$37. Then, during the first six months of 1996, they earned \$5 and reported good results across the board — with the single exception being their oil refining operation. So they very clearly seem to be operating much better than they have for some time, if not ever.

Yet, their price-to-book ratio at the middle of last week was slightly lower than it was at the beginning of the year — again, notwithstanding two very good quarters since. So, in effect, Salomon's stock actually *declined* relative to book value. Talk about a hated company...

OID: Based on subscriber feedback, we have to agree. We'll probably have to bring out the riot gear...
Niemczewski: It's actually trading very close to its book value. And that's amazing. In this market, with PaineWebber selling at about 1-1/3 times book or whatever it is, Salomon is within about 10% of its \$40+ book value.

OID: And that's stated book.
Mitchell: That's right. And let me tell you about Salomon's balance sheet. Their balance sheet is running at about \$190 billion for the quarter ending June 30th. And here's why the issue of conservative accounting — and how they mark their positions to market — is important. On \$190 billion, each 1/2 of 1% is \$950 million.

OID: Or nearly \$8 per share.
Mitchell: Exactly. And they mark their market not midway between the bid and the ask, but rather at the bid on the premise that it's what they could liquidate it for. But when you're running that big a balance sheet, that makes a huge difference.

OID: Where do their positions tend to sell — at the bid, midway between the bid and the ask or what?
Mitchell: There's no way for us to know that.

Niemczewski: Salomon gets what everyone else gets. And most firms don't mark positions at the bid.

Mitchell: If they had to liquidate their book — which is a theoretical exercise — we just think that they'd net something in excess of what they're showing.

So all we're saying is that we have very high confidence that the book value we're seeing is really rock solid. Maughan says — and I believe him — that their accounting for marking their positions to market is more conservative than anyone else's on the Street.

IF THE PEOPLE ARE RIGHT, YOU STAY WITH 'EM. BECAUSE THEY'LL FIX IT. AND WE THINK THEY HAVE.

OID: But weren't they saying that before, too?
Niemczewski: And I think they generally *thought* it. But they were *wrong.*

Mitchell: Their risk management systems simply weren't what they needed to be.

OID: What pained at least several of our contributors is that management said the last shoe had dropped and that systems were in place when they weren't.
Niemczewski: *We* believed it.

Mitchell: They made us look like idiots, too.

OID: I strongly resemble that remark.
Mitchell: But let me put it this way: If you've got first-rate people and they really embarrass themselves and their supporters — which they certainly did — if you think the people are right, you stay with 'em because they'll fix it. It gets back to *people.*

The keys at Salomon are risk management and getting the incentives of the talent aligned with the interests of the owners. And we made a people judgement about Maughan and Denham and their determination to get it right.

Niemczewski: To the extent it *can* be done.

Mitchell: That's right. They can never get it *100%.*

Niemczewski: Or even *close* to 100% for that matter. But we think that they've done what they can.

Mitchell: And the results show — and they've told us — that they believe that their risk management systems are vastly improved today.

OID: Why are they any more likely to be right today? What makes you think they aren't the equivalent of a publisher who repeatedly, wrongly says, "bimonthly, more or less" — hypothetically speaking, of course.
Mitchell: Of course. I can't imagine any publisher *doing* that. However, CFO Jerry Bailey was relatively new to Salomon at the time. And Eric Rosenfeld, who was revamping the system, left to join John Meriwether. So management thought its systems were OK. But they *weren't.* So management got embarrassed by telling its owners that its risk management systems were functioning properly when they clearly weren't.

But they *realized* their systems weren't good. They've focused on improving them very substantially ever since. And they've devoted a huge number of people and a substantial amount resources to doing so.

OID: And you think they're fixed.
Niemczewski: Recent evidence is consistent with that hypothesis.

OID: Don't go out on a limb....
Niemczewski: I'm completely an empiricist when it comes to Salomon. After having been burned as badly as we have been so far, we'll believe it when we see it — in their results. They've made and broken promises enough that however much we may like and respect management,

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MARSHFIELD ASSOCIATES'
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(cont'd from preceding page)

we need to see it in the results.

Mitchell: And now we feel like we have. We believe their results are *confirming* that they're fixed.

THEY MADE ALMOST EVERYTHING WORK
— DESPITE A 120 BASIS POINT HEADWIND.

OID: However, given Salomon's earnings volatility, what makes you think that they just didn't luck out two quarters in a row? I think even we did that once.

Mitchell: Four quarters of damn good performance suggest that they're getting it right.

OID: Two quarters, four quarters — what makes you think it's not just static or a short-lived aberration?

Niemczewski: The last six months may have been great in the equity markets, but they *weren't* so great in the debt markets — where Salomon is concentrated. If you look at what the long bond has done this year, you'll see that they've been working against a pretty stiff head wind given that they're always long bonds.

And yet they've made almost everything work anyway. And they've made a lot of money.

OID: Are they necessarily long bonds?

Niemczewski: Practically speaking, yes — because they're bond traders.

Mitchell: If they were just playing the yield curve or playing a rising bond market — if that's why they made their money — we wouldn't want to own Salomon. But in a choppy, difficult market, they've done surprisingly well.

Niemczewski: Do you remember what 1994 was like at Salomon?

OID: Actually, if you don't mind, we're trying to forget.

Niemczewski: Exactly. Well, this year, through the worst of it, we've seen maybe a 120 basis point rise in the long Treasury. Yet they made money in proprietary trading hand over fist. Whatever the conventional wisdom may be, Salomon is no longer a bet on the bond market the way that it arguably was two years ago.

OID: Somehow all of this sounds very familiar...

Niemczewski: And they've done surprisingly well on the equity underwriting side, too — which, frankly, has come as a *real* surprise to me.

Mitchell: Primary earnings per share for the first half of 1996 were $5 — $2.58 of that in the second quarter. So Salomon is selling at 8 times half-year earnings. Something's wrong with this picture.

OID: And 8 times their losses in the last nine months of 1994.

Mitchell: Touché.

OID: As you've said, one thing that you can count on — at least for now — is volatile earnings.

Mitchell: But assuming that they've finally got their risk management systems in better shape and that some of the people turmoil has quieted down and that the congruence of incentives between the talent and the owners is better than it has been, our theory is that volatility will be less than it has been and that they're less likely to have these scary, heartburn-generating losses.

Niemczewski: In 1994, Salomon shareholders saw the result of investment bankers at Salomon doing what investment bankers will do given half an opportunity — which is making big bets. They know it's heads they win, tails the firm loses. So management had to rein that in.

Mitchell: And we think they *have*. But, obviously, the Street doesn't agree.

Niemczewski: And Sam believes it more strongly than I do. I agree with him that we'll see less volatility than we have in the past. However, I also believe that they'll still have some interesting moments, too.

Mitchell: Incidentally, another encouraging recent development is that people have been voting with their feet in the *right* direction for a change. Salomon's been able to hire some first-rate people recently. So there's been a reversal of fortune in terms of the migration of talent. And I think that's telling, too.

IF MANAGEMENT GETS IT REASONABLY RIGHT,
SHAREHOLDER RETURNS SHOULD BE 15%+.

Mitchell: But people hate Salomon. Analysts can't predict its earnings. They're in a difficult business. And their returns will be volatile. We understand all of that.

On the other hand, the American investment banks are the most efficient financial intermediaries in the world.

OID: Hard to believe, but probably true.

Mitchell: They *are*. There's no question about it. However, the best investment opportunities long run are outside the OECD countries. So there's a huge need for intermediation between savings in the developed countries and opportunities in the developing countries. We believe a whole lot more bonds are going to be issued worldwide.

We believe Salomon and Morgan Stanley, for example, are extremely well positioned to benefit from this trend — this transfer of savings from the developed countries to the developing countries. So that's where the profits will be.

OID: On the other hand, hasn't Maughan himself suggested that the electronic flow of information may reduce market inefficiency — and, therefore, their profit potential in trading — quite dramatically?

Mitchell: In developed markets, he says that the opportunities are getting smaller and much less long-lived, but that new opportunities remain in developing markets. And even though those markets are will get more efficient, they'll also grow. Plus, the globalization of capital markets has a long way to go. As bond markets and equity markets worldwide continue to develop and globalize, arbitrage opportunities will develop, too. And we don't see why Salomon shouldn't be able to take advantage of their share.

Plus, global markets will continue to integrate. And, so, we think that the barriers to entry into this business —

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in terms of risk management, technology and distribution — are very high already and headed higher.

And Salomon is a low cost producer in bond trading today and will remain a low cost producer.

OID: Are they the largest bond trader in the world?

Mitchell: We think so — although we don't have the data to prove it. But, again, American investment banks are the low cost global intermediaries.

So I think the probabilities are very high that Salomon — provided it gets its risk management and its incentives reasonably right (as right as one can get it) — ought to be able to earn between 15% and 20% on its equity long term. Again, their returns will be volatile. But if I can buy a business that will earn 15% or more on equity for book or very close thereto — well, I think that's a good deal.

OID: Almost by definition.

Mitchell: Then, if you take a business with those characteristics and add shareholder-oriented management, then you have a good investment. And if there's one thing that I know for sure, it's that Salomon's management is *very* shareholder-oriented. There's *no* doubt about that. And that's important to us, too.

OID: You don't think commercial banks will come in and spoil the party for traditional investment banks when Glass Steagall is repealed?

Mitchell: No. I think they'll find investment banking is a lot tougher and less glamorous than they think. It's a damn difficult business to do. And, therefore, Salomon — as a trading house and an investment banking house — ought to be able to earn reasonably decent returns.

So that's our investment rationale for Salomon.

SMALL CAPS DO OFFER MORE OPPORTUNITY,
BUT THEY'RE BY NO MEANS A PANACEA....

OID: And the three ideas we've discussed are the only ones that you find compelling today?

Mitchell: There aren't many bargains around — that we can find, anyway — among the big cap stocks. Really knockdown values in the big caps are *very* hard to find.

OID: Then why not buy small caps?

Mitchell: We *are*. That's what we're doing with both White River and Fund American...

Niemczewski: But I'd take Sam's idea even further. We don't see knockdown values even in *small* cap stuff. None of these are Freddie Mac at 4 times earnings.

And what I found striking is that Sam came back from the Berkshire annual meeting. And he told me that the conventional wisdom out there basically seemed to be, "Let's look at smaller and smaller companies for value."

OID: I can certainly relate.

Niemczewski: And that's another good sign that it's a tough market. And I'm not convinced from the things we've been looking at that the values are better there — given the liquidity issues, etc.

Mitchell: Small caps aren't a panacea. We run a small money management firm — only about $500 million. And *we* have trouble getting in and out of small ideas without moving the market. There's a darned good reason why small caps are cheaper.

Niemczewski: It gets back to what we said before — that liquidity's worth something. So you have to build that into your price. And I should point out that the reason we want liquidity isn't because we're planning on trading, but because we know that we're going to make mistakes.

OID: Or, even — God forbid — lose an account because a client switches managers or exits the market.

Mitchell: Yeah. And when you have to liquidate, prices can evaporate on you.

OID: You seem to be making a great case for buying small cap stocks — based on the powerful incentive professional money managers have not to be in them.

Niemczewski: We draw a different conclusion — that you just have to pay less. Remember that some of that incentive will become *more* compelling when times get tough — because there's more liquidity in good times.

Today, with the stock market reasonably optimistic, there's already a pretty decent liquidity gap between the big caps and the small caps. And if past experience is any guide, that gap gets wider when the markets get tougher.

Mitchell: Incidentally, our portfolios have historically consisted primarily of large cap stocks — $1 billion and up. So Fund American and White River are, in effect, aberrations for us capitalization-wise.

Niemczewski: However, if Byrne is able to achieve even two thirds of the success he's achieved historically during his career, then we won't mind not having liquidity in Fund American...

Mitchell: And it won't be small cap for long.

Niemczewski: However, if it turns out for any reason to be a mistake...

OID: In effect, you're stuck — unless you're prepared to pay a severe penalty for leaving.

Niemczewski: Exactly.

OID: On that cheery note....
Thanks for sharing your ideas and insights.

Mitchell: Our pleasure.

Niemczewski: Any time.

—OID

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WESCO FINANCIAL'S
CHARLIE MUNGER
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moved him beyond Ben Graham and opened his eyes to the virtues of investing in excellent businesses. He also credits Munger as giving "the best 5-second opinions in the world" and tells your editor he and Munger "are interchangeable — what he says nearly always goes for me and vice versa."

Past editions of *OID* have included Munger's warnings on the S&L crisis before it was widely recognized, folly on Wall Street and numerous, wickedly insightful observations on investing, business, and human nature.

Besides being vice chairman of Berkshire, Munger is also chairman of 80.1% Berkshire-owned Wesco Financial. We're very pleased to bring you the following excerpts from Munger's comments at its most recent annual meeting which was held May 15th in Pasadena.

MODERN BANKING WITH FEWER PEOPLE, ETC. IS WAY BETTER THAN THE BANKING SYSTEM OF YORE.

Berkshire's unusual relationship with Wesco....

Shareholder: I'd appreciate a very quick rundown on why Wesco has [its own] public shareholders when virtually nothing else that Berkshire [manages] does.

Charlie Munger: It's been years since that question has been asked. We used to get it all the time....

That's an accident of history. The Caspers family — including Betty Peters — really invited us into Wesco. And the father of the current Caspers family directors founded this company. They kind of like it the way it is. It's been around a long time.

Since we were invited in and they're comfortable with the way it is, we've adapted. Since we lack executive skill and time, we *frequently* adapt to other people. If we *didn't*, we'd have to do things *ourselves*.

A thumbnail review of Wesco's major investments....

Shareholder: Would you give us a quick rundown on Wesco's major investments?

Munger: Well, that we publish. And we don't have a lot to add. Salomon is doing better. Coke is flourishing. Freddie Mac, our biggest investment, is, too. But every once in a while, it has to fend off some political assault. Some people think it flourishes *too much*.

I think we'll be selling our USAir very shortly....

Munger: We've offered our USAir stock back to the company — because they have a right of first refusal.

Shareholder: Have they accepted that or is that still up in the air?

Munger: The time has yet to run out. But I'd be very surprised if they bought it. I think we'll sell it very shortly.

Envious competitors means Freddie will be attacked.

Shareholder: Would you comment a bit on how you think about Freddie Mac with regard to political risk — the risk that someone will try to tamper with its business in the next 10 years? And how do you weigh that from a margin of safety standpoint?

Munger: Well, if Freddie Mac had *zero* political risk, I think it would sell for a higher price than it does. I think Freddie Mac will get attacks from time to time by people who think it makes too much money or whatever.

It's been a *very* efficient server of the interests of housing in this country. But I don't think political attacks just go away. It comes with the territory when you have conditions like Freddie Mac's. It has envious competitors.

Freddie and Fannie took over S&L's traditional function.

Shareholder: Perhaps this is too specific. But you were talking about Freddie Mac's potential competitors who eye them and aren't too happy about their advantages. If something were to change and they were to be taxed differently or taken private, do you think it would still be very difficult to compete with Freddie and Fannie?

Munger: Let me put it this way: We had a savings and loan business here. That was the founding business in Wesco. And the traditional function of a traditional savings and loan was pretty well taken over by Fannie Mae and Freddie Mac. Seeing this, we gradually *exited* the business and bought a big block of *Freddie Mac*.

The S&L area? Include me out. We like banking better.

Munger: If the world were to change for some crazy reason and we could go back into the savings and loan business as it's likely to be configured in the future, I think we'd have the attitude of Samuel Goldwyn when he said, "Include me *out*."

As they're organized now, I like the banking business better than the savings and loan business.

Banking is a good business — if it's run right.

Shareholder: Banking's largely a commodity business, I'd think. So what do you think's happening today so that its seeming extra profitability isn't being competed away?

Munger: I think modern banking with fewer people, better computers, and branches in supermarkets and so on is way better than marble palaces and the rest of the banking system of yore. I think banking's a good business for the survivors if it's run right.

I've been in my personal bank once in the last 25 years. Nonetheless, they've got[ten] a *lot* of free float out of me. And I'm not ordinarily too careless about such matters.

I'm not the only one providing good profitability for banks. There's also the fiscal alcoholic [who's] just good enough at handling high interest credit to pay off his loan, yet not so good that he avoids borrowing at high rates. And the banks have become *artists* at finding such people.

FACTORING IN THE TOUGH TIMES, SALOMON IS ONE DIFFICULT BUSINESS.

Salomon's doing much better, but it's still a tough hand.

Shareholder: Could you comment in a very general way about Salomon as a business and what they have to do to create or restore an advantage or moat or franchise?

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

Munger: As you know, Salomon is doing much better lately. I bumped into a key investment banker from their Los Angeles office at breakfast this morning — and he was practically tap dancing across the room. They've just knocked the ball out of the park in their Los Angeles office. So a lot is working better at Salomon.

That said, it's a very difficult business and very difficult to manage.

Salomon's always tried to be more conservative....

Munger: Salomon has always tried to be more conservative than the rest of Wall Street in its bookkeeping. On at least one occasion, it failed. And on other occasions, it succeeded.

It is *not* an easy business. There is *no* aspect of modern investment banking that I regard as a *bit* easy. I think it's easy if you run a business like Allen & Co. — [where you] get a handful of very talented people who are already rich and they basically earn fees for advising other people on a few little cinch deals and from time to time, meanwhile, they invest their own money. *That* works fine.

But that way of operating reminds me of the late Howard Ahmanson.... Some business school-type came up to Howard one day and said, "How would you advise a young man to get ahead?" And he replied, "Well, I always keep a few million in cash lying around in case a good deal comes along."

So some of the people that have an easier hand have one that the ordinary young person can't imitate.

The mortality rate among investment banks is very high.

Munger: If you look at a list of the 100 biggest investment banks of 50 years ago, about 90% are *gone*. And of those 90%, I'd say [that] about 90% were *forced* out — in liquidations, mergers under pressure or what have you. It's not an easy business.

I do think it's an ideal business for a very talented and aggressive young person to personally get ahead in. But for the shareholders, it is one tough business.

It doesn't *look* that way when you [just] look at the little handful of survivors. But when you remember the [other] 90 investment banks that aren't here, then the calculus gets a little different.

Generally speaking, the performance of stock market averages is a little misleading — because the failing firms are winnowed out. In due time, you're measuring the progress of the winning survivors.

Salomon crowd is smart; but dull may be more lucrative....

Shareholder: Are you still a director of Salomon? Do you still view that as important? And can you imagine being a director of Salomon for the indefinite future?

Munger: Well, I have to admit I like the individuals around Salomon. They're very interesting, very intelligent and very high grade. So I have some prejudice in favor of that particular crowd. And they're fun to be with. In fact, I'm seldom in a group *anywhere* that averages out as bright and sprightly as the Salomon crowd.

But dull and steady may make more money for the shareholders. Time will tell. I think Salomon is doing better for shareholders. God knows it's trying. But it is a difficult business if you factor in the tough times that are part of the cycles.

IF YOU'RE WITH US AND THE MARKET GOES TO HELL, YOU'RE GOING TO SUFFER, TOO. I *PROMISE* YOU.

But 15% isn't our target. It's a *ceiling* on our expectations.

Munger: Starting from this base, 15% is our maximum *hope*. It's *not* a *yardstick*. If you sat around Berkshire looking for investments that were sure to make 15% per annum starting today, [let's just say] you'd find that to be a very irritating position.

So our target is to meet our acid test of [adding] more than $1 of market value for shareholders for each $1 of retained earnings and to do as best as we can operating in a way we're familiar with.

The reason we even state a 15% figure as a ceiling on expectations, not a target, [is that] most people who adopt 20% per annum targets for new investments say "after taxes". They're in dreamland — as though they could sift the world and just pick out the 20%-ers.... I don't think that's the way it works.

Warren's not going anywhere — at least without Berkshire.

Shareholder: This market reminds me of the '70s markets. Would you and Warren ever walk away from this and give back the money like Warren did back in '71?

Munger: Warren closed the Buffett Partnership in '69, not '71. But, no, we can't walk away from Berkshire — and we don't *want* to.

Warren says he's going to be buried in "The Indefensible." And, sadly, he'd take *Berkshire* with him into the afterlife if he could. He does not want to leave. He's quite happy here. So we're not walking away.

We're not looking to be right every 70 years....

Shareholder: I didn't mean walk away. What I'm saying is get into a little bit of a negative posture and go into more of a cash position. Or would you still have to accumulate stock ... on the way up?

Munger: It is certainly conceivable that at some time in the future, our cash position would be way higher than it is now. It's also conceivable it could be way *lower*. Sure, a lack of opportunity could drive the cash position higher.

But, generally speaking, we're not in the business of waiting for 1974 to come again. I was in partnership years ago with Jack Wheeler. Many of you knew him....

And somebody came up to Jack once and he says, "You should buy *gold*." Jack at that time said, "Well, I think that's worked wonderfully once in the last 70 years. I'm *already* 70 years old. It's not my kind of investment."

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

We don't tend to look for strategies that would enable us to have some remarkable bunch of opportunities once in the next 70 years purchased at the cost of compounding at a lower rate until they came along.

If you're investing with us and the market goes to hell, you're going to suffer, too. I *promise* you.

IF YOU'RE RIGHT *ENOUGH*, YOU CAN PAY UP. BUT YOU BETTER NOT BE *WRONG*.

Marvelous companies have been wonderful inflation hedge.

Shareholder: In the early years of Berkshire, you owned some natural resource stocks like Amerada Hess, Handy and Harman and Kaiser Aluminum. Why do you view the businesses you own now — which have considerable free cash flow — as better hedges against inflation than natural resource stocks?

Munger: As you know, buying the five leading copper producers, the five leading uranium producers, the five leading iron ore miners, the five leading oil producers, you name it — all those "inflation-proof" stocks — hasn't worked all that wonderfully well as an inflation hedge.

[On the other hand,] owning marvelous companies of a more consumer-type with powerful competitive advantages *has* worked wonderfully as an inflation hedge. So just because they're in mining doesn't mean they're wonderful.

I think the average return on capital in mining is not all that much better — [although] it may be a *little* better — than Mark Twain figured it was. And his definition was as follows: "A mine is a hole in the ground with a liar on top."

And, by the way, some of the oil company accounting is not that far from Mark Twain ['s definition].

Our game *had* to change. And our *returns* will, too.

Shareholder: Thirty or forty years ago when you and Warren were managing much smaller sums, at least Warren, and possibly you, used a great variety of investment techniques and types of investment securities including workouts and control and non-control situations. Now, the pot of money at Berkshire is so enormous that the range of things you can do is much more restricted.

Over that 30-year period, you've also moved much more in the direction of buying high quality companies almost irrespective of price. Certainly, the most important factor hasn't been price.

Is that a better method under *most* conditions? Or is it largely a function of the enormous capital base you now have to manage? And if you were managing a small capital base again, would you do it the way you now do it or would you look a little more like you did decades ago?

Munger: I think a man as brilliant and energetic as Warren starting today with a very small capital base might scramble around roughly the way Warren historically did — and enjoy very high returns on small amounts of capital. So I don't think very much has changed.

[But] Warren can't *do* that anymore. That game's *over* for him. That isn't to say Berkshire never invests in some workout on a temporary basis because it does occasionally. But, basically, our game *had* to change.

As it happened, we did just about as well to date in the *new* game.... [But] that cannot continue. Our returns are going to go down — as we keep saying....

If you pay a high P/E, you better not be wrong.

Shareholder: If we were to simply leave Berkshire out of it and you were just advising other people in terms of investment philosophy, would you say it is a *better* game to pursue the Cokes and the Gillettes of the world and pay up for them?

Munger: Generally speaking, if you're right *enough* about your *companies*, you can afford to pay up quite a bit. But once you get up into these high multiples, you cannot afford to be *wrong*.

He asks a very intelligent question. But the answer is clear: Investing in super quality companies at high P/E multiples is a wonderful game if you don't make any significant mistakes.

Your margin of safety can be quality — *if* you're right.

Shareholder: Are you saying that if you're sure that a company is bar none, like Berkshire or Coke, the margin of safety could be its quality rather than [its] price so you pay up to a market multiple — whereas for the average or mediocre company, the margin of safety is in the price?

Munger: I would say that is roughly right. If you're absolutely sure that some company is going to grow at 15% per annum for 20 years and you're correct, obviously, you can afford to pay a market multiple for it and you'll do fine. Your margin of safety is that you're able confidently to predict a very unusually good future. That can happen, and, indeed, *has* happened with some of our investments.

Pickings may be slimmer going forward....

Munger: Now the *ideal* situation is when you can get something like that without having to pay up for it. And that's happened to us, too.

But I think you'll find that harder to do in the future. The very fact that all of you are here in this room is making it harder for us all. You see these soft, white hands? Getting rich with soft white hands is a very popular activity.

THE MARGIN OF SAFETY IN A GREAT BUSINESS IS THAT IT CAN *STAND* MISMANAGEMENT.

All we want is a fair *advantage*....

Shareholder: You use the term "marketing advantage" in your worldly wisdom speech.

[Editor's note: See *OID*'s May 5th, 1995 edition.]

Shareholder: I'd like to know the various kinds of marketing advantages you and Warren look for when you buy equities.

Munger: Well, all we want is a fair *advantage*. And we don't care whether it's a marketing advantage. What we want is an *edge*.

But many of the edges do come in the marketing field. Scale effects for Wrigley's Gum — which I think I mentioned in my speech at U.S.C. — are *awesome*. So, sure, you've

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

got to understand the microeconomics of marketing and what scale effects are going to give you big advantages — and who has them. I would not like competing with Frito Lay in salted snacks. They have a big edge and they're fanatics and run the damn business very skillfully.

Luckily, they're not quite so good at bottling.

A great business will *stand* a fair bit of mismanagement.

Shareholder: Do you agree that most great businesses are managed by [average] managements? And if you agree, how does that sit with your investment style that you buy great businesses and you keep the management?

Munger: Obviously, the best situation is a great business being run by a great manager. And we have been fortunate enough to have enjoyed that on much more than one occasion.

The margin of safety in a great business is that it will *stand* a fair amount of mismanagement if that unfortunate circumstance happens to come along. The business doesn't do as *well* during the period when it has mediocre management or worse. However, if it's a great business, it *handles* it....

All intelligent investing is value investing....

Munger: We say the same thing over and over again. *All* intelligent investing is value investing. There's even a subclass wherein paying high price-earning multiples and high price-to-book multiples is OK because you have intelligently decided that the good prospects are so sure that you're *still* getting more value than you're paying for even if you're buying a bunch of so-called growth stocks at 35 times earnings. And if it's sound, it's because you're getting more value than you're *paying* for. But it's still value investing.

So the whole concept of dividing it up into "value" and "growth" strikes me as *twaddle*. It's convenient for a bunch of pension fund consultants to get fees *prattling* about and a way for one advisor to distinguish himself from another. But, to me, all intelligent investing is value investing.

That's a *very* simple concept. And I don't see how anybody could really argue with it.

(continued in next column)

FLOAT DOES GIVE US SOME *ADVANTAGE*,
BUT IT'S BUILT INTO OUR STOCK PRICE.

Everything in our past is higher....

Shareholder: In the Berkshire annual report, it says Berkshire's float pre-GEICO has increased 20.7% per year since 1967.

Munger: ...*Everything* in Berkshire's past is higher than [it will be] in the future. I'll vouch for the *past*....

A big difference: Berkshire's float will grow. Wesco's....

Shareholder: In calculating Wesco's intrinsic value, you value Wesco's deferred tax liability at about 33¢ on the dollar [whereas Buffett says he wouldn't sell Berkshire's float for 100¢ on the dollar].

Munger: Yeah. The situations are entirely different. We think Berkshire's float will grow and, by and large, Wesco's won't.... [And] that's a *hell* of a *difference*. We're not set up to cause ours to grow easily here. That would take a miracle — maybe not a miracle, but a lot of good luck.

You'd be surprised how much attention we pay to float.

Shareholder: You obviously have a whole lot more money working for the shareholders of Berkshire and Wesco, if you will, than book value.

Munger: Right.

Shareholder: So you don't have to make 15% for it to come out very beneficial to the shareholders. Do you know what I'm saying?

Munger: I know *exactly* what you're saying. You'd be *surprised* what close attention we pay to such matters.

If you take the reported book value as accountants compute it and the investment practices of Berkshire as they are, yes, it gives us some advantage in compounding ... reported book value.

But since you can't *buy* Berkshire or Wesco anywhere near reported book value, it doesn't make the problem a no-brainer for you folks. Generally speaking, capitalism is organized to make it hard for you people. Fortunately, a lot of you are *already* filthy rich....

IN LIFE INSURANCE, YOU *PAY* FOR YOUR FLOAT.
PLUS, THE ACCOUNTING IS A LITTLE OPTIMISTIC.

In life insurance, you *pay* for your float....

Shareholder: We've rarely heard you or Mr. Buffett talk about the life insurance industry. Could you talk about the economics of float in the life insurance business and how it's different from the property and casualty insurance business?

Munger: In the life business, you *pay* for your float. And you pay quite heavily for it. And we don't like the accounting in the life business quite as well as a lot of other people do. We like *very* conservative accounting. And we think that the accountants have let the life insurers be a little optimistic. So, by and large, we have not been big in the life business.

Structured settlement business is a type of life insurance.

Munger: We're at the edge of it because we have a

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

fair-sized structured settlement business — not here at Wesco, but at Berkshire. And that is something close to an annuity function for people who have horrible injuries and a long life expectancy ahead. So we are doing that in our own way at Berkshire. In modest quantities, it fits us fine.

We do have a little life subsidiary we formed because some buyers of that product for some crazy reason really prefer a life company issuer instead of a casualty company issuer. And, of course, we accommodate buyers when it makes no practical difference to us.

WHEN WE *ARE* FINDING LOTS OF OPPORTUNITY, I DON'T THINK ANY OF YOU WILL *LIKE* IT....

In super-cat business, you need more than a history book.

Shareholder: I was curious about the super cats and the amount of time that goes into making a decision like the 20th Century Insurance thing you did. Do you have a big Cray computer in a back room over in Omaha or is that done on the back of an envelope?

Munger: I think that stuff is very carefully done. But it is done not quite on the back of an envelope. We do have records of past earthquake experience and so on. But future earthquake experience is not necessarily going to be like the past.

Some idiots in the insurance business actually think that if a long time has passed after the last earthquake, that means that there's practically no chance that one will happen. But, of course, you and I know that [only means that] the forces are building....

So decisions like that have to be made by a mind that is more than a typical actuary's mind. You have to have some grasp of the reality behind the numbers.

Our advantage in that field is that we think quickly. The *disadvantage* of that is that someday we're going to think very quickly and be very wrong for large numbers. But, so far, the record has been great.

We're finding less opportunity in super-cat insurance.

Shareholder: I understand that it's been fairly difficult to find opportunities in super-cat insurance over the last couple of years. Would you comment on the current state [of that market] and whether you're seeing many opportunities?

Munger: I think that market is getting worse for us... — in that less fits in to the way we want to operate.

Shareholder: There's more money around?

Munger: There's more capacity in reinsurance now.

Shareholder: And people are bidding prices down?

Munger: There's more capacity. Others are always more action-prone than we are. Part of the advantage of the Berkshire group, to the extent it's *had* an advantage, is that it can *stand* periods of just quietly sitting on its tail with a lot of assets. Other people find that more difficult.

We'll have our share of misfortune in insurance, too.

Shareholder: Insurance hasn't had a hard market in a number of years. Could insurance have a hard market again, even briefly, powerful enough to make underwriting generally quite attractive — because of a major hurricane going through Long Island [or something of the sort]?...

Munger: Sure. Something really horrible — like some major catastrophe — could happen. And, sure, it's possible that in its aftermath, underwriting opportunities might be greater. But so what? When it comes, we're likely to get tagged with our share of it. It doesn't lead to any obvious strategy for us.

We do tend to operate so conservatively that when horrible things come, our last bullet tends not to be fired. So, to *that* extent, we do have some possible advantage. However, I don't think that any of you are going to like it when we have that advantage — because it's going to follow a period when we've caught our share of some trouble.

A VERY GOOD THING TO DO FOR YOUR CHILDREN AND A WAY FOR ANYONE TO GET WAY WISER....

Darwin is just a wonderful lesson to us *non*-geniuses.

Munger: Darwin would have scored poorly on an SAT test. In *spite* of that, he is now buried a few steps away from Sir Isaac Newton in Westminster Abbey. And that is not where the rest of us are going. So I'd argue that he was one of the best thinkers who ever lived.

And his lesson is that even people whose brains don't work very quickly can outthink the rest of mankind if they develop certain thinking habits.... Darwin's great method was forcing objective habits on a very curious and diligent mind. I once said that an objective man is often like the only man without a blindfold in the game of Pin the Tail on the Donkey. That's the position Darwin put himself into....

Anybody can see you'd think better if you're Feynman of Cal Tech. Somebody like that comes along maybe once every 100 years. But what good does that do people like you and me? Now Darwin, that is *very* helpful.

So Darwin is just a *wonderful lesson* to everyone else. If you imitate the methods of Darwin, you're likely to get way wiser than you would otherwise have been with the equipment God gave you.

A great way to meet people....

Shareholder: Would you give us a brief history of how you became affiliated with Warren Buffett?

Munger: We were introduced by a mutual friend when I went back to Omaha to wind up my father's law practice. We hit it off. And we've been doing business and buffering ideas against each other for nearly four decades now. So mutual friends are a great way to meet people.

Awful, boring repetitive labor is a very good lesson for kids.

Munger: I had worked in the Buffett family grocery store. So had Warren at different times. So you're talking to somebody who knows how to deliver groceries. And neither Warren or I liked it very much.

But that's a good lesson to teach a young person — how awful and boring really repetitive labor is. I mean that is a very good thing to do for your children.

—OID

WALLY GAYE, INDIVIDUAL INVESTOR

"There's lots of froth — lots of signs that people are very interested in the stock market. But just do what Buffett does: Just forget about all this macro stuff — whether it's economics, politics, you name it.

For example, financial stocks are *cheap.* Why does Merrill Lynch deserve a P/E of 9? Does Cascade Communications really have a future that's 15 times *better* than Merrill selling these generic little switches that *anybody* can make? I don't think so.

And Ace Greenburg has Bear Stearns buying back its stock at something like 1-1/2 times book value. *Think* about it. Here's a guy who hasn't liked the market for a long, long time. And yet he has Bear Stearns buying back $250 million worth of their stock. Here we are — supposedly at the end of this great bull market, at the end of this wonderful time for securities and it's all supposedly going to be downhill from here — because a huge bear market is going to settle in next year and last forever. And Ace Greenburg is buying back stock. In effect, a very knowledgeable insider in the investment business thinks these stocks are cheap — and they *are.* And Wells Fargo is buying back shares at 10-12 times what they'll earn next year. The people who run these businesses think that this is a good place to *buy* their shares, not to *sell* 'em.

And here's Salomon earning $5 in the first six months — and I'll bet you they earn $10 for the whole damn year — with their stock at $45. But what do *I* know? Everybody says that the reason they're earning this money is because the markets have been so advantageous and that the wind's been at their back. But Deryck Maughan says it's been a *difficult* environment.

Are these rosy returns that they're earning today? I don't have any way to judge. However, based on what Maughan says and how they're beefing up their operations around the world, I don't think that these are abnormally high earnings because everything is so wonderful. I just think they finally got their *act* together. And I think the big surprise is going to be that one day very soon they're going to get a credit upgrade. And that's going to mean they can buy their stock back.

People think that financial stocks *ought* to be cheap. I don't. The financial world isn't going to stop growing anytime soon. It's going to get bigger and bigger and bigger. So far, it's really just a handful of countries with decent-sized financial markets. But the whole world is going to be like that. And American companies know how to do it better than anybody. Deutsche Bank sends people over here to learn how Salomon does its business. Salomon's not Coke. However, it's a business for the future. And if you look at many of the businesses Buffett's interested in, a lot of them are like Salomon. He has a lot of financial stocks."

Conversation with *OID* — August 7, 1996

SAM MITCHELL AND CHRIS NIEMCZEWSKI, MARSHFIELD ASSOCIATES

"Financial businesses tend to have several attributes we like. First, Wall Street seems to find them hard to understand. There's almost a systematic inability for Wall Street to differentiate between financial businesses earning very different returns. And [financial stocks] have historically traded at a discount to the market. However, the return on equity of well-managed financial service companies is almost always higher than those of the S&P 500 as a whole. Sure, we'd like to get an expansion in the P/E or the price-to-book multiple. But if we buy businesses that generate high returns over long periods, we really don't *care* — because everything else will take care of itself."

Conversations with *OID* — July 20-August 7, 1996

Dear Subscriber,

Our heartfelt condolences go out to the families, friends and associates of Danielson President and CEO C. Kirk Rhein and National American Insurance Company of California President and CEO William R. Story and the families, friends and associates of all those who perished on TWA Flight 800.

When we think about today's investment environment from any of several different macro perspectives, we quickly think ourselves into a state of fear, paralysis and confusion.

Fortunately, however, a long list of our contributors — Marshfield's Sam Mitchell and Chris Niemczewski, and Wally Gaye, Robert Noel, Shelby Davis, Bruce Berkowitz, (to name but a few), suggest that selected financial stocks are being mispriced to the point of opportunity.

Speaking of opportunity, we're particularly intrigued by several of the bargains within this edition's assortment and hope that you find them as fascinating as we do. Happy hunting.

Until next edition,

Henry J. Emerson

Your Editor

P.S. We continue to have fantasies about setting up a website (at http://www.oid.com) and remain excited about its potential to help us serve you better. Stay tuned.

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