Outstanding Investor Digest

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

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OID MAILBAG:
FAIRFAX FINANCIAL'S PREM WATSA
"HOW DO WE FEEL ABOUT LAST YEAR? EMBARRASSED AND MUCH POORER...."

At a recent client conference, Longleaf Partners Funds' Mason Hawkins expressed an enthusiastic view about the prospects for their newest fund, Longleaf International. Said Hawkins: "[It] ought to be up 50% per year during the next five years because its small and manageable."

In the Fund's second quarter letter to shareholders,

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LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
"FINDING A FEW GREAT IDEAS AT A 50% DISCOUNT IS NEAT. FINDING A PORTFOLIO FULL OF 'EM IS UNPRECEDENTED."

Mason Hawkins' success as a stockpicker is well known. Equities purchased by Southeastern Asset Management, the advisor to Longleaf Partners Funds, handily outperformed just about any index around during the 20 years ended December 31, 1999 — earning a compound return of 19.5% per year versus 17.9% and 15.6% per year for the *Ibbotson* S&P 500 and Small Company Indexes, respectively, during that same period. (All performance data was

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GRANTHAM, MAYO VAN OTTERLOO'S
JEREMY GRANTHAM
"BUBBLES HAVE ALWAYS GIVEN BACK EVERYTHING. THERE HAVE BEEN NO EXCEPTIONS — *NONE*."

Grantham Mayo Van Otterloo's Jeremy Grantham observes that perhaps 1-2% of the population at any time are mutants — that they have, in effect, a contrarian gene. So when the rest of the tribe reaches any concensus at all, he feels a need to attack it. And attack it he does.

He says that whatever financial professionals may say, virtually every one of them expects a substantial bear market. Saying so, needless to say, would be bad for business —

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GAMCO INVESTORS' MARIO GABELLI ET AL.
"DON'T EXPECT A TAILWIND DURING THE NEXT 10 YEARS. BUT SOME OF THESE IDEAS WILL DO FINE IN *ANY* MARKET."

For the 22 years ended 12/31/99, value equity accounts managed by Mario Gabelli's GAMCO Investors have earned a compound annual return before all fees and expenses of 21.8% versus 17.4% for the *Ibbotson* S&P 500. His firm has outperformed its benchmark in the small-cap area, too. Its small-cap equity accounts have earned a compound annual return before fees and expenses of 16.2% versus 14.6% for the *Ibbotson* Small Company Index.

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OID MAILBAG: FAIRFAX FINANCIAL'S PREM WATSA

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Mason and his co-portfolio managers Staley Cates and Andrew McDermott had the following to say about two of the fund's largest holdings — both of which, incidentally, they reported buying during the quarter:

"Brierley Investments and Fairfax Financial declined during the quarter despite positive developments in their underlying businesses. Brierley CEO Greg Terry negotiated an attractive sale of a portion of the company's Air New Zealand stake to Singapore Airlines. Brierley's balance sheet has improved over the past year; progress at all businesses has been positive; and the company has bought in shares. Despite all this, the stock trades near its all-time low and widest-ever discount to our appraisal.

At Fairfax, both the underwriting cycle and the investment environment have turned in Prem Watsa's favor. He's taking advantage of Fairfax's low price by repurchasing shares at a discount to book value."

A long-time admirer of Warren Buffett, Fairfax's Prem Watsa has modeled his insurance holding company after Berkshire Hathaway. But while many have admired Buffett's accomplishments and have modeled themselves to one degree or another after his example, few have done it with Watsa's apparent success. For example, as of the end of last year, Fairfax had compounded its book value during the prior 14 years at a hard-to-believe 40% per year.

Just as with any number of other money managers with superb long-term track records, today's market seems to be according Watsa (and Brierley) no respect. Thus, we find it particularly noteworthy that the shares of Fairfax are among the best bargains available not only in the eyes of the folks at Longleaf, but also in those of Watsa himself. And therefore, we thought it might be a good time to review some of what Watsa had to say in his letter to shareholders accompanying his most recent annual report:

We have much to be grateful for — like a 40% per year gain.

Prem Watsa: ...While the low return on equity in 1999 resulted in our long-term average return on equity slipping slightly below our objective of 20% (to 19.2%) since inception, there were only two companies in Canada and 75 companies in the U.S. that have had a higher return on equity than ours over the period. In fact, in the U.S. property and casualty industry, there is only one company that has had a higher ROE than Fairfax in the last 14 years and *none* have compounded book value or stock price as fast. So you can see why we are grateful for the this long-term record — which has been achieved during the longest and toughest down-cycle in the history of the property and casualty insurance business....

(continued in next column)

Our financial position is strong — our targets unchanged.

Watsa: While we have always emphasized underwriting profit, today ... there is a renewed focus on achieving a 100% combined ratio by each President. Anything less is *unacceptable*. Also, we ended the year in the strongest financial position in our history with cash and marketable securities at the holding company in excess of $700 million and long term, unwithdrawn, unsecured bank lines in excess of $1.3 billion.

We certainly believe in eating our own cooking.

Watsa: How do we feel about the stock price decline in 1999? First of all, much poorer!! Remember, directors, officers and employees own 16% of the shares outstanding and have not sold any shares of consequence. All the key officers of Fairfax, including myself, most of our directors, the principals at Hamblin Watsa and most of our subsidiaries' Presidents have a very significant portion (over 90% in my case) of their net worth in Fairfax shares. So we certainly believe in eating our own cooking....

And we're definitely taking advantage of the opportunity....

Watsa: There is a silver lining in every cloud. Because of the very significant decline in our stock price, we were able to buy back 706,103 shares of Fairfax — approximately 5% of the shares outstanding — at an average price of $293 per share. And so far in 2000, we have repurchased an additional 244,044 shares at an average price of $190 per share. In 1990, under similar conditions, we repurchased 1.8 million shares or 25% of the shares outstanding at approximately $9 per share — one of the better investments we have made!...

While buying back shares at attractive prices does not increase the total intrinsic value of the company, it significantly increases the *intrinsic value per share* of the company. Also, by shrinking the denominator, it will help us achieve our 20% return on equity objective over time.

I'm embarrassed by last year's results....

Watsa: Last year was a disaster for almost all our underwriting operations. There is no other word for it. I'm embarrassed by these results and apologize for them — particularly because we have an outstanding group of companies run by an exceptionally talented group of Presidents. None of our companies achieved our [target] 100% combined ratio....

We suffered a year during which the risks of the insurance business were crystallized widely and substantially throughout all of our companies. Catastrophes and a high frequency of large losses in very soft (read underpriced) insurance markets took their toll on all of our insurance operations....

We have something to prove to you (and ourselves) this year.

Watsa: But having not sugar-coated results for 1999, I must tell you we have the strongest group of Presidents running our decentralized operations that we've ever had. In 2000, we expect all our Canadian companies to get back to the 100% or better combined ratio they have achieved in the past.... Our consolidated target combined ratio for the Fairfax Group in 2000 is 105% and all our companies are striving for 100% in 2001. We have to prove to you (and ourselves) that we can achieve these results in 2000....

—OID

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
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provided by Southeastern Asset Management and *Ibbotson*.)

The folks at Southeastern are usually thrilled when they're able to find just a few superior companies with great management trading at 50% of their appraised value. So you can imagine their glee (and ours) when we learned that they're currently finding so many of those securities so cheap that each of their *portfolios* trade at 55% of value or less.

The excerpts which follow were selected from the prepared remarks of Hawkins and co-portfolio managers Staley Cates, C.T. Fitzpatrick and Andrew McDermott and their answers to shareholder questions during Longleaf's annual meeting of May 10th, Longleaf Partners Luncheons for Advisors which occurred on June 19th and 28th and a conference call which took place on July 14th.

Following that feature, we're also pleased to bring you excerpts from a series of conversations we had with Longleaf President and Co-portfolio manager Staley Cates which began on July 21st and continued until shortly before we went to press. In the past, we've never found Hawkins or his associates lacking in the quality or quantity of intriguing ideas or in-depth insights and knowledge. They nonetheless managed to exceed our expectations. We hope you agree.

QUOTATIONS ARE ARBITRARY AND CAPRICIOUS. BUT THEY'RE AN OPPORTUNITY, NOT A PROBLEM.

Our companies did just fine last year....

Mason Hawkins: ...Over the last 12 months, almost all of our investees made good, solid, fundamental corporate progress. Their revenues increased as they sold more units and, in many cases, raised their prices. In our real estate companies, occupancies were stable to higher and rents and room rates were raised.

Operating cash flows grew. And after subtracting out working capital needs, required capital expenditures and taxes, our free cash flows rose quite materially. Thus, our corporate values moved steadily higher as most of these cash earnings were retained.

And their private market values reflect their progress.

Hawkins: Even more important, our intrinsic values per share moved faster still because the vast majority of our businesses repurchased and retired significant amounts of their discounted shares.

Were Longleaf a partnership investing in private companies, we'd have marked up our investments and reported healthy returns to our partners. However, we operate as an SEC-sanctioned investment company in the arena of publicly-traded securities. Thus, we must mark our holdings daily to the last marginal quotational value — a price that can be most ephemeral, and some might even describe as capricious....

Our long-term returns have still been quite satisfactory.

Hawkins: In 1999, a number of our stocks' prices failed to match the progress of their underlying companies. In a few situations, the businesses disappointed. And in quite a few cases, the gaps between share prices and our appraisals widened. Longleaf's quotational returns were not foregone, but they were deferred as many impetuous shareholders voted to seek fast fortunes supposedly promised by the internet and other technology enterprises.

It's the longest time that value investing has been out of favor. *Ibbotson* just published data going back [about] 100 years on value versus growth. And value has done a couple hundred basis points better than growth investing over 100 years. It clearly hasn't over the last five years. Value has certainly lagged.

But we don't look at it that way. We don't view ourselves as pursuing value or growth, but rather a combination of both. But the Longleaf Funds made less progress last year than we've grown to expect.... An equal-weighted investment across our funds over the past nine years under your current managers resulted in a compound return of 18% per year. And importantly, these returns have been achieved in diverse asset categories, without leverage and we believe with a minimum exposure to business, financial and market risk.

A stock market mania may have begun to lift....

Hawkins: Now for the good news. Beginning in the second week of March, the market began to weigh our companies more fairly when speculators seemed to experience almost an epiphany.... There's been a tectonic shift in investor sentiment since March 10th. Mindless momentum-following began, as the Brits say, to give way to what we consider to be rational thinking — that customers, revenues and cash flows do matter. They are what determine corporate values.

As though returning from never-never land, they began to realize that many NASDAQ firms needed more than conceptual business plans in order for them to prove successful — they were going to need customers, revenues and operating profit margins high enough to deliver earnings to support demonstrable values that compared favorably to share prices.

The baby hasn't been thrown out with the bathwater....

Hawkins: So the wide dichotomy between established, dominant businesses and nascent, evolving *"adventures"*, as we'd call them — not ventures — began to close back on March 10th. Yet, many skeptics doubted that the NASDAQ's excesses, including an aggregate valuation of 135 times earnings, could be corrected without dragging down further an undervalued value universe.

Well, ... Dr. Graham's description of the market being a weighing machine in time is beginning to take effect. Fortunately, from that day in the middle of March, our world is up very dramatically. Some of the speculative, superfluous stuff has begun to wane. I don't know if there's been a time in market history when you've had that kind of magnitudinal diversion occur that quickly....

Now you've seen from peak to trough almost a *60%* relative change. The Partners Fund was up 25% at its peak from March 10th — and the NASDAQ was down 35% [at its low]. So a 60% change in about 65 days. I don't remember anything quite as dramatic — even in '73-'74....

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LONGLEAF PARTNERS FUNDS'
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Internet bubble rivaled any bubble ever — even tulip bulbs.

Hawkins: The speculative mania that was hyped in the net rivaled *any* previous bubble — including the one in 1620 with tulips. The speculative mania that hyped the net separated a heck of a lot people from their capital. And it did so permanently. It wasn't just a matter of share prices deviating from value, but rather, in many cases, one of share prices disappearing and not reappearing....

IT'S ALL ABOUT VALUING BUSINESSES. AND YET NOBODY SEEMS TO *DO* IT.

That's what it's all about. Yet people never seem to do it.

Hawkins: Everything depends on your ability to plot what a business is worth. We've been around for 30 years or so. And the longer we do what we do, the more we realize that very few people value businesses. At a cocktail party or reading the newspaper or watching CNBC, all they talk about is price: "What's the stock trading at?" No one ever says, "What's it worth?"

When you buy your house, you say, "What's it worth? What did the house next door sell for per square foot?" When you buy your car, you really get down there and look at what it's worth. You know, if you put $25,000 in a car or $300,000 in a home, you really just grind away trying to figure out what it's worth. You ask the question.

But boy, people looking at publicly-traded equities never seem to ask that question. That's what it's all about. But very few do it in the ephemeral world of stock prices.

We're the investing equivalent of the Maytag repairman.

Hawkins: That's *all* we do at Southeastern. So there's not a lot of buying to do here unless there's a big deviation from economic value. But when there is, you then need to assess your partners correctly — and, as we've said before, it's businesses/people/price.... And at Southeastern, our question is would you put your *entire* net worth in it, because we do have approximately $240 million of *our* money in these four funds — between our retirement plan, our foundation and our personal stakes. And unlike any other mutual fund family, none of us can invest outside of the four Longleaf Funds.

So is it worth a substantial premium to the price and, second, do we believe its value will grow over time? You can't separate value from growth. We're interested in both. We want a huge premium to what we pay and we're interested in that economic worth moving north....

A closing discount can provide most of your return.

Hawkins: And here's why. If you buy a company

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that's able to grow its value by only 12% per year at a 50% discount to its value and its price rises to reflect that value five years hence, you achieve a compound annual return of 29% per annum. If you paid fair value, you would earn a total return of 12% a year as the underlying value accrues. If you bought it substantially above its value and the market reflected economic value five years hence, you would break even or lose money. That tells you how *incredibly* important price is. The price you pay — the closing of [that 50%] discount — provides you with two-thirds of your total return.

So the margin of safety that Ben Graham talked about is important for two reasons: First, if you buy a dollar bill for 50¢, you're not going to lose any money. Your capital is protected. And that's very important to everybody. But equally important, in terms of offensive considerations, the closing discount can provide you with most of your return.... And it's *very* unlikely that 50¢ dollars are going to stay there long in a freely-traded capitalistic society....

Over the next five years, the NASDAQ *has* to go down.

Hawkins: In the NASDAQ world, I don't know *what* growth rate you'd need to have to equal its P/E, but it's a huge growth rate.... So, quoting Mr. Buffett, you want to be approximately right instead of precisely wrong. You need a lower multiple and a higher growth rate to make sense out of those values.

We can assure you that in the next five years, those prices will go down. They *have* to go down because the economic profitability of those enterprises — even with *really* fast growth rates — does not equate to the price....

March 10th will long be remembered. It was not only the day I turned 52, but the day when Longleaf Partners Funds again began to deliver above-average absolute and relative returns. We thank you for your patience....

OUR HOLDINGS ARE INCREDIBLY CHEAP — IN FACT, UNPRECEDENTEDLY SO.

Serious undervaluation and buybacks go hand in hand.

Staley Cates: There are two things that I'd like to discuss today that are unprecedented in the history of our funds: And they are, #1, the degree of undervaluation at present across the board in our portfolios and, #2, the magnitude of share repurchases by almost all of our companies in Longleaf Partners Fund and the great majority of companies across all four funds.

As you can imagine, these two things go hand in hand — because if you're a CEO and your company's stock is selling at 50¢ on the dollar, it's hard to beat buying your own shares in. I'll get to that math in a second. But the final thing I'd like to go over is what our companies are doing to get these values realized.

Our flagship's price-to-value ratio is unprecedented.

Cates: As you know, we go to great lengths to appraise our businesses based on their net assets, their discounted free cash flows and comparable transactions. Every month, we then aggregate those appraised values and compute an average price-to-value ratio for the portfolio as a whole....

Over the long term, our composite [price-to-value] ratio has averaged slightly less than 70%.... That should

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make intuitive sense — because we buy companies at no more than 60% of value. And usually, we still own a handful that may have risen to, say, 80-90% of value — positions that are still holds. So you can see how our average might tend to be around 70%.

Right now, we are actually at an average price-to-value of just over 50% ... [which is way] out-of-whack historically. That's a remarkable number because usually we're happy to buy a superior company with great management at *60%* of value. And if one comes along at 50%, we're *ecstatic*. Even to have three or four new ideas per year at 50% of value instead of 60% is something that we've never seen. And usually, three or four new names per year are enough to satisfy a full year of demand. So for the whole portfolio on average to trade at just over 50% of value is simply unprecedented.

AND THESE AREN'T WIDE-EYED, LUSTY VALUATIONS. IN FACT, THEY'RE PRETTY DARNED CONSERVATIVE.

Bargains used to be scarce. Today, they're abundant.

Cates: Only two years ago at this very same meeting, we mentioned the difficulty we were having finding new names. Our cash position was huge and our average price-to-value ratio was 77%. Well, today, that 77% is down to 53%.

If that drop had been entirely due to our companies' stock prices declining, the Fund would have been down over 30% in those two years. Instead, we've been essentially flat — still an ugly number, but much better than a negative 30% return — because underlying values have grown and our portfolios have been managed out of high price-to-value names into lower ones.

Just to reach a normal discount, our fund will need to pop.

Cates: More importantly, as we look forward, once our price-to-value ratio gets back from 50%+ to around 70%, that would imply a significant bounce back — nearly 40%. Then, from that normal 70% level, our goal will be to make the same strong absolute and relative returns that we've achieved over the history of our company.

That's one of the reasons why, as we mentioned before and as Mason said earlier, we believe that those returns have been deferred and not foregone forever....

These aren't exactly wide-eyed, lusty valuations....

Cates: I'd also like to highlight the conservatism of our valuation appraisals — how we get to these numbers.... One example ... is Knight Ridder [KRI/NYSE] — the newspaper company which many of you know. Because of concerns about the classified advertising part of the newspaper industry, we value newspapers at a historically conservative multiple of only 8-1/2 times cash flow. And appraising Knight Ridder at that multiple gives us our estimated value per share of $69....

However, Tribune [recently] agreed to buy Times Mirror — a chain with lower growth prospects and a weaker web presence than Knight Ridder — for *11* times cash flow. Even if Tribune gets all of the synergies and cost benefits it expects from the deal, they will have paid 10 times cash flow. And we're only using 8-1/2 times for what we think are better properties.

Another example is General Motors. To arrive at our $150+ per share value, we've appraised their car and truck business at $40 billion. However, a few years ago, Chrysler sold for $39 billion. And GM's certainly a lot more valuable than Chrysler by any measure. So to summarize, what we own is incredibly cheap.

BUYBACKS WILL UNLOCK THE VALUE DISCREPANCY OR INCREASE THAT DISCREPANCY IN OUR FAVOR.

A primer on the math of share buybacks....

Cates: On the subject of share buybacks, we just wanted to review that math with you:

IMPACT OF SHARE REPURCHASES

	Co. A	Co. B
Current Market Value:		
Total Market Value	$100	$100
÷ Shares Outstanding	10	10
= Stock Price	$10	$10
Current Appraised Value:		
Total Appraised Value	$100	$200
÷ Shares Outstanding	10	10
= Stock Value	$10	$20
Value after 20% Share Repurchase:		
New Appraised Value (*original - $20 repurchase cost*)	$80	$180
÷ New Shares Outstanding	8	8
= New Stock Value	$10.00	$22.50

Note: A share repurchase program is just one element among many that contributes to a company's value/share and should not be viewed as a guarantee of positive performance.

This table shows two companies that have the same share price — which is $10.... Then we show our appraisal. Company A is worth $10 and sells at fair value. And Company B is worth $20 even though it also sells for $10.

We assume a 20% share repurchase in this exercise. So in both cases, you'll see the shares drop by 20% — the denominator at the bottom. Then you'll see the nominal value go down accordingly — by the cost of the repurchase. As you see, even though it's returned some capital to its shareholders and maybe made its capital structure more efficient, Company A's value per share does not change. Its value stays at $10. And that should ring true since there shouldn't be some immediate valuation benefit associated with repurchasing shares at fair value. Company B, in contrast, is repurchasing shares for $10 that are worth $20. So after the buyback, its $20 value has grown to $22-1/2.

That growth in value, which occurs before the ink is even dry on the trade ticket, comes with no incremental business risk. So if Company B's normal retention of earnings plus its organic growth would normally mean that

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its value would grow during the year at, say, 12%, in this particular year its valuation is going to grow more like 25% because of the share repurchase.

Our companies are buying back a *huge* number of shares.

Cates: We always own undervalued companies. So we almost always have had more than our fair share of corporate repurchase activity. Even so, it's usually maybe a third of our portfolio companies — and they usually buy in a few percent in any given year which is still a relatively large repurchase program.

But right now, in Longleaf Partners Fund, all but three companies are buying in their shares. And we're not talking about authorizations where a company puts out a press release trumpeting the repurchase and then doesn't really follow up on it. The median and average amount that they're buying in is 8% of the company per year. That's a *huge* amount.

It's the equivalent of an 8% dividend yield — only better.

Cates: Let me put that in perspective. Think of a share repurchase as you would a dividend yield — because, like a dividend, it's a simple check mailed out the door to shareholders. In this case, it's mailed to departing, selling shareholders. So that gives us as remaining owners a proportionally higher percentage of the business. In other words, instead of receiving a cash dividend in the form [of a check], we're in effect receiving a dividend in the form of our higher ownership per share — which is actually more valuable because it is tax-advantaged.

So our companies right now are in a mode of paying out the equivalent of an 8% yield which, if that were in the form of a tax-inferior *cash* dividend yield, would certainly get investors' attention. And as illustrated above, that 8% repurchase yield is pushing up our values per share and, therefore, our eventual payoffs.

Buybacks either unlock value or significantly increase it.

Cates: "But Staley," you may say, "so what if these stocks are so cheap and getting cheaper against your very conservative appraisals? That hasn't done us any good over the last couple of years. And if the market liquidity keeps running to the NASDAQ and other hot stuff, how will

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we ever get paid?"

Well, there are four main answers: (1) Share buybacks, (2) merger and acquisition activity, (3) restructurings and (4) partial liquidations. These answers actually apply to all four funds. But I'll just stick to Longleaf Partners Fund since John, C.T. and Andrew will cover the other three.

We've already talked about share repurchases. At these levels of repurchase, either our cash on cash returns alone are so high that it's effectively its own catalyst or the company ends up basically going private. On the margin, the companies are taking out that last marginal seller. And eventually, the companies' own resources will win the liquidity battle currently being lost in the stock market by value funds.

OUR HOLDINGS ARE ALREADY CHEAP —
AND THEIR VALUES ARE GROWING RAPIDLY.

Bargain-priced franchises won't stay undervalued for long.

Cates: The second catalyst is merger and acquisition activity. This one is heating up quite rapidly and isn't surprising given widespread undervaluation among the "old economy" stocks. In the last few months alone, two of our Partners Fund's companies have seen this. Aetna received an unsolicited $70 bid which they turned down. But that may not necessarily be the end of that saga. And Nabisco Holdings, prompted by a Carl Icahn bid for sister company, Nabisco Group, is apparently in play. That's not something we're that excited about because we did not

PORTFOLIO REPORTS estimates the following were Longleaf Partners Fund's equity purchases during the quarter ended 6/30/00:

1. TRICON GLOBAL RESTAURANTS
2. NIPPON FIRE & MARINE INS CO LTD

have time to build a meaningful position in Nabisco. However, both examples show that quality franchises won't just sit around for long at implied huge free cash returns without attracting suitors.

[Editor's note: Just five days after the annual meeting, UniCredito Italiano Group agreed to buy another Longleaf Partners Fund holding — Pioneer Group — for $43.50 per share in cash, which was a 40% premium to its previous close and a 250% premium to its Year 2000 low].

Some catalysts come from within — like restructuring....

Cates: The third catalyst is restructuring activity. GM is a great example here. We're in the middle of a share exchange whereby they're swapping some of their controlling shares in Hughes Electronics, whose main business is DIRECTV, for GM shares. This is a huge transaction that in one fell swoop sells a huge chunk of Hughes for a good price, avoids any capital gains on that sale and buys in around 15% of their own shares. Some on Wall Street wanted this restructuring to go even further to a full spin of Hughes, but we like this way better.

Other strong candidates for a major restructuring within our portfolio include the following:

Canadian Pacific [CP/NYSE] — where it's hard to

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envision the railroad and its 87% ownership in PanCanadian Petroleum not somehow being restructured in a year or so. That's because the railroad deal moratorium that came in the wake of the Canadian National deal will go away. And that should be a catalyst there for a lot of reasons.

[Editor's note: Despite the recent extension of the moratorium on railroad mergers, Longleaf informed us that they still believe it will eventually go away.]

Cates: Georgia-Pacific Timber Group [TGP/NYSE] — which is a great, shareholder-oriented company that we believe will consider all different kinds of ways to get much higher end value to shareholders than is possible in their target stock structure today.

Aetna, where if things go the way the board wants, will be restructuring into two separately traded pieces — the HMO and the financial services business.

And UCAR, who recently filed to do an IPO of GRAFTECH — which supplies graphite for use in Ballard's fuel cells. If fuel cell technology catches on to the extent that Ballard's $6 billion market cap implies, then GRAFTECH will be a huge part of UCAR's future value.

Mgm'ts arbitraging valuable assets against cheap shares.

Cates: The fourth catalyst that we anticipate could be dubbed a partial liquidation, which arbitrages the very strong private market values of these companies' assets with their absurdly low public market prices. These companies are not in full liquidation mode and they have healthy and growing enterprises. But as long as there's this massive disconnect in the market between stock price and private market value, they're going to sell assets for fair prices and buy the remaining similar assets in their own companies via share repurchase.

TrizecHahn [TZH/NYSE], for example, just announced the sale of their mature Canadian office buildings for a multiple of over 12 times cash flow. They'll use much of the proceeds to then repurchase their own shares — effectively buying their higher growth U.S. office properties that they already own for 8 times cash flow. This process could and should continue until either the market recognizes the underlying value or we end up with a smaller enterprise, an even smaller share base, and a much higher remaining value per share that could also be monetized at the end of the process even more easily than the Canadian assets were.

Georgia-Pacific Timber sold significant western timber acreage for $2,000 an acre and over 13 times cash flow — and they'll be using those proceeds to buy back their own shares and the remaining trees that they already own for 8 times cash flow and $500 per southern acre vs. the $1,000 an acre it should command.

Host Marriott [HMT/NYSE] sold the Boston Ritz-Carlton for a multiple of over 14 times cash flow. And they've used the proceeds to buy in their own shares representing the remaining Ritz Carltons and other high quality hotels for only 7 times cash flow.

So our Funds are very undervalued, those values are *rapidly* building via unprecedented share buybacks and our partners are taking actions to get us paid....

OUR SMALL CAP PORTFOLIO IS EXTREMELY CHEAP.
FOR EXAMPLE ... LET'S MAKE THAT *THREE* EXAMPLES.

Common sense tells us the best bargains are in shares....

John Buford: Longleaf Small Cap Fund's portfolio is extremely cheap.... I have three companies I'd like to highlight today — three of our larger positions. But before I do, let me read a quote from a recent presentation given by Deltic Timber — a Small-Cap Fund investment. I think it summarizes the feelings and actions of the managements of most of the companies in our funds:

"In our continuing efforts towards locating and acquiring timberlands at a price that is discounted from fair market value, we're increasingly drawn to the timberlands we already own. Your Board firmly believes that the value of Deltic's timberland is significantly greater than the current aggregate price accorded the enterprise in the stock market."

"Good common sense and sound judgement lead us to take advantage of this disconnect by allocating capital to buy in our own shares, thus increasing the number of acres allocated to each remaining share and, in effect, growing the value of those shares. It is just that simple."

And we would concur with that.

We like what we see at Gulf Canada....

Buford: [Each of the] three securities [I'm] highlighting today [has] its own unique partners and its own unique

PORTFOLIO REPORTS estimates the following were Longleaf Partners Small Cap Fund's equity purchases during the quarter ended 6/30/00:

1. FAIRFAX FINL HLDGS LTD
2. HOLLINGER INTL CL A
3. WHITMAN CORP
4. NEIMAN-MARCUS GROUP CL B

opportunity to grow value and realize that value in the marketplace. I'll start with Gulf Canada [GOU/NYSE] — a large oil and gas firm in Western Canada. The stock price today is about $4-1/2 and the value is about $8.00.

Our partner at Gulf Canada is Dick Auchinleck, a career oil and gas engineer. Since becoming Gulf's CEO two years ago, Dick has cut the company's cost structure by 40%, significantly lowered its finding costs, and cut the company's debt from C$2.7 billion to C$1.9 billion.

Gulf has several avenues of value growth open to it. It's currently finding reserves at an average cost of $3.30 per barrel. That's compared to $5.50 per barrel in value for every barrel that they find. Gulf's also selling assets at prices significantly above our appraisal — which in turn raises the value of the firm. And the company's seeing continued development of market infrastructure in areas where they have huge reserve pools — development that will greatly increase the value of those reserves.

Recent transactions and buyer interest confirm our view.

Buford: In terms of market realization of this value,

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LONGLEAF PARTNERS FUNDS'
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(cont'd from preceding page)

we've filed a 13D to give us the flexibility to explore all options with the company's management or with interested third parties. The company has numerous non-core assets which can be sold as well as a large position in a publicly-traded entity [Gulf Indonesia]. Proceeds from these sales would, of course, be available for share repurchases.

And there's been increasing interest in Canadian oil and gas reserves. Recent proposed transactions for Union Pacific, Ranger Oil, and Ulster Oil support our appraisal and the high level of interest from large oil and gas companies looking to boost reserves through acquisition.

WCLX ENJOYS A 50%± DISCOUNT TODAY ON DEPRESSED UNDERLYING ASSETS.

With Wisconsin Central, there's a lot to like....

Buford: Wisconsin Central [WCLX/NASDAQ] is the nation's largest regional rail line and owns several foreign rail operations. The current stock price is $13 versus a value of about $25. Our partners ... are original founders of the firm and owners of a substantial amount of stock.

The company has several sources of value growth. One is that domestic rail will continue to participate in the growth of traffic in the Northeast corridor which is itself fueled by trade between Canada, the U.S. and Mexico. It should also see improvement in the profitability of its international operations — especially its U.K.-based [unit,] EW&S [English, Welsh & Scottish Railway]. This entity was very poorly managed by its previous owner — the U.K. government. Furthermore, the company is repurchasing its own shares.

Plus, we expect a pop in the underlying value of its assets.

Buford: Value realization could come from several areas — one being that the entire rail sector has gone from an average P/E of over 16 times to under 10 times today. This is due to several large, poorly executed mergers. However, as the industry works through these problems, we expect to see an increase in the multiples ascribed to rail companies — especially those rail companies which have shown no operating problems like Wisconsin Central.

Mgm't may speed up the process. And maybe we can help.

Buford: Its foreign rail assets are entirely severable and could be sold to fund continued share repurchases. And the domestic rail is an important connection to several much larger rails. You could lower costs and significantly increase revenues by folding them into such an entity.

Here again, we've filed a 13D to give us the flexibility to discuss these and any other possibilities with the company's management and/or third parties.

FLEMING MAY WELL HAVE ALL THE INGREDIENTS — PEOPLE, PRICE, BUSINESS AND MORE....

A deep discount, pedigreed mgm't and huge insider buying.

Buford: The third company I'd like to highlight is Fleming — the largest food distributor in the country and the owner of several large food retail chains. Today's price is about $15.50 — and we estimate that its value is $35±.

Our partner at Fleming is Mark Hansen — formerly with Wal-Mart. Mark and his team have not been with the company long enough to acquire significant ownership. However, over the past 12 months, Fleming's shown the highest level of insider purchases of any company that we're associated with.

And what we see so far, we like very much....

Buford: In the short time he's been there, Hansen has closed a significant number of the company's smaller warehouses greatly improving efficiency and margins. He's also positioned Fleming to be the preferred provider to several fast-growing alternative distribution channels — including the large store value chains, the expanded mini-marts and e-based food retailers.

Fleming's also been successful in growing its large store value concept chain — which has proven to have higher margins and returns than traditional food stores.

Based on asset sales, our appraisal may be conservative.

Buford: Fleming has recently announced the sale of its traditional retail stores with the expected proceeds significantly higher than our appraisal. These proceeds will give the company a very strong balance sheet and the flexibility to support growth of the large store chain and share repurchases....

VALUATION HAS BEEN LARGELY IGNORED BY MOST, BUT WE BELIEVE THAT APPROACH IS INSANE.

Just because everyone agrees doesn't mean they're right.

C.T. Fitzpatrick: The Longleaf Realty Fund's composite price-to-value ratio is at an all time low — which means that its long-term prospects have never been better. Over the last two years, however, our value-based approach hasn't generated satisfactory returns. Besides real estate being out of favor, those of us who place so much emphasis on valuing businesses and what we pay for things have been ignored by most investors as they've chased momentum.

Our results would have been much better had we simply paid ever-higher prices, regardless of fundamentals or valuation, simply because a stock was going up. But as long-term, rational investors, we think that approach is insane. Just because everyone else is marching down the same road doesn't mean they're right. Instead, we select superior businesses and properties managed by capable partners who can consistently compound their value — and we don't pay much for them. For real estate, it's people, properties and price. That, in a nutshell, is our approach.

We have an opportunity today to buy great businesses.

Fitzpatrick: Over the last two years, our companies have reported steadily rising cash flows from properties and they've built value per share. And yet most of them are currently selling at prices that are below where they were two years ago. What that means is that we own a collection of great companies and some of the finest properties in the world, literally — and we own them at

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greatly discounted prices.

That also means you have diversification. Many people questioned whether or not publicly-traded real estate provided diversification — and indeed it does. If you look at the NASDAQ for instance, you see that we seem to move in exactly the opposite direction. So in the case of publicly-traded real estate, it's done exactly what it's supposed to do — it's provided great diversification. Yet, the long-term returns are very similar to that of equities. So you give up almost no return, if any. In fact, I think you can make an argument that on a looking-forward basis, you'll pick *up* return.

So what this means today as we stand here is that you have an opportunity to buy great, real businesses that have real cash flows that are growing and that are managed by good people at greatly discounted prices. And you can hedge some of the more speculative elements of the market.

There's been something of a rebound, but it's been narrow.

Fitzpatrick: What's our outlook? Well, we really don't know. We focus on the companies themselves. But we will nonetheless offer some observations:

The publicly-traded real estate industry has experienced negative capital flows from our little segment of the market for the last two years. But over the last few months, real estate has begun to rise from the dead. At the beginning of this year, we saw just a little bit of capital return to the market. And when that happened, REIT prices rebounded pretty dramatically — because there were no sellers. No one who understands these companies would sell them. Therefore, with only a few buyers, prices adjusted very quickly.

However, it's been very narrowly-focused and concentrated. Most interest in publicly-traded real estate has been focused on the very largest REITs — the blue chip REITs — those that are very obvious and almost index-like in their nature. Thus, there's now a very big disparity between the largest cap REITs and everyone else.

One way or another, our holdings will participate.

Fitzpatrick: Well, we mostly own everyone else. And in our own portfolio, the companies that have performed best for us were in this larger category. What that means, we think, is that the rally, if it continues, should broaden to our other names.

And one of two things will happen: Either the capital that's flowing into the area will become more discerning and flow to these smaller, cheaper companies or these larger companies, whose valuation levels are much higher, will buy them.

Mack-Cali, which is a multi-billion dollar REIT, recently bought Prentiss Properties in a multi-billion dollar transaction. And Equity Office Properties, one of the largest real estate companies in the world, just recently bought Cornerstone — which has a lot of properties in the Bay Area — at prices that would imply that everything we own is better than a 50¢ dollar. Incidentally, our weighted average price-to-value ratio for the portfolio is in the mid-50s.

Third party interest represents opportunity *and* danger.

Fitzpatrick: What are we doing about this? Well, we're doing several things: We have filed 13Ds with respect to a number of the companies we own which gives us greater flexibility to talk to management and offer our opinions as to how they can maximize shareholder value. We've done this in a reactionary mode because we've been approached by third parties interested in acquiring a part or all of companies that we own.

I think one of the biggest negatives and biggest risks we face is that these companies will be taken away from us too cheaply. Therefore, we're working very hard right now on making sure that that doesn't happen....

EASING THE PAIN IS THE OPPORTUNITY — GREAT BUSINESSES SELL AT LUDICROUS PRICES.

In real estate companies, it's not EPS, but FFO that counts.

Fitzpatrick: I'm going to briefly describe [two] of our top five holdings. You can decide if our approach sounds like it will produce adequate returns over the long term.

Because they're real estate companies, GAAP earnings per share is not a very meaningful measure of profitability.

> PORTFOLIO REPORTS estimates the following were Longleaf Partners Realty Fund's equity purchases during the quarter ended 6/30/00:
>
> 1. TRIZECHAHN CORP

Instead, real estate companies are usually measured in terms of cash flow — sometimes referred to as "Funds From Operations" or FFO. At the risk of oversimplifying, for a real estate company, FFO per share is equivalent to earnings per share. While it is a crude measure, if FFO is growing, it is a good indication that the underlying value of the business is growing as well.

So how are we doing?

E.g., one of the world's leading brands at 50¢ on the $1.

Fitzpatrick: Hilton Hotels [HLT/NYSE], our largest position, owns branded real estate, mostly in supply-constrained markets, and franchises its hotel brands to third party owners — generating superior economic profits without having to use its own capital to grow. We increased our stake in Hilton substantially late last year through the company's acquisition of Promus Hotels. After adjusting for the acquisition, FFO per share was only up 5% in 1999. The acquisition, however, solidified Hilton as one of the leading branded hotel companies in the world.

All indications are that the combined company should generate double-digit growth in bottom line results in 2000 and beyond. FFO should be at least $1.69 this year. So that means Hilton is selling at 4-1/2 [now 6] times that number. Therefore, this *extremely* high quality company is selling at less than 40¢ [now 50¢] on the dollar.

Put another way, Hilton can sell its trophy assets, which are irreplaceable, such as Hilton Hawaiian Village, the New York Hilton, the Waldorf Astoria, the Palmer House, etc. and repurchase all of its shares — the entire company

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— and we'd be left with a high quality franchise business and the suburban hotels....

Hawkins: Clearly, hotels are very undervalued. And we've got them covered — Marriott on a fee stream basis, Hilton with very significant CBD [central business district] hotel properties and great fees, and then we own some of the best real estate in the world through Host Marriott. So that's one class you could say is *dramatically* undervalued vis-a-vis our long-term appraisals.

Fitzpatrick: Our outlook for the [hotel] companies that we own is much better than the industry in general because we tend to own companies that have a concentration of properties in supply-constrained markets and/or franchise fee streams. That's true of Hilton, Host Marriott and Marriott International — which are our three big hotel positions. So we feel *very* good about the outlook for our companies. And we feel OK about the outlook for the hotel industry. But we think our companies are much better positioned than the average within the industry....

A disconnect between Prime Group's fundamentals & price.

Fitzpatrick: We highlighted Prime Group [PGE/NYSE] last year. It's one of the few REITs we own. The bulk of the company's value is in its Chicago office assets. Despite growing its FFO by 11-1/2% last year, its stock is only up 4% since last year's annual meeting. And its fundamentals this year look better than they did in 1999 as it benefits from a tight downtown Chicago office market, below-market leases and contractual rent increases.

Currently, the company sells for 7-1/2 times FFO and ... its fundamentals are fantastic. Demand exceeds supply. Our buildings are full. Returns on investment for renovations to improve its buildings have been fantastic. We have one building called Dearborn Center that you might have read something about in the press. Bank One is going to be the anchor tenant there for a 15-year lease. It's just going under construction now. The returns are fantastic from this asset. Once it's finished, it will be one of the landmarks in Chicago. So business is very good.

A 40¢ dollar today....

Fitzpatrick: And in the market, despite steadily rising earnings, despite great property fundamentals, this company sells for the equivalent of $89 per square foot. And the properties it owns are not that different from the one we're in here in Chicago. And more and more people are moving downtown. Chicago's central business district is becoming a more and more desirable place to live. And that helps our values.

And we can prove that our value has risen and that if we owned it as a private investment — if we owned 100% of the company — that we would be *extremely* pleased with our progress. But it's publicly-traded and the stock trades at an *incredible* discount to its intrinsic worth. And that has hurt our performance over the past couple of years, despite the steady buildup in value.

What we look at as long-term investors is the opportunity that creates.... Here's a company that sells in the market for $89/foot [where] replacement value is very conservatively $200-250/foot. To give you some idea, they sold their largest single asset last year for *$300*/foot.

And our value per share should grow dramatically.

Fitzpatrick: Furthermore, they plan to sell assets and repurchase their stock. They're going to sell about $500 million of assets that are being marketed as we speak. And they're going to pay down about $250 million worth of debt and buy in $250 million worth of stock. They will then have $1 billion in real estate assets left over. And they will be able to shrink their share base by two thirds. That means that their remaining $1 billion in assets will be divided over a denominator only one third its current size. So our value per share will grow even *more* dramatically.

We're finding great businesses at *ludicrous* prices....

Fitzpatrick: These companies ... are representative of what we own. They're underappreciated in the stock market, they're producing excellent bottom-line results, they're managed by capable shareholder-oriented management teams and they're increasing their values per share at double-digit rates. As long-term investors, we *will* realize these returns. They're only deferred, not foregone.

Ironically, the very forces at work causing our recent results are also the same ones creating the opportunity to buy these great businesses at ludicrous prices. And while we are not pleased about the recent performance in the real estate area, we are *thrilled* about the outlook....

We're about ready to start pounding our fists on the table.

Andrew McDermott: I spend my time on Longleaf International Fund — which is about to celebrate its second anniversary. We have about $300 million under management. That is split with about 20% in Asia, 30% in Europe, 40% in Canada and 5% elsewhere. That's using a totally bottom-up allocation. We don't try to figure out what countries we want to invest in and pick companies that fit. Instead, we pick companies and let the country allocation fall where it may. And we're about ready to really start pounding our fists on the table and tell you how excited we are.

We're not your average international mutual fund.

McDermott: We've been surprised to learn that the way we look at investing in the international arena is very different from the way most of our competition does. We want to concentrate in our 20 best ideas regardless of geography. We want to take foreign currency risk out of the equation. And we want to invest in companies that we understand, run by partners we trust, available at a steep discount to our appraisal of intrinsic value.

Most of our competitors focus on things that don't matter to us at all as owner/operators. Most of them look at country weightings and sector weightings and try to predict foreign currency moves. And, of course, they spend a lot of time trying to match various indices — whether it's EAFE or something else of that ilk.

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We started Longleaf International two years ago because we had more international ideas than we could fit into our existing funds. We wanted to put our own money into these ideas — and we wanted to have an opportunity for our clients to join us. Well, that worked out great.

And being different gives us an incredible advantage.

McDermott: But what we found over the last couple of years is that our approach is so different from the way most people look at international markets that we have an incredible advantage. [There's] this continuing move to indexation by international fund managers. So if you're a very disciplined, fully-hedged long-term investor in international markets, you can take advantage of the actions of these indexers and other group thinkers who decide ... to put entire countries or sectors on sale.

For reasons we can never understand or figure out, entire countries, regions and sectors fall in and out of favor on what seems like a weekly basis. And that provides us with fantastic opportunities because all we do is hang numbers on businesses. For example, we don't care if Morgan Stanley suddenly decides to include Malaysia in its international indices and forces all these index-weighted guys to sell Singapore.

We don't care if Goldman Sachs decides that food and beverage companies aren't going to grow faster than 10%, so they don't want to own any of them and that gives us a chance to buy Diageo at 10 times earnings. We just don't look at any of this macro stuff, but we can take advantage of it.... We were able to buy a collection of Johnnie Walker, Burger King, Pilsbury and Guinness — some of the best known consumer brands in the world — at less than 10 times earnings and yielding almost 5%....

Our international fund truly is a unique product that takes advantage of these cracks that appear in the sidewalk when you're investing internationally....

But we're not looking for trouble. Quite the contrary....

McDermott: We don't have any geographic bias. We are totally agnostic about being in particular regions — with the proviso that we want to be in countries where we're comfortable opening a bank account. In other words, just because we think Southeast Asia is going to come back, we're not going to make a bet there if we can't get comfortable with the country risk.

And our hedging policy keeps us out of a lot of trouble — because when you actually specifically account for the cost of hedging yourself back into U.S. dollars, you find that a lot of companies that appear cheap on your screens aren't really that cheap. So when we value international companies, we explicitly reduce our values by the cost of hedging back to U.S. dollars. Then we assess whether or not it meets our criteria using that value.

Diversifying for diversification's sake is never a good idea.

McDermott: [And we have another] disagreement with conventional wisdom. We don't believe that diversification in international equities is a good thing in and of itself. International investing is riskier. Disclosure is worse, costs are higher and it's difficult to find management teams who think of shareholders as highly as U.S. managements do. So on an apples-to-apples basis, just diversifying into international equities in and of itself doesn't do very much — at least not for us....

It's particularly not a good thing to do if what you're really trying to do is make a foreign currency bet — which often drives the performance of unhedged funds. I think the industry's done a terrible job explaining to investors the impact that foreign exchange movements have on both investment performance and investment managers' decisions.

For us, the reason to invest is to take advantage of the volatility that's created by this indexation mentality — to really go in there and take the lowest possible risk and have an opportunity to compound in ways you can't do domestically because those price swings aren't present....

HLR'S OUTLOOK MAY BE UNCLEAR TO WALL STREET, BUT ITS VALUE PROPOSITION LOOKS CLEAR TO US.

Share buybacks are "like buying dimes for nickels".

McDermott: We've had four presentations so far on share repurchases — so I think I'll talk about share repurchases. We talk a lot about them here. But it's a hard concept sometimes for listeners to grasp. Frankly, I never understood it myself in my old job as an investment banker. And we were supposedly trying to convince companies to execute share repurchases....

> PORTFOLIO REPORTS estimates the following were Longleaf Partners International Fund's equity purchases during the quarter ended 6/30/00:
>
> 1. TRIZECHAHN CORP
> 2. GUINNESS PEAT GROUP PLC
> 3. MOLSON INC CL A
> 4. HOLLINGER INTL CL A
> 5. DE BEERS CONS MINES ADR
> 6. NISSAN FIRE & MARINE INS CO LTD
> 7. BRIERLEY INVESTMENTS LTD
> 8. FAIRFAX FINL HLDGS LTD
> 9. NIPPON FIRE & MARINE INS CO LTD

[Here's] a quote from Hollinger's CEO, Conrad Black, who I think is the best annual report writer in our portfolio. He explains share buybacks in layman's terms: "It's like buying dimes for nickels on a grand scale when we sell newspaper properties for 11 times cash flow in the private market and use the proceeds to repurchase our higher quality properties [by buying back our shares] in the stock market at half the multiple."

His description applies to Longleaf International Fund today and the three holdings I'll review.

One thing the gutless & gutty agree on — Hollinger's value.

McDermott: The most important number for prospective partners is our price-to-value ratio.... In Longleaf International Fund today, it's 53% — one of the lowest ratios that we've ever had for an entire portfolio. Hollinger [HLR/NYSE] sells in the market for $12 [now $16.25]. We value the company at $23 per share based on

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numerous comparable transactions and our own discounted cash flow analysis. Staley mentioned some of these transactions earlier in his valuation of Knight Ridder.

Incidentally, Wall Street agrees with our appraisal. For example, Merrill Lynch's estimate of intrinsic value is $23 to $27 per share. Yet they rate Hollinger "neutral" because the sector outlook is "unclear."

Black understands the value, has his net worth invested in the stock and is taking advantage of Wall Street gutlessness to repurchase shares at a discount.

[Editor's note: As you may recall, Tweedy, Browne told us about Hollinger in our December 10, 1999 edition.]

NIPPON'S SELLING AT ROUGHLY 1/3 OF ITS VALUE. AND DE BEERS' BUSINESS & INVENTORY ARE FREE.

Nippon sells at roughly a third of our appraisal.

McDermott: A similar attitude prevails at Nippon Fire & Marine Insurance Company — one of the Fund's largest holdings. We've explained in the past that a number of Japanese nonlife insurance companies trade at *stunningly* cheap valuations, but that we weren't comfortable enough with the individual management teams to pick a single horse. Well, after two years of research, we've concentrated our nonlife position in Nippon.

Nippon's President Ken Matsuzawa is the first Japanese CEO in Japan's nonlife insurance sector to grasp the importance of corporate governance, management compensation, and increasing returns for shareholders, not just employees and other customers. He's acted on this belief by repurchasing shares, executing an attractive merger with a smaller company, cutting costs, and reforming Nippon's investment process. Despite this, the company sells at roughly a third of our appraisal of ¥1,100 per share.

With De Beers, you get the business and inventory for free.

McDermott: De Beers [DBRSY/NASDAQ] is my last example. As many of you know, De Beers dominates the mining and marketing of diamonds worldwide. In addition, the company owns 42% of Anglo American, South Africa's largest mining company. We bought De Beers at $14 versus our appraisal at the time of $32. The stock trades

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at $22 per share today, but the value has grown to $47 per share thanks to the work of CEO Nicky Oppenheimer who rationalized De Beers' corporate structure.

Over half of this $47 value consists of conservatively valued public securities. So at today's price, the diamond inventory, the mines and the "A Diamond is Forever" franchise are all free. Of course, none of its products are.

Record cash flow and, maybe, De Beers' first-ever buyback.

McDermott: De Beers has produced record cash flow in the past year and is considering its first-ever buyback. Staley will meet with Nicky later this week and I'm sure will bring all of your enthusiasm along with his own in encouraging Nicky to actually execute this plan — because it will create so much value per share.

We hope you share our enthusiasm for these values....

WE LOVE TECHNOLOGY — AT LEAST WHEN IT'S FREE. AND IN A COUPLE OF SITUATIONS, IT IS FREE TODAY.

In technology, the fundamental things still apply.

Cates: We thought we would start the Q&A by asking ourselves a few of the questions that come up the most that are very good and valid questions. That way, we can leave out all the different cuss words that people usually throw in there when they ask them. First, "Why don't you stupid blankin' blankety blanks do more tech — because it seems to be working?"

Well, there are several different answers. First, like everything else, technology and every other industry group gets down to businesses, people and price. And we *have* done technology and we'll *continue* to do technology, but it has to be on our terms....

But along the businesses/people/price model, we need to understand what they do; we need to understand their [competitive] advantage; we need to know and trust and like the managers riding that technology. And I guess most importantly, we have to buy cheaply....

We're not stupid enough to pass up tech — when it's free.

Cates: Our biggest winner in the Partners Fund in 1999 was Philips Electronics. Philips' single biggest segment is semiconductors. We didn't buy Philips because we sought out that semiconductor business or pretended that we could add value by seeing value in semiconductors that others didn't see. We ended up with that because we paid a price for Philips that was less than its cash and securities on the front end. So we got all of its semiconductor plants for free.

So we can't value those down to the last nickel. But we're not stupid enough to pass up $20 billion worth of semiconductor assets for free ... plus its flat panel displays and the other kind of techie things that they did.

And it's the same with GM and UCAR, today.

Cates: Let me give you a couple of current examples: General Motors — which you think of as cars and trucks. But as I think you know if you've read our materials, we're as interested in Hughes — which is mainly DIRECTV at this point — and GMAC as we are in its cars and trucks.

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LONGLEAF PARTNERS FUNDS'
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Within DIRECTV is a value that we think we understand. It's very comparable to cable companies that we've owned. But we're assigning a value of zero for any kind of future satellite benefit the Hughes engineers might come up with.

Right now, for example, the big battle is DSL versus cable modems when it comes to internet access. And that's because satellite doesn't really figure in there — because even though the broadband satellite coming down is superior, its return path is through a phone going up. So it's just not even competitive. However, in a few years, Hughes argues that they will have, on a more mass scale, two-way satellite broadband — which would clearly be of *enormous* value. That's something we couldn't quantify. So in our appraisal, we assign it a value of zero. However, we're happy to take that for free and see how it develops and maybe get value later.

It's the same with OnStar. OnStar is a neat service you may either have or maybe you've seen ads for it. They're going to have a million subs paying $20 a month by the end of this year. Again, we're paying nothing for it. But over a long period of time, we'll see how that pans out. Eventually, it probably makes its way into our appraisals.

UCAR is cheap. GRAFTECH could be a huge bonus.

Cates: Ditto for UCAR. I mentioned GRAFTECH. What's going to happen with fuel cells? We have no idea. We read about it — and we can pretend like we know, but we don't. However, if fuel cell technology truly works out, this is a huge deal to UCAR. And UCAR itself is cheap on its own assets. So this isn't part of our logic in buying it. But that can turn out to be a huge number if it pans out.

It all boils down to value....

Cates: A similar question: "Why not at least make [technology] a certain fixed percent of the portfolio?"

Well, the answer to that is that it's just like any other industry group where it just depends on the value. At any given time, we can be heavily weighted in some industries and lightly weighted in others. But the values drive that. We look at some of the values of big tech, barometers like Cisco which is at 25 times revenues — even the great revenues that they recently reported. And we look at AOL which trades at $7,500 per sub and they pay $20 a month. Then we contrast that to cable companies who have subs who pay $60 a month that sell for $5,000 per sub. When the values are like that, that's not the time you're going to see us wade in.

Another example: In the past, cellular companies were a hot technology. We couldn't see what the population penetration would be. At the time, people had phones as big as a brick. We didn't know how that would play out. But as cell phones did become more established with franchises and moats we could understand, we were able to buy cellular companies very cheaply. And we made a lot of money.

We don't like crystal ball risk — whoever's doing the reading.

Cates: "Why not hire some Ph.D.s and go after tech that way?" The overall macro crystal ball way, as you know, is not the way we do things. We think it has its own risks and flaws that often become apparent later.

And what's interesting right now is a common refrain we hear: "Why not buy an internet equipment maker?" — because then you don't have to guess which "dot com" wins. You benefit by the guys who make the equipment — and there's no way you can go wrong doing that.

Well, we think this is really similar to a decade ago when value investors were having the same hard time that we're having now. At that time, it was biotechs, environmental services and drugs. And biotech has come through on huge promises as far as a business — and in the recent year, they've done well. But for most of the '90s, as you know, they didn't do so hot.

As for environmental services, I don't have to explain to this particular crowd what happened to a lot of the waste companies that were considered sure fire in 1990. And as for drug companies, well, by the mid-'90s, when Hillary Clinton was involved with health care, those stocks had fallen to 10 times earnings. So when you combine the crystal ball risk with valuations where they are, that's why we don't beef up that way....

TECHNOLOGY'S MUCH TRICKER THAN IT LOOKS,
BUT THERE'S MORE THAN ONE WAY TO SKIN A CAT.

Risks in technology are greater than they may appear.

Hawkins: We address technological risk, obsolescence risk and all of those things. It's a very competitive world. When asked why we don't invest more directly in technologies, we go back to 15-20 years ago — and returned the question back to the questioner, "What would you have had us invest in 15 years ago?" And he said, "Well, the leading companies."

And I said, "The leading companies? How about Control Data, Burroughs, Data General and Amdahl — and even Hewlett-Packard and IBM? Fully four of the six are pretty much footnotes today." These companies were *absolutely* market share, dominant leaders at the time. But the technology revolution, the technological risk and the *lack* of real barriers to entry caused those companies to become less significant over time.

But there's more than one way to skin a cat....

Hawkins: In our annual report, we attempted to delineate how we were going to expect to position your assets to benefit from the technology revolution. And since we've spent some time on that annual report, we thought we'd read it again for those of you who are newcomers:

"First, we can invest in a unique, strongly competitive, non-tech business that will become more profitable through the use of new technologies." We cited Marriott, Hilton and Waste Management as companies that would be big beneficiaries of new tech systems they're employing.

"Second, we can own companies that will benefit significantly as service providers to rapidly growing technology enterprises." And we gave the example of Federal Express which is serving Dell and Cisco — two rapidly growing tech companies.

If the price is right — or, even better, if there is no price....

Hawkins: "Third," we wrote, "we can purchase the

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stock of above-average companies that are so undervalued that we, in effect, are acquiring their established and/or nascent high-tech endeavors either for no consideration or, in many cases, actually a negative consideration."

Staley's already talked about getting Hughes through GM, semiconductors and digital technologies such as DVD through Philips, and Nokia — another leading company in the digital phone world — through Sampo [Insurance Co.] for free. And being a service provider like FedEx is to the very rapidly growing Dells and Oracles of the world is not a bad gross profit royalty, in effect, on the unit growth leader.

So that's a third alternative of how we might position ourselves to benefit from things going on in the tech world.

Believe it or not, sometimes we *do* understand technology.

Hawkins: Finally, we can own technology companies directly.... MediaOne and 360 Degree Communications were great examples where we had huge, huge successes. We believed very much that MediaOne's fiber-optic and coaxial cable around the neighborhoods they served could carry telephony as well as internet and cable TV and that those fixed costs could be covered pretty quickly given the added revenue streams.

"In this last alternative, the businesses clearly must fall within our sphere of understandability, be competitively entrenched, and have a definitive cash earnings stream that determines our value — and, [after all of that], be available ... at less than 60% of our appraisals."

So that's a comprehensive way of taking a look at what's going on, what's evolving and how we position ourselves to benefit from it with a margin of safety we're comfortable with where we have competitive entrenchment. We go about it from the perspective that it's our money. And we'd like to be sure we get it back first — and get a return on it second. The first is most important. That pretty much sums up our view on technology.

AT WASTE MANAGEMENT, THERE'S A LOT TO LIKE. AND IT'S ONLY GONNA GET BETTER (AND BETTER).

The people and the price are *very* right.

Hawkins: Here's the next question that we wanted to pose to ourselves: "What about Waste Management? Where are we?" I'd like to give everybody an update on it because, as you know, it's our largest investment.

Waste Management is one we feel very good about. Our appraisal for it is north of $40 — more than twice the current price. And our appraisal was confirmed by the most extensive audit in U.S. corporate history — which ended last year and which we received on March 27th when we got the 10-K.

Maury Myers has assembled what we consider to be one of the best management teams we know. And that management team is making great strides in putting their plan in place and building the kind of culture that we're extremely excited about. It's taken a while to get it here.... But we believe its value will build very nicely as they enter their next mode of evolution from the management change. That next mode should produce dramatic savings on the cost side, it should help us capture revenue opportunity and produce *substantial* free cash flows. There's [already] been tremendous progress on the working capital front in the last quarter. And that's produced a tremendous amount of operating cash flow.

On the divestiture side, the company's non-core and foreign asset disposals are proceeding ahead of schedule. They have announced $2 billion of the $3 billion worth of [planned] sales of their non-strategic assets [that] they fully expect to close on ... before the end of the Year 2000. Once they receive those proceeds, $2 billion will be earmarked for debt repayment and $1 billion will be dedicated to share repurchase....

And so is the business — today, and looking forward....

Hawkins: To summarize what we said in the third quarter report to shareholders, we think Waste Management [WMI/NYSE] — actually we *know* — has the best landfill and collection assets in the industry. Landfills are virtually impossible to duplicate because of our environmentally-conscious society today. You can't get one permitted if you want. It's pretty easy to put a truck on the street. However, it's *very* difficult to get an EPA-permitted landfill. We feel even stronger about the waste collection industry than we have in the past year — mainly that landfill space is beginning to be looked at as a premium asset opportunity.... And we see the supply continuing to shrink and an improving supply/demand equation.

Waste Management is the dominant operator in each of its regions. Its strongest competitor, Allied Waste — which, as you know, recently bought Browning-Ferris — is extremely leveraged and just put through a 2.5% overall price increase in the first quarter. So we feel very good about the fact that our competitor is financially leveraged and is also a pretty good pricing statesman. That should allow Waste Management to receive pretty good revenues as we go forward. [So we feel] the company is operating in what we consider a very good price environment.

Within 3 years, we expect Waste to be substantially higher.

Hawkins: Waste Management's operating cash flows are growing nicely. Its capital requirements are coming down. Its free cash flows are building. And to sum it up, they should do north of $1.50 in GAAP earnings this year. Plus, there's another 70¢ of amortization of goodwill. So we're talking about $2.20 in free cash flow.

Next year, that number rises north of $3.00. And within three years, those cash earnings should be significantly greater as they realize the synergies of the USA/Waste Management merger. There are huge economies to be captured in terms of cutting costs and taking your collection to the most profitable disposal site — which is your own....

We think other worries are short term and overblown.

Hawkins: The other challenge they've faced has been fixing the computer systems/MIS. Well, we got a great management team as the result of very good board work. And we're in the throes of getting, we think, one of the

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finest computer systems. The man that did the GM conversion for EDS was at Perot Systems. And Ross Perot, who is a friend of one of our directors, put us in touch with that head computer man. And he brought a team of 10 consultants. And they not only jumped on the project, but they coordinated with the head of MIS that came from Yellow Freight with Maury.

They've made great strides. Their accounting days receivable are down from 80 days to around 50. And we're looking forward to the day when they turn on their new computer system sometime near year-end 2000.

And we think we're more than adequately reserved legally.

Hawkins: They have one more hurdle to clear — and that's the settlement of their lawsuits. And we think they're making substantial progress there. The SEC just ruled that their audit was clean. And the SEC accepted the internal audit done by Waste. That was a big hurdle. And they also narrowed the time horizon that litigants could claim damages.

Now it's up to the defense attorneys for Waste to settle with the plaintiffs. Fortunately, the judge appointed a lead plaintiff attorney — you know, they fight over who becomes the lead attorney because they get more for the lead position than they do for the last one.

So that's the next major thing. We've already factored that into our appraisal. I'm not going to tell you how much we've set aside for a claim. However, it's substantial. And we're hopeful that they will settle for *less* than substantial....

We think we'll be well rewarded in the next year and a half.

Hawkins: It's one of our most undervalued major holdings. But it's moving in the right direction. It's finally gotten on the right track. And we've bought more in recent days. A mid-to-high teens stock price doesn't make any sense.... [As I mentioned,] our appraisal based on current cash flows is approximately double the current stock price. And we're glad to have that operating cash flow at Marty Myers' disposal. We're also very, very optimistic that those operating cash flows will improve so dramatically in the next year-and-a-half that we should be able to look forward to an appraisal that is demonstrably higher.... So we've foregone some opportunity that we hope to capture very shortly....

DOES THE SIZE OF OUR WASTE STAKE WORRY US? I WISH WE HAD *50%* IN WASTE RIGHT NOW....

Do we have too much Waste? I wish we had *more*.

Shareholder: You guys have been concentrated for years and years. Are you worried about that with something like a Waste Management where it's kind of a high profile company?

Hawkins: I wish we had *50%* in Waste Management right now.... We're very happy with our investment there. There's not a collective group in this room that owns more of Longleaf Partners Funds than the ones standing up here trying to answer your questions. And we're very, very happy with our stake in Waste, our partnership with Maury and the huge uninterruptible cash flows that will emanate from just taking this waste stream to the right landfill.

We look forward with great opportunity to the closing of Fresh Kills in New York because we're surrounding that closure like a shotgun blast with our properties.

But we get paid for being *right*. Whether we have 1% or 15% in something is not the issue to us. It's whether we have cash flows and asset values that will ultimately give us an outcome substantially more than the price we pay....

If we own six companies of the calibre of Marriott and Waste Management, that's enough for us where we have a *dominant* and impenetrable market share position. When we owned Quaker, they had an 81% share with Gatorade. And Coke and Pepsi threw every single thing they could throw at that company for five years. But five years later, Quaker's share was still 81% — truly a really, really competitively entrenched thing in the eyes of the consumer. We like that kind of position.

We have the number one waste disposal company in the world with Waste Management. Their 305 landfills can't be replicated. In fact, Reg D, EPA and NIMBY groups make it almost impossible to get a new landfill built.

Our kind of risk/reward ratio....

Hawkins: It gets down to the business' competitive position, the partners you have running those businesses, and how attractively priced they are vis-a-vis their worth. And a lot of uncertainty and risk is going to give you a volatile price. But we have a *very* low price vis-a-vis our appraisal of Waste Management. That's how we look at it.

OUR RECENT *UNDER*PERFORMANCE IN REAL ESTATE COULD CHANGE VERY QUICKLY TO *OUT*PERFORMANCE.

So far, owning better real estate values has *cost* us.

Shareholder: The real estate industry obviously has not been doing well for the last couple years. But the Fund in particular has been underperforming its peer group. Would you comment on the mix in the Fund between real estate operating companies and REITs?

Fitzpatrick: Through a little over a year ago, the one thing we could say was that our relative performance was fantastic. And about a year ago, that changed. What has happened is that we have increasingly concentrated our positions in our most undervalued names. And they've been in medium-cap companies and C-corps — or what you refer to as operating companies or REOCs [real estate operating companies].

[As I mentioned earlier,] what has happened is that in recent months — really since the beginning of this year — the big cap, very large, multi-billion dollar REITs responded very dramatically to moderate inflows into the real estate mutual fund area. But they just simply never were as cheap. So we didn't want our capital in those names when we could own the same or better properties at much bigger discounts.

But we think we're one trade away from *out*performing....

Hawkins: Catellus [CDX/NYSE] is a wonderful example. We talked about it last year. The stock was at

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$12. And I understand that it's up $1 today at $17-and-a-fraction. We had an appraisal in the mid-$20s a year ago. That number could work north of $30 now....

But Catellus did languish, I mean, literally until [mid-June].... And we think we're one trade away from leapfrogging [our competitors]. Our largest positions are Catellus, Hilton, Forest City Enterprises and Prime Group.

Plus, we have 13Ds on two of those major positions. And I can assure you that there are others interested in these companies more so than we are. And one trade gets us up a big number.

At Catellus, much more than the price is right....

Fitzpatrick: Catellus owns one of, if not *the*, finest real estate portfolio in the country. Among its major assets are 313 fully entitled acres of land on the waterfront in downtown San Francisco and one of the largest remaining blocks of developable land in Silicon Valley. The Bay Area market has performed better than our wildest expectations. Catellus is a direct beneficiary with a *zero* cost land basis, very limited competing supply and strong demand driven by the technology boom literally centered in its back yard.

Catellus grew its FFO per share by 26% in 1999. We expect it to grow FFO by 15% this year. The company sells for 10 [now 12] times that number although its most valuable asset, its land, actually reduces its reported results.

Catellus will lock in future growth and continue to increase its value by developing its highly sought after real estate. And like many of our companies, Catellus is buying back its stock....

The rents they collect are real. We'll benefit sooner or later.

Fitzpatrick: As I alluded to earlier, the rally in REITs has been very narrowly focused. And it's either going to broaden or these larger companies (as they've just begun to do) are going to acquire other companies. And the ones that we own are obvious candidates. That's why we had to file 13Ds on some of the companies we own. So you can take that to the next logical step. It's a pretty good bet that the relative performance you refer to might change pretty soon.

But again, that's the market. We're focused on the companies. About 15% of our portfolio is located in the Bay Area. What we're really excited about there is that we're getting $85 a foot at Embarcedero Center on new leases. And our existing leases that are actually on the current rent rolls average about $35 a foot. So forget where the market's pricing our equity. That rent's *real*. And we will benefit sooner or later....

WE LIKE BRIERLEY AND ITS MANAGEMENT A LOT.
AND WE'RE PAYING ABOUT A THIRD OF APPRAISAL.

We're buying Brierley at about a third of our appraisal....

Shareholder: There have been some negative announcements with respect to Brierley Investments — such as writedowns expected from their major holdings [among other things].... Do we still own it? And do you still hold hope for it?

McDermott: Of course, we've seen all of those articles. And the short answer is that we like Brierley more than we did when we first bought it. As regards their writedowns, that was a *Bloomberg* story — and there was a very quick correction. That was just a misrepresentation of what had happened. They're not writing down any of those positions.

What they'd said was that they may have to report an accounting loss on a portion of the Air New Zealand stake that they sold. And it may be an accounting loss, but it was a very attractive value for us. This was a position that they've held over 10 years. And we're buying Brierley now at about a third of our appraisal — and an even lower percentage of their stated book value. So they can sell many of their assets [such that they generate] an accounting loss and still build value for us. Even better from our perspective is that they don't have to pay taxes on those sales.

So the current management team is doing a great job of realizing values at our appraisal....

The real credit rating *improved* at Brierley.

McDermott: The *Standard & Poors* downgrade was really a reflection of the situation of a year-and-a-half ago when the company had roughly twice the debt per share and was in real difficulty. *S&P* simply didn't downgrade 'em then. And there are a lot of things going on now with a new guy coming in at *S&P* in Australia. And the old guy had downgraded a number of companies before leaving....

But the real credit rating has *improved* at Brierley — which is demonstrated by the fact that they renegotiated their bank deal on very favorable terms.

And some of Brierley's assets aren't apparent....

McDermott: Then if you look at their other assets: James Hardy just announced a very strong year in the U.S. and is trading up nearly 30% in the last two weeks at A$4.62 — which is an all-time high. Singapore Air has bought a piece of Air New Zealand. And Thistle Hotels remains at a discount to its asset value, while it holds a bunch of hotels in London that have stronger real estate values than even its cash flows indicate.

Shareholder: Yes. And I understand that they're upgrading them a lot, too.

McDermott: Yes, they are. And of course, [the impact of] those renovations hasn't yet flowed through to its operating cash flows as we'd like to see. On the other hand, the London real estate market has tripled.

Also, the company has bought back shares. And we're real comfortable with management. We like it a lot.

INCENTIVE STOCK OPTIONS MAY HAVE ZERO COST
OR THEY MAY HAVE HUGE ECONOMIC IMPACT....

The diligent analyst should factor in the cost of options.

Shareholder: How do you folks factor in the cost of stock options for compensation in your appraisals?

Hawkins: As you know, the cost of stock options isn't run through the P&L [profit and loss statement — the income statement]. And thus, an adjustment should be made by the diligent analyst for that cost.

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If a stock sells for substantially more than it's worth and that company gives an employee an option at a price greater than the value of the business, then the cost should be zero. If a stock sells for half of appraisal, then you're transferring *huge* economic value to the recipient of that option. And, therefore, that would be a very big economic cost that you should expense....

Microsoft has issued probably more stock options than any company in history. Most of those stock options were issued above what Microsoft was worth — in our view. That's debatable today. So now it becomes a consideration that most analysts of Microsoft should start taking a close look at. But that's an excellent question.

In our appraisals, we assume every option is exercised.

Cates: In our appraisals, the denominator uses the shares outstanding. But then we go back to the footnotes. And there you can tally up all the options. So we fully dilute our value, besides just the P&L adjustment that Mason was talking about, assuming every single one of those options gets exercised. We include them even if they're not yet exercisable — or even if officers leave and they get forfeited or whatever. So we fully believe in factoring that in.

Our 13D filings give us legal flexibility....

Shareholder: Last year, you filed some 13Ds. Is this a change in strategy for Southeastern from being a long-term supportive passive shareholder?

Hawkins: First, we file 13Ds where we feel we can assist management in either building value or getting it recognized. But in nearly all cases, we've filed 13Ds because third parties/other companies have approached us either about our position that we own in a particular company — in the sense that they'd like to buy it — or they've approached us about possibly buying the whole company.

We file our 13Ds so that we can have the legal flexibility as permitted by the SEC to enter into very open and frank discussions with these third parties about the value realization or creation. It also gives us the flexibility to have very open and frank discussions with the Board.... It's a legal nuance between the 13D and the 13G.

And Charles Reeves and Andy McCarroll — our two in-house counsel — are very conservative people. And they're paid to be that way. So we follow their advice.

We filed 13Ds on Catellus, Prime Group, Aetna, Vicorp, Pioneer Group, Gulf Canada and Wisconsin Central — all in the last year. And I think if we were at liberty to share all of our thoughts and some of our knowledge with you, you'd conclude that we are being good stewards of your capital and that this new flexibility works to all of our benefit.

ALSO UNUSUAL, FUNDS ARE EQUALLY ATTRACTIVE.
HOWEVER, INTERNATIONAL'S POTENTIAL IS HUGE.

It's unusual for our funds to be roughly equally attractive.

Shareholder: Do you happen to know how the quarter billion dollars of Longleaf employees' money that is in the Longleaf Funds is distributed between the funds?

Hawkins: It's pretty equal — because our P-to-Vs [Price-to-Value ratios] are very comparable across the four funds. That's not always been the case. When we started Longleaf International, the Longleaf Partners Fund was a pretty expensive fund. And we were finding, as Andrew said, a plethora of qualifiers that happened to be offshore. And we thought we had a sufficient number of qualifiers — say, 16+ or thereabouts — to start a fund and opportunistically to take advantage of it with our money.

It's unusual to have them all as statistically attractive as they seem to be today versus times past when we had the larger companies more expensively priced vis-a-vis, say, Real Estate or Small-Cap or International.

So right now, we've got money pretty equally divided amongst the four funds. We don't sell and move the money around, but we're fortunate to have a lot of cash flow. And we're always looking at the most attractive P-to-V when that cash flow rolls in — whether it be our retirement plan, our foundation or our personal assets. So your partners at Southeastern and Longleaf are buying aggressively into the mutual funds — across all four funds — because they're equally attractive....

We're still putting our money where our mouth is.

Shareholder: Andrew, if you came back to your office and learned that $30 million of cash had just come in, where would you invest it?

McDermott: That's a great question because we were talking about that on the plane. That is going to happen, literally, on July 5th. And the aggregate price-to-value of the Fund is 53% right now. And of the 20 names we own, there are no more than five that are not new money buys. So if you were to give us $30 million of new cash, we would pretty much replicate the existing fund. We're able to invest about 75% of what we get in today in what we already have. And then we have a couple of new names.

If you mean geographically, those names are largely in the U.K., Canada, and Singapore (there's one large position we have there) — as opposed to, say, Japan, which is where we were heavily weighted in the beginning. However, it's fairly broad-based, and it's pretty much what you see in the quarter-end portfolio. Most of our holdings are cheap enough to buy.

Hawkins: Longleaf International, as you know, is our newest fund. It's $300 million in size. We've been receiving a few dollars lately, but it's been pretty static. It's the fund — and Andrew might take issue with me here — that ought to be up 50% per year for the next five years because it's small and manageable. It's very easy to manage a small pool compared to one that's up around $15 billion....

THE SCRIPT FOR MOST E-COS IS ALREADY WRITTEN.
AND THE ENDING IS EXCITING, BUT IT'S NOT PRETTY.

Here's the script for most e-companies....

Shareholder: Mr. Hawkins, in a recent speech at the University of Florida, you responded to a question about whether graduating MBAs today should be concerned about

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going to e-companies. Would you elaborate on that?

Hawkins: I didn't know I would have to account for that. I think I cautioned them that they needed to be careful about the promises that were being made — promises that clearly involved stock options in most cases and not very significant cash rewards....

I made myself some notes because I knew we might have a question about e-companies. I think the script for many e-companies has been written. And it goes like this:

Lockup periods (holding periods for insiders) expire. Insiders rush to sell. Stock options thus stay underwater. Employees demand much higher *cash* compensation to compensate for their worthless stock options. The companies are burning through their IPO cash and, finally, *do* burn through their IPO cash. The companies fail. And finally, the employees have to return to companies that have cash and staying power.

Not *every* e-company is going to fail. Only 90% or so....

Hawkins: That's not to say that every e-company is going to fail — although we were recently with one leading retailer who avows that *every* e-company that retails goods and services is going to fail. Our number was 90% — his was 100%. And the reason is that it would cost $12 to $15 to pick the product off the shelf, put it in a package and get FedEx or UPS to take it to the buyer. And when you do the math, that implies you've got to have a very high ticket order in order to have the economics work.

Incidentally, we had a very, very bright individual who was the chairman and CEO of MediaOne in our shop who said that, obviously, Wal-Mart's economics are far superior to some of those proposals and confirmed, once again, what we hear anecdotally all over the business lot. So I think our advice on that score is pretty sound.

I think our time has come.

Hawkins: Thank you for joining us and being supportive of a value manager who was a member of a group that was quite disdained. I think our time's come.... It was *incredible* how with a business plan, a recently round up board of directors and an announced intention to do something.com, you could attract half a billion dollars — or even $1 billion — for an idea. That's one of the things that makes America great. But we've talked to shareholders who've lost 70-80% speculating — even though they did it with minor amounts of their capital.

That's not to say that the internet and e-commerce world aren't wonderful for our economy and wonderful for the consumer and that it won't help our productivity. However, owning it is another matter. Having your capital at risk in businesses where you don't know whether or not they'll survive or whether they'll get enough revenues or operating profit margins to produce a return for the owner, that's a whole other subject....

Once burned, twice educated....

Hawkins: Two or three months ago, C.T. observed, "Every generation must learn the definition of risk." And the way you really teach 'em about risk is via margin calls. For example, 1973 and 1974 taught a whole generation about risk. Those people that made lots of money in '69 in Telex, Memorex and those "-ologies" and "-onicses" that were the speculation *du jour* and everybody kind of forgot about that — until early 2000.

FLEMING WAS BASICALLY JUST A PIECE OF JUNK — BAD BUSINESS, BAD GUYS, OVERLEVERAGED, ETC.

OID: One of the ideas you talked about that sounded particularly intriguing was Fleming [FLM/NYSE].

Staley Cates: We think it is.

OID: It sounds like it's in the middle of a truly remarkable transformation.

Cates: I can tell that you've already got it. We think it's ironic that we own it because we've followed it forever and disliked it for most of that time.

OID: There's been very little to like...

Cates: That's right. It's been an overleveraged piece of junk. As you know, Fleming is a food wholesaler. And the reward for being a good food wholesaler was often the account taking the business back and self-distributing. So they've had a shrinking pool of clients because as some of their grocery chain clients got bigger, they'd self-distribute more and more. So it's been a pretty ugly business.

OID: It sounds very similar to Berkshire's business back when Warren Buffett first arrived on the scene there — a commodity business with relatively strong, price-sensitive clients.

Cates: Yeah, exactly. There are razor-thin margins everywhere on both sides. And even if you're doing a terrific job for a local independent and Albertson's comes in and buys that local independent, overnight they'll start self-distributing anyway.

We realized their core business was shrinking and unattractive industry-wide — that there was no pricing power to begin with and that as more people took distribution in house, the middleman would get squeezed harder and harder. Therefore, we figured that the business would shrink a few percent every year. The best case was that Supervalu — the other big player — and Fleming would take enough share to keep their results flat.

OID: And that's your best-case scenario.

Cates: Exactly. It's such a cruddy business that staying in place was its best hope. And if that wasn't bad enough, let's just say we weren't exactly thrilled with the prior management either — as you can see in *Value Line*.

OID: Yeah. It looks like they never managed to earn a 1% net profit margin as far back as the eye can see — or a double-digit return on capital.

Cates: Plus, they apparently engaged in some wrongdoing that led to them being sued by former clients and ultimately losing a lawsuit based on those actions.

Furthermore, they were overleveraged. It was

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basically just a piece of junk — way overleveraged, questionable management, bad business and lawsuits.

OID: Picky, picky, picky.

Cates: So based on knowing the company, during most of the time that we've known it, we would have been more inclined to *short* it than we were to buy it. If you'd told us a couple of years ago that we'd buy Fleming, we'd have laughed in your face.

OID: No problem. We can take it. That's what our subscribers do when we use the term "deadline"...

Cates: But they did have hard assets. They had warehouses. Plus, they had a lot of operating cash flow. So even if it were to stay flat, it was worth something.

And it was kind of cheap. As you can see, the stock went from the $30s down to $10 or something.

OID: Yeah. It was $30 as recently as mid-1995 — and $40+ as recently as early 1991. And on the low side, it got down near $7 last year.

Cates: Sounds right. So it began to look cheap. But we still had no interest in it for all the reasons I described.

BUT THEN A STRANGE THING HAPPENED —
A FABULOUS MANAGER TOOK THE REINS.

Cates: Then, we just woke up one day and, *voila*, there was the catalyst for our interest — Mark Hansen. And that's what did it. Here was a guy who had success in a very entrepreneurial role at PETsMART. Then he went over to Wal-Mart and had a very big job there. So the first thing we said to ourselves before we'd done our homework on Mark was, "Even if Wal-Mart kicked him out, why would he go to a failing hunk of crap like this?"

OID: The same reason people go into publishing?

Cates: He had a resume such that he could have picked from a lot of spots. So we found it intriguing, first of all, that he'd go to Fleming.

Second, in the course of our research, we learned that he wasn't run off. They loved him and hated to see him go. It turns out that he left because of a chemistry issue with someone Wal-Mart subsequently fired — in part because he ran off Mark and a couple of other really good people. So we found *that* intriguing.

Well, he cleaned out Fleming's senior management. Out of the top 13 guys, I think either 11 or 12 are new. So here's a brand new team. And that begged the question in our minds, "What exactly is it that they see here?"

OID: Or think they see?

Cates: Also, although Fleming's prior management was bad, they knew that wholesale was a cruddy business. So they'd been reallocating every penny of cash flow from wholesale into retail operations. They own a number of different grocery chains — including Sentry, Baker's, Rainbow and Abco. These were all chains that were strong in a particular city. They might have eight stores located in that city and everybody knew that chain. And each was a leader. But outside of that city, nobody had ever heard of it. So that's how they'd been redeploying their cash flow.

OID: Into dominant, local grocery stores.

Cates: Yeah. They had an in with those people because they often supplied 'em. If there was a local guy unaffiliated with the giants, chances are that they're buying their groceries from Fleming or Supervalu. And Supervalu has undertaken the same strategy. In effect, they've both been going up the food chain, forgive the pun. They'd know the guys having already supplied 'em, they'd know the guts of the operations — and they wanted to be in retailing because of the better returns and better margins and because there's a brand there, etc.

OID: Everything's relative.

Cates: Plus it's a way to ensure that Fleming and Supervalu keep the wholesale contract. Therefore, the old management had begun buying these chains.

OID: On the other hand, going from wholesaling to retailing sounds like it's going from one bad business to one that's not much better.

Cates: It's tougher. That's right. So that strategy, although it made sense, didn't exactly get us excited — both because of what you said and, importantly, because they were running 'em very poorly. The comps were bad, the margins were bad, etc. It would have been one thing if they were reallocating their cash flow into some kind of fantastic retail franchise that we were excited about, but their retail numbers were also very poor. That's still another reason why we weren't excited.

OID: We're convinced. But the reward or penalty in retail for being good or bad is very dramatic. As Buffett says, there are some franchises you can manage badly for a long time and they can take a licking and keep on ticking and others that are very fragile and unforgiving — like retail.

Cates: That's what was happening. But Mark's background at Wal-Mart and PETsMART was in retail. And everybody he hired was pretty much retail-oriented. So their idea when they began was just to keep wholesale flat. And they concluded that retail had been run badly — because they'd had wholesalers running it. And they knew that it was two different worlds. The wholesale mindset wasn't going to work. For example, the old management wouldn't pay up for good retail locations because that wasn't the same factor on the wholesale side. Plus, they didn't know how to manage the people on the retail side. And I could go on and on.

But they concluded that if they could just get the retail business back up to average returns for a retailer and average comparable store sales that they could create huge value at Fleming. And then, if you add to that the value of the wholesale operation assuming it stays flat, they realized that they could get a value in the $20s. And again, the stock was in the single digits.

So that's basically why Mark came.

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AN INDUSTRY LEFT FOR DEAD BEGINS TO GROW
— AND NEW MGM'T TAKES SWIFT, SMART ACTION.

Cates: However, a whole bunch of good stuff happened after that and made us even more excited and led us to dig deeper. First, the wholesale business has turned out to be better than expected. A couple of grocery store formats have taken off. One is the supercenter concept. Wal-Mart started it, but Target and K mart are doing it, too. And now Fleming and Supervalu are the biggest suppliers to those two players.

OID: Interesting.

Cates: We think so. That's actually become an interesting growth engine in their wholesale area. And that's intriguing because everybody is switching over in order to be able to compete with Wal-Mart. Therefore, in the first quarter, for the first time in more than four years, they began to show growth on the wholesale side. And they just reported the results for their second quarter. And that business' net sales grew 6% — which just amazes me.

OID: Does Fleming supply either CostCo or Wal-Mart?

Cates: Unfortunately not. Both Wal-Mart and Costco do everything in house. Target and K mart are the ones who say, "We're traditionally merchandisers. We'll let someone else distribute the food."

And the other interesting thing that's happened is that counter to this trend of these bigger and bigger stores — these huge supercenters with their expanding footprints — you're now seeing convenience stores expanding to 15-20,000 square feet and beginning to do OK in groceries. In part, that's because all of these 25,000 square foot retail stores have now migrated up to 80,000 square feet. And a lot of people are sick of that. They don't want to take the time to go into an 80,000 square foot store and wait in some huge line where they need roller skates just to get to the other end of the store. They'd rather buy their milk by going in and out real quick even if it means they have to pay a little more. That's, of course, why they're called "convenience stores".

So that channel and other alternative formats like it are providing growth.

OID: Gotcha.

Cates: The third thing they're focused on in wholesale that's really been interesting is the E-commerce players. The folks at Fleming conclude — and we agree — that one way or another, within five or 10 years, a meaningful number of consumers will use online buying for a significant amount of their purchases of food. And whatever their public relations and advertising suggest, these companies require somebody to serve that function. Believe me when I tell you they need a real distributor. And Fleming and Supervalu are uniquely well positioned to serve those companies.

OID: Very interesting.

Cates: We think so — especially when you consider that one of the reasons why these guys thrived during the 1970s and 1980s is that they served independent grocers back before the big guys grew and consolidated and the independents shrank away. These players are, in effect, the new class of independents.

And while nobody knows who the winners will be, whoever wins is going to need someone to do fulfillment. The business of the ultimate online winners is going to be taking electronic orders and the logistics of home delivery. But that has nothing to do with getting the stuff from Procter & Gamble to the warehouse. That's where Fleming and Supervalu still add value.

OID: Unless the online winners are Wal-Mart and Costco, of course.

Cates: That's right. The online players could never build that up. In fact, it would be stupid to even try.

OID: Speaking of online, Value Line mentions Visionet — a "business-to-business solution ... that allows vendors and retailers to do business on the Web."

Cates: It seems like everybody's doing an exchange. Pick your industry. Everybody's got a web exchange. That's Fleming's version. They've rolled it into a separate company — Ceres.com. It's based in Atlanta. And we think they can make a good case for it (at least they have a better chance than most companies that we see) of making this web exchange work because everybody wants to do their purchasing and have their suppliers online.

But these guys have actually had EDI (electronic data interchange) with their customers for several years anyway. And it does make sense for them — you can see where a website would be kind of logical. And they already have some track record in their effort to service their independent clients.

OID: You didn't bother to mention it.

Cates: Because I still give it a zero. It has the potential to be an IPO. It would come under Ceres.com. But it has its own distinct management. It's totally out from under Fleming right now — because they want to bring in other industry players, etc. But we're skeptics until we see the revenues.

OID: Is anyone else doing anything like it?

Cates: I've read about one other firm doing something similar — and I assume Supervalu has its own. But again, we don't assign it any value at this point.

OID: Then all is forgiven.

Cates: Visionet aside, let me tell you a quick anecdote that carried more than a little meaning for us. We'd visited and valued Richfood Holdings — which sold out to Supervalu. And it was like a little Fleming with a very similar mix of wholesale to retail. So we valued it the same way that we valued Fleming. Well, lo and behold, the price that Supervalu paid for Richfood was pretty much along the lines of our valuation.

But one of the interesting things was that when we visited Richfood, they told us, "Fleming will never work because it has all of these little warehouses that only do $350 million of volume each. And until you get up to $600 million of volume in any given warehouse, you're not going

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to get the efficiencies that represent your entire value-added proposition to the retailer. Therefore, you're not going to be low cost enough for an independent to justify the fee you want him to pay you. That's the structural flaw in Fleming."

Well, interestingly, it only took Hansen about one year to shut down something like a third of Fleming's warehouses (I believe it was 11 or 12 of 35 or thereabouts). And sure enough, Fleming has wound up at that critical threshold of around $600 million per warehouse.

OID: So Hansen is nobody's fool.

Cates: Definitely not. The reason why that's more easily said than done is that the customer likes it the way it is. It may be better for you to consolidate, but your customer doesn't like being further from the nearest warehouse. So it's not an easy thing to do. Yet Hansen managed to do it in only one year. That was great to see — because that was one competitor's only knock on these guys being competitive in this business.

OID: Yeah. Value Line says Fleming is lowering costs — that it's already identified $50 million per year of savings and expects to reduce costs by $100 million per year by the end of 2000.

Cates: That probably just goes back to the customer. And this is very Wal-Mart-ish — which is not surprising coming from Mark. But they even say that they're not trying to grow their gross margins. They're healthy. And if they're able to save money, they're going to pass it on and give customers a better value proposition.

Where they hope to see the big payoff is in sales. So their recent sales gains may have something to do with their cost savings.

OID: A la Wal-Mart.

Cates: Exactly. And in any case, Hansen's come in and taken a business that was left for dead, patched the holes in its bucket to keep it from shrinking and is actually *growing* it.

THEIR EXISTING ASSETS AREN'T CHOPPED LIVER —
AND ITS FUTURE LOOKS SO BRIGHT WE NEED SHADES.

Cates: Then, on the retail side, Fleming's assets are actually worth decent amounts of money. In private deals, local chains go for big prices still. Whatever the reason, some people want to buy the dominant grocers. And Fleming recognized that and decided — wisely in our view — to take the money and run. Therefore, they're taking good money out of their miscellaneous retail assets and focusing their energies on one food concept — which is called Food 4 Less.

Food 4 Less is neat for a lot of reasons. It's almost like a Target in that it's a low-price format, but it brings in affluent shoppers. Food 4 Less sticks the merchandise out there in bulk. They don't advertise at all. However, it's good quality stuff. And the traffic counts are great and the margins are huge because it's a low-cost operation.

Plus, you don't really need the economies of scale because there's no advertising. Generally, grocers require about six stores in any given market before it makes sense. Here, they can have only one or two and be fine — because advertising isn't part of the model anyway.

OID: Sounds neat, all right.

Cates: And most important to Mark, who's the resident expert on Wal-Mart, is that in all kinds of tests and all kinds of ways that he's looked at it, these are by far the most Wal-Mart-resistant stores.

OID: That would be an extraordinary virtue.

Cates: Exactly. That is rare. Mark knows as well as anybody exactly how Wal-Mart attacks. So he's properly paranoid of 'em. And he likes how their format stacks up.

OID: Like Intel Chairman Andy Grove's book's title — Only the Paranoid Survive. That gives us hope...

Cates: I'm with you there. However, I think that just about *any* value manager would say that these days.

I'm sure almost everyone in the grocery store industry has the same nightmare — and that is Wal-Mart coming into their neighborhood.

OID: And not just the grocery store industry...

Cates: That's right. But many other retailers are *already* living the nightmare. Of course, the same thing applies to Costco. So this one model has really held up.

In Fleming's Food 4 Less retail area, the margins are great, the returns on capital are *huge* and it plays to their strength of distribution — being able to pick up the stuff and get it efficiently onto the shelf. That's their wholesale backbone. So it just makes sense.

One of the things that's neat about the stores is that because they do what you might call straight-in supply — that is, supply directly on a bulk basis into the store — they can have a pretty small back room. So the store feels bigger than it is. For example, the stores might have only 10,000 square feet allocated to their back room where normally it might be closer to 20,000 square feet. So the store feels really big, although in terms of real estate, it's not.

OID: Because of the efficiency Food 4 Less gains because its parent is a food wholesaler/distributor.

Cates: Right. They're building on that skill — and, in effect, taking the merchandise straight from P&G to the dock and straight to the shelf. I don't know if you've been to a low-end grocery retailer or not, but basically they have the entire carton out there rather than placing each item neatly on the shelf.

OID: Isn't that what Costco does — and Ralph's?

Cates: Yeah. It's similar to Costco. It's like you see at the discount clubs.

OID: And they probably don't dust very often — like Home Depot. You need to wash your hands after you've been there. But the prices are so good that nobody seems to mind.

Cates: Exactly. That's the same deal. They just stick the box out there. And I hope they have the same success

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as Home Depot.

OID: Might we all.

Cates: So it's a neat concept. Hansen is betting a lot on it. And so far, it's making tons of money. Therefore, Hansen said he's selling all of his other retail. And he's said that he's not only going to keep Food 4 Less, but that he's going to grow it like crazy. So we believe you'll see it become a much larger business.

They're putting a lot of money and effort behind it. It's going to constitute their entire retail effort. In fact, that's where all of their discretionary capital will go.

HOWEVER CONSERVATIVE THE ASSUMPTIONS,
FLEMING'S STOCK IS DIRT CHEAP TODAY.

OID: You've said Fleming trades at a steep discount?

Cates: Definitely. And we value it two different ways. First of all, we think that they'll get 40% of revenues on these local retail grocers that they plan to divest. That's equivalent to an EBITDA multiple of about 10 times.

OID: Ten times?!

Cates: If you just see the figure 10 times EBITDA, that seems like a nosebleed-level valuation. But that's with depressed EBITDA margins. They're currently around 4%, whereas they should be 7%.

OID: So you're talking about less than 6 times normalized EBITDA.

Cates: That's right. And there's been a ton of comparable sales at 8-9 times EBITDA when they've been earning healthy, mature margins of 6-7%.

OID: Which implies prices of 60-70% of revenues.

Cates: Exactly. I think 60% is more typical, but there are comps for the really high-end stuff at 75% and even 80% of revenue. But that's rare. It's not something that we'd bank on.

And the retail that they're planning on divesting has revenues of about $2-1/2 billion...

OID: Out of total revenues of about $15 billion.

Cates: That's right. So we're estimating proceeds on their to-be-divested retail operations of about $1 billion. And again, they've said that they're going to be selling it. It's on the tape. We should see it any week now. Everybody knows that all of their retail operations excluding Food 4 Less are up for sale.

Then, we assign Fleming's Food 4 Less operation a multiple of 8 times operating cash flow or EBITDA — which is 60% of revenues. And when we do that, we arrive at a value for it of $400 million.

OID: And implies Food 4 Less has EBITDA margins of about 7-1/2%.

Cates: Yep, which, as you know, is very healthy. And those aren't pie-in-the-sky figures. They're *already* great. And so are their returns on capital — more than 20% after tax unleveraged.

OID: Wow.

Cates: Yeah. Usually, we hate the idea of anybody putting any capital into any kind of store.

OID: But you can live with 20%.

Cates: You've got it.

OID: Who would believe that this former dog (with apologies in advance to canines everywhere) would be able to invest capital earning a 20% after-tax return?

Cates: *Nobody*. That's never happened. And listen to these figures: Food 4 Less' sales are a third higher than the industry average — because 80% of its stores' 50,000+ square feet is selling space with minimal back room. Prices to the consumer are very low — partly because of the very low service component and partly because of this flow-through distribution and direct servicing by Fleming's wholesale arm that I described earlier.

OID: But is it possible that Food 4 Less' earnings are overstated based on including some or all of the distribution margin in the retail figures?

Cates: If so, you'd see a margin decline on the wholesale side. And that hasn't been the case.

OID: Good answer.

Cates: The average customer at Food 4 Less has a $55,000 salary and owns their own home and a PC. So they have a great customer demographic even though it's a low-cost store. They carry 10-11,000 SKUs — which is the best of the 30-35,000 SKUs that a Wal-Mart Super Center would have.

Incidentally, it only costs Fleming $6 million to put up a Foods 4 Less store — including its inventory. And they're over two thirds lease financed. They only put up $1.8 million per store. And given that sales per store are running about $25 million per year, you can do the math on the returns. So even if you disregard the fact they only have to put up $1.8 million net of lease financing, you can see that they're earning very healthy returns indeed. In effect, they're investing capital at 4 times EBITDA.

OID: That sounds healthy indeed, all right.

Cates: So we think that the Food 4 Less stores are clearly worth 60% of revenues.

OID: You'll get no argument here.

Cates: And each one that they put up costs them less than *25%* of revenues. So it's got great math. And because the Food 4 Less stores have no displays, their ongoing cap-ex requirements [in other words, their maintenance capital expenditures] should be very low, too.

OID: We're convinced, already.

Cates: So, finally, what you're left with is Fleming's core wholesale business. We have a value on it of between $1.5 and $1.7 billion. That's assuming 5 times EBITDA — which is the same as slightly over 6 times free EBITDA.

OID: Free EBITDA?

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Cates: EBITDA less required cap-ex. To us, that's always more meaningful. We use EBITDA multiples in our comparable sales. But if we're actually discounting back cash flows, all that matters is the *free* EBITDA.

We provide a range of value because when they divest retail operations accounting for $2-1/2 billion of sales, we don't know how much of it they'll get to keep servicing and how much will be sold to companies like Albertson's that self-distribute. However, the $1-1/2 billion is, we feel, truly a worst case scenario. It essentially assumes that Fleming loses every single dollar of that business.

Also, it assumes no growth. But as I've said, thanks in part to Mark Hansen, Fleming's wholesale business has begun to grow.

OID: So your valuation is probably conservative.

Cates: That's certainly how it looks to us. Finally, Fleming has about $250 million of other investments. And those are mainly equity sliver investments in grocery chains — in many cases, investments that were made in order to help a customer grow and thereby create more wholesale business for Fleming. As you may suspect, that led to a lot of not-so-great investments. And they've written down tons of 'em. However, we're confident that the $250 million is a real number. So that's basically book value — and it's finally good.

Then on the liability side, Fleming has debt and leases of about $1.65 billion. So we take that out. And we budget something for ongoing litigation — which is anyone's guess. Take out what you think is fair. However, we don't think it's remotely enough to torpedo this value.

And when we do that, we come up with a value of something in the neighborhood of $1-1/2 billion. So given Fleming's 42 million shares outstanding, we're talking about a value of something around $35.

OID: Not too shabby on a $15 stock.

Cates: We don't think so. And I think we paid $11±. Another way to look at Fleming's valuation is to look at the Wall Street consensus estimates — which are between $1.40 and $1.50 depending on which analyst you choose.

However, Fleming's depreciation and amortization is $160 million. And its required capital expenditures — the capital expenditure outlays necessary to avoid starving the business — are only around $100 million. Therefore, the spending that they do over and above that $100 million figure is for new Food 4 Less stores.

So there's $60 million of excess depreciation and amortization. And that's nearly another $1.50 per share.

OID: Gotcha.

Cates: So Fleming has $1.50 of reported earnings and $1.50 of excess depreciation and amortization. So it has $3.00 of real cash earnings.

And what are they doing with that $3 of free cash? Well, as we've discussed, it's going into Food 4 Less. So when we put what we consider to be a very modest P/E of 11 or 12 on that $3.00 of real cash earnings, we arrive at that same $35± appraisal.

FOOD 4 LESS GIVES FLEMING LOTS OF UPSIDE — AND WE DON'T BELIEVE THERE IS MUCH DOWNSIDE.

OID: What are Food 4 Less' revenues currently?

Cates: At its current run rate, Food 4 Less has revenues of about $650 million from a total of 26 stores. So there's your $25 million per store.

OID: How rapidly are they growing?

Cates: They're growing like *crazy*. Sales are basically doubling every year. And that's not in our math. When we value this thing, we value it as it stands today — what they'd get for the chain were they to sell it as is. We don't give them any credit for all of that reinvested capital. Of course, that would goose the value.

OID: As you should know, that's customary in investment newsletter valuation...

Cates: You can do it either way. We just think it's more conservative not to give 'em credit for the high return on capital spending and growth potential until it actually comes through.

OID: Numbers aside, Food 4 Less has the potential to make Fleming what some might call a growth stock.

Cates: Yeah. If this Food 4 Less thing does work out, it does change the nature of the company entirely. But again, that's not the way we appraise companies or invest.

OID: Never go into investment publishing.

[Editor's note: In its second quarter press release, Fleming said it plans to open 100 additional Food 4 Less stores over the next three years.]

OID: On the other hand, if Food 4 Less isn't on the radar screen of Wal-Mart or Costco already, you know that they will be soon enough.

Cates: It'll take a long time — because right now, they're tiny.

OID: If Food 4 Less' concept is good, why wouldn't either or both do whatever it takes to squash their efforts before they become a real competitive threat — their tremendous efficiency?

Cates: No. It's even better than that. It's real estate. Think about a 50,000 square foot Food 4 Less store compared to a Wal-Mart supercenter. Wal-Mart is just going to put up supercenters. And that's for reasons having to do with its own financial dynamics.

OID: They're not going to change that for Food 4 Less.

Cates: No way. And those supercenters are huge. They can't go sticking supercenters in the same places that Food 4 Less will put its stores. The outskirts of town is about as urban location-wise as they get — there and small towns. I've been to a bunch of their supercenters in small towns around here. They're just mind boggling — and they're doing real well. But Food 4 Less won't be where Wal-Mart can fight 'em geographically.

OID: Wal-Mart can't locate in the same places.

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Cates: You've got it. They can't locate pads that big in those places. So that's one reason.

Also, this is such a peanut. We're talking about a $650 million enterprise. It would have to grow like *crazy* for at least five years to hit Wal-Mart's radar. It's not worth them squinting and even contemplating dropping in a badly located supercenter just to hurt Food 4 Less.

OID: So even if somebody is going to squelch 'em, they won't do it right away.

Cates: That's right.

OID: Who, if anyone, would have the incentive to respond that way if it's not Wal-Mart or Costco?

Cates: Their competition is just going to be whoever's strong in each particular city.

OID: So really nobody views that niche as their turf — aside from local players?

Cates: That's right.

OID: If so, it sounds like they've found a great niche.

Cates: I think so. And again, Mark's team consists of people with backgrounds in retail, not wholesale. So they're not going to put a *penny* in wholesale. They look at wholesale and they say, "We think we can grow it a little. And we'd be happy to do that. But we're going to do that with sweat. We're not going to put a penny into it."

Yet most of the world still views Fleming as a complete hum drum, piece of garbage, overleveraged wholesaler.

LIES, DAMN LIES AND INTEREST COVERAGE —
FLEMING'S MORE SOLID FINANCIALLY THAN IT LOOKS.

OID: That was my next question. You mentioned that the company's been overleveraged...

Cates: Yes and no. Although the debt is a big figure, one neat thing is that right before Mark got there, in the summer of 1998 (this is a better lucky than smart story) they locked in all that debt right before things got ugly. So most of their $1.65 billion of debt and capitalized leases — say $1.3 billion — is funded long-term debt. They don't have banks in their face. The structure of the debt is fantastic. Only about $300 million is short-term.

OID: On the other hand, Value Line only gives 'em a C+ for financial strength — and says that they only cover their interest expense 1.4 times.

Cates: Our math is a little different — because the company currently has about $350 million of free EBITDA. And that $350 million of EBITDA is servicing $1.3 billion worth of debt. To us, that's fine. That looks like coverage of about 3 times to us. And that's *free* EBITDA, not EBITDA. So EBITDA coverage is even better.

Plus, when they sell the retail, they'll be down to hardly any debt at all — only about $300 million. And then they'll have $250 million of free EBITDA to service their $300 million of debt. So they'll have interest coverage of about 9 times. The sale of these retail operations is going to completely wipe out any balance sheet concerns.

And we don't think it's a problem even before that given that it's already 3 times. To us, that's fine — given that the debt is mostly locked in and long term.

OID: What about the risk of Fleming alienating its wholesale customers by competing with 'em?

Cates: Good question. But their net retail is actually dropping like a rock. Even with ramping up Food 4 Less, by selling their conventional stores, they're reducing their net retail exposure.

OID: So that even if they're alienating some retailers, more retailers will be forgiving 'em...

Cates: Exactly. Also, this is such a defined format — with low cost and low service — that it's generally not going to compete with the dominant local retailers. I'm not saying that there won't be any pushback, but I don't think it'll be that big a deal.

OID: They certainly won't be any less popular than Wal-Mart is with retailers generally.

Cates: Yeah, exactly. And hopefully they'll do as well.

OID: Where's the moat? Why can't anyone just copy their Food 4 Less concept — especially Supervalu?

Cates: Supervalu is doing something very similar to Food 4 Less already. They're absolutely trying to do the same thing. But there's plenty of room for both of 'em. But aside from Supervalu, the only competition they're likely to get is from other retailers — because there's no other big wholesale player who's going to try this. And Hansen maintains that then it boils down to their expertise — and their format boils down to being a great wholesaler even more than being a great grocer.

OID: If Fleming does turn out to be a mistake, what do you think the reason is likely to be?

Cates: Good question. They'd probably have to not get their retail stores sold and end up choking on those. Plus, their wholesale business would have to get uglier.

OID: But you don't think that's likely.

Cates: Not at all. And when we only put a P/E of 11 or 12 on the whole thing, I think we've accounted for that. And our ace in the hole is Mark Hansen. We know that if he sees Food 4 Less' returns start to flag, he's not going to

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throw more money at it. That gets back to the importance of really liking your partner — which we very much do here.

OID: I got that impression somehow.

Cates: And by the way, speaking of our partners, the insider buying at Fleming has been *gigantic*. It's one of the biggest insider buying binges that we've ever seen.

OID: It really is. Value Line reports 10 instances of insider buying over the prior 9 months.

Cates: Yeah. And it's been real numbers. Fleming is truly a fascinating story.

PUBLIC RELATIONS CLOUDS HANG OVER TRICON,
BUT INSIDERS FIND SHARES FINGER LICKIN' GOOD.

OID: It seems there's also been lots of insider buying at Tricon Global [YUM/NYSE].

Cates: Insider buying's been *huge*. Jamie Dimon, formerly at Citigroup, now at Bank One, is on Tricon Global's Board. Well, he bought $15 million worth of Tricon Global's stock. Another director, Ken Langone — one of Home Depot's cofounders — bought between $5 and $10 million of Tricon's stock. And officers at Tricon have done the same. It's been heavy.

OID: I see that there's even been share buybacks.

Cates: Yeah. They bought back a *ton* of stock in the first quarter. And they'll be ramping share repurchases back up in a little while. Tricon Global is a big position of ours in Longleaf Partners Fund.

OID: And presumably it's a bargain?

Cates: It's *ridiculously* cheap. And the reason why is that the company is operating under two or three clouds. However, they're really all just public relations clouds. Their financial impact is actually quite negligible.

Interestingly, all of these directors bought their stock up around $50.

OID: Or nearly double the current stock price.

Cates: And I think part of what got it going may have been Tiger Fund. Tiger was a big owner at one point. And Tricon got up to around $75...

OID: Actually $73-7/8, but who's counting.

Cates: I think one reason why it dropped so fast, which then fed on itself, was the liquidation of Tiger's shares. We watched it go from $75 to $50 and watched as insiders bought it. And we thought that was kind of interesting. And then it just kept going down — to where it's trading today at around $27. So it's been wild.

Another reason has to do with disappointing comparable store sales in one of their units. Tricon operates three major fast food restaurant chains: KFC, Pizza Hut and Taco Bell. And Taco Bell is having a horrible year. It recently reported comparable store sales declines of 6%.

And of course, this stock market looks at companies and says, "I don't care *what* the P/E is. If the comps are weak and there's no momentum, get it out of the portfolio."

OID: And conversely, if it doesn't disappoint, no price is too high.

Cates: Exactly. The third and final cloud hanging over this company is AmeriServe. They distribute food and supplies to all of Tricon's stores. And they went bankrupt. So that's been an ugly story. The guy who did that played real hard, got overleveraged and went under.

OID: Why would that put a cloud over Tricon?

Cates: Well, AmeriServe also serviced Burger King. So Tricon and Diageo had to put money into AmeriServe. And the fear is that Tricon will end up having to take over AmeriServe and get into that business — not because they want to, but because someone has to serve their stores.

If they do, they'd have to spend a few bucks per share and they'd be in this business that they don't want to be in — and it would be a waste of a few bucks. But in the context of our valuation of over twice the current stock price, it's just not a big deal.

OID: Doesn't sound like it.

Cates: It's not. Tricon hasn't taken a stake in AmeriServe yet. They just want to see someone get it who can continue to service their restaurants. However, that's the fear. It's a worst case. And even then, it's no big deal.

WHEN IT COMES TO TRICON, LESS IS MORE.
IT'S BECOMING A VIRTUAL FEE MACHINE.

OID: On the other hand, I don't mean to alarm you, but its revenues are moving in the wrong direction.

Cates: That's what's so great. Here's another case where the quality of a business is in the process of being upgraded. That's why its revenues have declined.

OID: Lower revenues mean an upgraded business?

Cates: In this case, they do. When Tricon was spun out of Pepsi in 1997, it owned the majority of these restaurants rather than just taking a franchise fee. Well, that was a lose/lose proposition. Owning restaurants is not a business that we like or want to be in. It's horrible — especially in the competitive world of fast food restaurants.

OID: Horrible is the word, all right.

Cates: It's *massively* competitive. It soaks up capital. And I could go on and on. But as it was spun out of Pepsi, the new management team, led by David Novak (who we like a whole lot) decided to become more like McDonald's — i.e., to be more of a fee or royalty company.

When they came out, they owned over half their stores — plus they had a lot of debt. And what they've been doing is selling their restaurants and retaining the franchise fees. By doing so, they've won two different ways: First of all, they become a more attractive business — for the same reason why Buffett likes Dairy Queen and we like IHOP. It's a great business.

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OID: Minimal capital investment, high returns, the joys of a leading consumer brand...

Cates: Exactly. But even better, instead of these unwieldy bureaucrats running the store, as they've sold it off and kept the fee, they've sold it to a guy who'll run it a lot better...

OID: Because he's highly motivated and local.

Cates: Because it's his *life*. That's exactly right. So it's a win/win situation. The local restaurant operator runs it better. He makes money. You get a better fee. And you're out of the ownership business.

OID: Plus you can do a better job of creating goodwill, free up capital, earn higher returns...

Cates: Yep. Basically, there's no capital required. That's one of the things we love about the fee business. Some people don't like it because it doesn't grow much. But what we like about it is that although maybe it doesn't grow much, it takes no capital to grow it — i.e., it's other people's money building those stores. So the return on marginal capital — which is all that ever really matters — is a pointless computation.

OID: You can call 'em pointless. But it's not entirely pointless when you include the pleasure you get...

Cates: But it's actually important to retain ownership of *some* restaurants — say 20% or so. The reason why, as shown by Diageo's problems with Burger King, is that when you don't own *any*, you have no sway with franchisees. They suspect everything you do. It would be like us, as fund managers, not owning a ton of our own funds' shares.

OID: Not eating your own cooking...

Cates: Precisely. And that's a big deal. Burger King has all of these problems, in part, because they only own about 6% of their stores. That's too low.

So Tricon Global's management has been going to this 80/20 model. That's why their sales have gone down. But observe in *Value Line* that as their revenues have declined, their debt has declined a whole lot, too.

OID: I see that.

[Editor's note: According to *Value Line*, long-term debt has fallen from more than $4.5 billion in 1995 to slightly over $2.5 billion as of March 18th. And they expect it to decline further, to $1 billion, in the next three to five years.]

Cates: So they've paid down their debt as they've sold off their stores. And they've just kept all the fees. So this thing is in the process of becoming a fee machine. It's very much like Dairy Queen because even if comp store sales are weak or flat, you can still grow — because another guy with his own money is putting up new stores for you and you get the fees off of it.

So now the debt has been paid down dramatically. Plus the bulk of their earnings are generated by the fees they receive, not by their company-owned restaurants. And that's worth a *lot*.

NO MATTER HOW YOU SLICE THIS PIE,
IT'S WORTH OVER TWICE TODAY'S PRICE.

OID: I'll bite. How much is Tricon Global worth?

Cates: There are two ways to look at Tricon's value. The first is just to start with the company's consolidated earnings per share. And that requires a little background:

First, the recent disappointing results at Taco Bell resulted in this year's estimate falling from $3.25 to $3.00. So I'm using the lower figure.

OID: Don't worry. We'll edit that figure back up later.

Cates: So everybody's mad at 'em because the company promised earnings would be $3.25.

OID: So since it's illegal to shoot the manager — not to mention messy — they shoot the stock.

Cates: Exactly. And I'm not looking at a *Value Line* right now, but everybody that I see screws up the earnings because they include a lot of these refranchising gains where Tricon sold all those stores.

OID: Including non-recurring earnings.

Cates: Right. But if you look through to the fees, Tricon has grown its earnings incredibly well. And that's what you would expect — because they're taking in capital and keeping fees at the same time that their stores have done well. So on an apples to apples basis, they have grown very nicely. It's just that some of the early numbers in *Value Line* probably overstate Tricon's earnings.

OID: Yep. For this year, they show $3.60. And for 2001, they show $3.80.

Cates: Exactly. That's messed up. So Tricon should have $3.00 of GAAP earnings. But because they do own some U.S. real estate and all of these new foreign stores, there's excess depreciation and amortization — just as you would expect from owning real estate.

OID: Because reported depreciation and amortization exceed economic depreciation and amortization.

Cates: You've got it. And that's about 90¢ per share. So there's almost $4 of free cash earnings. And the stock's trading around $27.

OID: And you think 7 times free cash earnings is attractive for a very high return, high quality company?

Cates: You bet.

OID: So do we. Sign us up, too, please.

Cates: We think it's worth a P/E of 16. So we get a value in the low to mid $60s.

OID: One last question: Do you take Master Card?

Cates: And we get to that same value another way, too. Again, they've sold off most of their U.S. restaurants, but they still own some to keep their skin in the game. If you put a multiple of 5-6 on the EBITDA from those stores and a multiple of 8 on their international owned stores — given that they're high quality, higher growth and higher

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returns — and you put 12 times EBIT (or operating income) on the fees, we arrive at a value of about $2-1/2 billion for the U.S. stores, $2 billion for the international stores, and a little over $8 billion for the fees. Meanwhile, net debt's about $2.56 billion.

And there are other little pieces here and there, but those are the main numbers. So when we add 'em all up, we arrive at a value of around $10-1/2 billion.

And the fully diluted shares — which are much greater than they show in *Value Line* because there are just *tons* of options — are up around 172 million. So when we divide that $10-1/2 billion by the fully diluted shares, we arrive at a value of $62 per share — right back around the same figure we came up with using adjusted EPS.

OID: So you didn't just pluck a figure from the air or venture out on a wing and a prayer.

Cates: No. We get low $60s no matter how we do it.

CHEAP, SALTY, FATTY AND QUICK SELL HERE.
BUT OUTSIDE THE U.S., THERE'S A WAITING LIST.

OID: We were very impressed with the enhancements in menu and merchandising at Pizza Hut and, to a lesser degree, KFC several years ago. But wasn't the creative guy behind those improvements recruited by McDonald's to do the same thing there?

Cates: That doesn't ring a bell, although it's possible. However, when KFC was on the ropes in the mid-'90s, the guy who turned it around was David Novak — who's now Tricon's CEO. In fact, he got promoted to run Tricon primarily because he did such a good job at KFC.

OID: So you're comfortable that he'll do fine.

Cates: We really are. David's a restaurant guy. And Chairman Andy Pearson is the finance/Wall Street guy.

OID: Nobody's perfect. But what, then, do you think accounts for their problems at Taco Bell?

Cates: That's a good question. New products drive this business so much. Unless you have the hot new product, it really hurts. I think that's evidenced by the announcement that in the wake of the disappointing quarter, they fired the head of the Taco Bell unit and the ad agency.

Also, it's very promotion-driven. Last year, Tricon got cheap because Star Wars was a big flop. But meanwhile, over at Pizza Hut, The Big New Yorker was just a massive win. And that drove double-digit comp gains. It's just volatile based on new products and promotions every year.

OID: But does that suggest the franchise is inherently less attractive — that one or all three of its concepts could go the way of the hula hoop, if you will?

Cates: It could. But I think all of these promotions are really about how you *grow* it. I don't think it's hard to keep sales flat. And if you keep them flat, the franchisee will have a nice take-home pay, keep the store open and send you your fee.

Plus they're just *so* dominant within their niches. If you look at their category and what their customer's after: The math is very different in casual dining, for example, than when you have a 21-year-old male looking to eat as much fat and salt as possible while taking as little as possible out of his change jar.

OID: I strongly resemble that remark — or, at least, I used to.

Cates: Me, too.

OID: But how does that get impacted by the graying of America, greater health consciousness, etc.?

Cates: The graying part probably hurts. I think that has represented a headwind — and will continue to represent a headwind for years to come. But I just don't know how to quantify it.

As for the health part, I think it represents less of a headwind. The health consciousness phenomenon was huge for awhile. But it looks to me like that trend is moving the other way today. People seem to be more interested in convenience than they are in health.

OID: Yeah. Cheap and sweet seems to trump healthy every time.

Cates: And portable and convenient. General Mills has been very successful at developing new products. And I read recently that CEO, Steve Sanger, asks the same question about every new product they develop — and that is, "Can I eat it one handed?"

It's not, "What does it taste like?" or anything else. And sure enough, they've been rewarded for that. They don't care whether it's low fat or healthy or anything. It's just whether it's portable and convenient — period.

And that plays to fast food's strength.

OID: That certainly seems like the way to bet — whatever the implications may be health-wise.

Cates: And Tricon's units are trying to do things along those lines. For example, KFC made a big splash with this chicken sandwich. They looked around and said, "Why in the world is everybody eating a chicken sandwich at Wendy's when we're the chicken people?" So they put effort behind that. And they're tinkering with other things in what are already dominant brands to play to the trends.

Also, the aging population isn't so much of a problem in most of the rest of the world.

OID: Yeah. I understand that there are lots of kids outside the U.S. — and that the average age in many developing countries is surprisingly low.

Cates: Internationally, the sky's the limit. In fact, that's another really exciting thing about this company. Where we *do* like them to own the stores, and where they do own 'em instead of franchising 'em, is internationally. It's *unbelievable* what these brands do in Asia. It really is. For example, Andrew McDermott [portfolio manager of Longleaf International Fund] is based in Japan. And he was telling us that around the New Year's celebration, some of the Kentucky Fried Chickens in Asia have a waiting list for reservations of a *week* or more.

OID: Wow.

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Cates: It's *crazy*! It's a big deal. And the birthday parties are a huge deal, too. They make reservations ahead of time and have the party there.

OID: And that's not only for kids, but adults, too?

Cates: It's for *everybody*. Birthday parties are just one of the reasons that people use to go there. Tricon's restaurants in Asia including Japan are doing fantastic. But KFC Japan structurally at the corporate level leaves a lot to be desired, although the brand's a big deal there, too. Of course, Peter Cundill talked about KFC Japan in *OID*.

[Editor's note: See our March 13, 1998 edition.]

OID: As did his partner, Tim McElvaine — who also just happens to be one of North America's leading culinary experts on fast food cuisine.

Cates: Hopefully, KFC Japan's value will be unlocked one day, too. As you probably know, we've owned it, too.

OID: Do you own it still?

Cates: We don't. It was just such a small position and hard to add to.

So outside the U.S., we do like to own the stores. They've been *great*. That's one of the few times we like owning restaurants as opposed to just getting fees. So we like taking the fees within the U.S. and owning 'em outside the U.S. That's our strategy in a nutshell.

WHAT COULD GO WRONG? NOT MUCH.
IT'S UNLIKELY TO CRATER OR GO AWAY.

OID: On the other hand, within the fast food area, McDonald's is the 900-pound gorilla. What keeps them from taking over chicken, pizza, Mexican food or anything else they want?

Cates: Certainly, McDonald's is a competitor in the fast food area. But these are also very different niches. Tricon is just absolutely *so* dominant within its niches. KFC *owns* chicken. If you want chicken, you're not going to McDonald's.

OID: And we understand that KFC does chicken right.

Cates: And Pizza Hut owns the pizza market. And Taco Bell owns Mexican food. Tricon has niches that I think will totally hold their own against the burger people.

OID: You think Tricon's niches are very defensible.

Cates: I do. And I'm more neutral on this next point. But if Tricon's management were sitting here, they would have another argument. You can call 'em #2. But have you seen some of these multi-brand facilities — in malls, airports, stand-alone locations or what-have-you?

OID: Of course.

Cates: The returns on capital for a franchisee are all that matters. And if that guy can make a lot of money being a franchisee, it doesn't matter if McDonald's is way ahead. He's going to put up the store. And if he puts up the store, Tricon is going to get the fees. I don't think the market is so saturated that franchisees won't continue to put up stores. If that's the case, they grow a few percent domestically. Again, they're not laying out any capital to do it. And they get a big fee stream that can grow a little.

OID: You say that their market is not "so saturated". How saturated is it?

Cates: I can't convey how strongly they believe — because I'm more of a wait-and-see type — that these multi-brand outlets have so far to run. They've had enormous success in their trials where they have a KFC and a Taco Bell in one store. The returns on those are good. The double brand seems to be good for traffic. And they just think that there are tons of those that can be put out. So multi-branding is what gets David Novak all excited when you're talking to him about how they're going to grow the store base.

Meanwhile, the foreign sales are growing like crazy. For example, in this last quarter that disappointed people so much, foreign earnings were up 20%. And I believe foreign revenues were up something like 14%. But it's just going great guns. So they're gonna keep growing.

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

Cates: In a way, Tricon's like Fleming. So *what* if Fleming's wholesale business leaves much to be desired. Going forward, they'll put their capital in Food 4 Less. Likewise, Tricon will be putting its capital in restaurants located outside the U.S.

OID: It will get tough eventually, but it isn't yet.

Cates: That's right. And you can definitely say that their return on capital invested in restaurants located outside the U.S. is over 20%. Tricon doesn't like to get very specific about its returns for competitive reasons. However, you can say that very comfortably.

The distressing thing about AmeriServe is that it's taken them out of the market in terms of buying in shares. That's the worst thing about it. We know it's going to get resolved. It's not a big number. It's only painful because the company may have to cut a check for several hundred million dollars in August — under the worst case scenario — if they have to take out AmeriServe. Therefore, the board doesn't want to authorize a half billion dollar share repurchase. That's just playing too hard.

And that *does* hurt — because with the stock at $27, we'd be laughing all the way to the bank if the company could just be buying it in.

OID: Although part of the reason why it's at $27 is the fact that they aren't buying shares back in.

Cates: Yeah. But if you look back in the first quarter of this year before all of this AmeriServe stuff heated up, Tricon bought back a *ton* of stock. However, they did zero share repurchases in the second quarter. And they've done zero share repurchases so far in the third quarter. But again, that's not because they don't want to.

And they'll get back in there, we think, once AmeriServe is cleared up. It's just a public relations cloud.

OID: So if Tricon Global turns out to be a mistake, what do you think is the most likely reason why?

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Cates: If comparable store sales remain horrible in the U.S. and they deteriorate internationally, I suppose. However, our kind of mistake is one where we believe that we can't lose. And that's where I think Tricon would be. Remember, Tricon has a base of $4 of free cash earnings. So I don't know how bad it could get. And it's hard to imagine those cash earnings going way lower.

Again, whatever the comparable sales in the U.S., as long as their restaurants are open, they're getting their fee.

OID: And as long as franchisees open new restaurants and we don't have a severe depression worldwide, their fees will continue growing.

Cates: That's certainly the way it looks to me. So I don't know how much downside there really is. I'm not saying it can't turn out to be a mistake. But even if it does, it's hard for me to imagine it cratering or going away.

A WEIRD AND WONDERFUL COMBINATION AT AN ABSOLUTELY CRAZY (I.E., GREAT) PRICE.

OID: You said earlier that IHOP is a great business.

Cates: Absolutely.

OID: Why do you say that?

Cates: I explained why we like royalty businesses in our conversation about Tricon. But IHOP [IHP/NYSE] is also great because it's a weird and wonderful combination: Its name recognition is off the charts. Everybody knows IHOP. And it's very highly regarded all over the country. Yet the market for its restaurants is *so* undersaturated. In so many parts of the country, IHOP doesn't even have stores.

I don't remember exactly why that is. I believe the chain used to be big and a bunch of 'em went bankrupt.

OID: Do you know what caused the prior disaster?

Cates: I think it was because somebody LBO'ed it. I'm almost positive.

OID: I'm convinced that leverage is the source of most human misery. Certainly it is in publishing...

Cates: And that's the way IHOP Chairman Richard Herzer wound up getting control of this thing — in the aftermath of it being a busted LBO. I'm almost sure of it. I believe it was a Boston Chicken kind of deal where the stores themselves were sound and good, but it was a big financial disaster.

OID: Let me ask a dumb question: What's their niche?

Cates: Breakfast. It's an absolutely fantastic niche. They just kill *everybody* in breakfast. Memphis is such an interesting example. We faithfully eat at IHOP to scout out our investee — and we can't get *in* the place.

OID: And it's not because your dress code is lax...

Cates: The place is packed all morning. And in terms of name brand recognition, consumer satisfaction and market share, they're in a class by themselves. IHOP is weak the rest of the day, but they *dominate* breakfast.

OID: And that's enough?

Cates: Yeah. It's such a great niche.

OID: What makes it such a great niche?

Cates: That's IHOP's focus. And because it's their focus, they do it well. It's low cost, clean — and good food. Everybody tries to do breakfast to move some extra food. All the fast food people try. Interestingly, I understand that breakfast is the single thing that gives McDonald's the highest sales per store in the industry. But it's only because of breakfast. At lunch and dinner, Wendy's sales are better.

But drive-thru Egg McMuffins just aren't the same thing as a good sit-down breakfast experience. And very few of the casual dining chains — the zillion family steak places, etc. — specialize in breakfast.

OID: Like Charlie Munger says, the world belongs to the specialist.

Cates: Definitely. But whatever the reasons may be, you know they have a great niche given their long-term growth. It's just been so good. Also, you know they'll continue to have a lot of new stores built every year and they'll continue to get decent comps for years and years to come — and that their sales will continue to grow in the low to mid-teens.

And that justifies a valuation that's far higher than the current stock price. IHOP's just *absurdly* cheap.

OID: We'll bite. How cheap is it?

Cates: IHOP will probably earn about $1.75 this year. But that's very misleading. And to explain why, I have to get into what IHOP does best — which is making their local managers owners. IHOP does that by picking the location, building the store, providing the capital and, three months after opening, flipping it to the manager.

OID: And presumably that's not how others do it?

Cates: It's not. Other chains get the franchisees to do all that stuff. The franchisee picks the site, pays for the store and equips the store. Then he just sends them a fee. In the short term, that's better — because if you're the franchisor, you never put up any capital and you just get your fee. But the downside is that your franchisee is probably not a very good real estate guy. And what happens if he cuts corners on the real estate. Then you're in a location that leaves something to be desired long term.

IHOP does all of that. They believe that they have a really great real estate team. And they believe that they're better at real estate than any franchisee is going to be.

OID: They should certainly have more practice.

Cates: That's right. And as a result, they really do have great locations. And once it's humming, then and only then do they sell it to the guy. Well, that's a great business model — because as they grow, they spend the capital, get it back and put it right back out. So for three months, it's their money — though it's really other people's money putting up all those stores.

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But that also means that although it's a fee business, IHOP temporarily owns a lot of stores. So they have a bunch of excess depreciation and amortization — about 50¢ per share — which reduces reported earnings despite the fact that the company isn't really an owner long term.

And therefore, adding back that 50¢, you see that IHOP's free cash earnings are actually around $2.25. Thus, with IHOP's stock trading at around $16.50, that's between 7 and 7-1/2 times earnings.

OID: If you're right about IHOP being a great business, I think 7-1/2 times free cash earnings sounds like it would definitely qualify as absurdly cheap.

Cates: No question about it. It's absolutely crazy. To arrive at our in-house valuation, we take IHOP's $2.25 of real cash earnings and put a P/E of 17-18 on it. And that gives us an appraised value of between $38 and $40.

OID: So we're talking about a discount of nearly 60%.

Cates: That's right. And that's not far removed from what Buffett paid for Dairy Queen. Actually, he paid a little less, but you might say he stole it based on who he is — although, to be fair, I think the seller in that case was intent on a transaction for shares of Berkshire. In any case, I don't think our appraisal is pie-in-the-sky at all.

When we break out their income between rents and franchise fees and value their receivables separately, we arrive at a value of $42.

OPERATING MGM'T-WISE, IHOP RATES VERY HIGH.
CAPITAL ALLOCATION-WISE, IHOP'S IMPROVABLE.

OID: Even when you add back the 50¢ per share of excess depreciation and amortization, the returns on capital don't look all that exciting — certainly not great business territory.

Cates: No. But remember, IHOP has a lot of capital tied up in receivables — because when they sell the store, they're lending him a lot of stuff. He's got a loan on the store and the equipment. And they get a good interest rate for it. Plus, they know their collateral and have control of the collateral. However, they don't need to be a banker.

It's like Snap-On Tools. They used to finance their dealers' tools and trucks. Finally, they learned and subcontracted it out. So they still originate the loans and control the collateral, but a bank provides the money.

OID: That way, they don't tie up the capital.

Cates: Exactly. So we want them to take the capital out of those loans and buy in their shares.

OID: If they were to do that, what kind of return on capital and equity do you think they'd earn?

Cates: Just adding back the excess depreciation and amortization brings their free cash return on capital up to around 13%. But that includes the capital they lend out at 12% pretax — or maybe 7% net. So if they take their capital out of that activity, let a bank perform that function and use the excess capital to repurchase shares, then their free cash return on capital will be well into the mid-20s.

OID: My pulse is quickening already.

Cates: However, I should probably mention that even though we'd like them to stop playing banker, in truth, the purpose of everything they're doing is totally to make that local guy an owner. And that's so dead on — and the reason why they've done so well over a long period of time.

You can do all the big picture stuff you want. But when everything is said and done, this entire business gets down to that single guy in the store: Does he give the customer a good experience? Does he keep it clean? And does he make good food? And the only way to make that happen is if he's an owner, not just a paid general manager. That's why they go to all this trouble.

And IHOP could make its numbers look better if it just required all of its franchisees to put up restaurants themselves. That would be great in terms of free cash and returns, but it would compromise their quality control.

OID: Although, again, that's the way McDonald's and most everyone else other than IHOP does it.

Cates: Yep. But IHOP wants it done right. And they're control freaks — which I mean as a compliment. They want it in the right location. They want it done right. And then and only then do they want the guy to own it.

So we'd give IHOP's operating management a very, very high rating. However, in terms of capital allocation, we just wish they'd do a couple of things differently.

OID: Does IHOP have any international presence?

Cates: Despite the slightly goofy name, very little. They've toyed with Canada and made some noises about looking at Australia. But basically they're just domestic.

OID: So presumably International House of Pancakes isn't headquartered in Lausanne, Switzerland...

Cates: No. They're based in Glendale, California. And I have no idea how they got that name — not a clue.

OID: To what degree are Tricon and IHOP's results tied to the health of the economy?

Cates: Honestly, I don't know. But I would think that it would hold up relatively well — especially given the price points, the value propositions, etc.

OID: What could turn IHOP into a mistake?

Cates: IHOP could turn into a mistake if its expansion program goes awry — or they do stupid things with their capital.

OID: But that's always true. And you probably don't think that's very likely here given the track record.

Cates: No. Plus, Herzer is a big owner. It's his baby. He says "I" a lot. He's run it forever. And once again, he got control out of bankruptcy or near bankruptcy — and he fixed it and revived it.

OID: Anything else?

Cates: What could turn it into a mistake? Not much. It's just a cool, fee generating franchise dominating a great little niche. Honestly, our biggest fear — and it terrifies me

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— is that Herzer sells out too cheap. It scares me to death. And that's not so farfetched, unfortunately. We're just hoping he won't give away the business.

WE BELIEVE THAT NIPPON'S DIRT CHEAP,
BUT NOT EVERY SUPER-INVESTOR AGREES.

OID: Speaking of giving away businesses, are there any others being given away in today's market that you'd like to tell us about?

Cates: We own Nippon Fire and Marine in two funds — Longleaf Partners and Longleaf International. And you've had us in *OID* where we've talked about it in the past — and it's still dirt cheap. Today, it's selling at about 30% of adjusted book.

OID: Wow.

Cates: And we *love* the management. As you know, it's hard to find managements that we like over there. And we love this guy. Ken Matsuzawa is fantastic. He spent over 10 years of his career in different parts of the world.

OID: In what industry?

Cates: Ken's always been in the non-life industry. They've just had him stationed different places. So he's very open minded. Plus, he makes his shareholders a priority. And you know how rare that is over there.

OID: What has the stock done since you bought it?

Cates: It's been flat. It hasn't done anything.

OID: Has Matsuzawa been successfully building Nippon's value in the meantime?

Cates: He certainly has — and he's done it on all fronts: The investments are doing fine. They're growing as we hoped. That was part of the logic — that we were buying these closed-end funds at a good time to come into Japan. And that part of the value has gone north. Ken continues to underwrite well. Nippon's combined ratio is still below 100. Plus, he's buying in shares — which is rare, too. This guy is great.

OID: Super management, a combined ratio below 100 and a 70% discount to book is a helluva combination. You probably don't need to know a whole lot more.

Cates: I don't think you do. But I get the impression that Buffett would disagree.

OID: Why do you say that?

Cates: Because I read him say in your publication (and I'm paraphrasing): "So what if Japanese stocks sell at 30% of book because they earn such a low ROE."

I feel like I'm probably committing heresy to say this, but I think Buffett's making a mistake.

OID: How does it feel to know you're going to hell?

Cates: On the surface, what he's saying makes sense. But that's just wrong here — because unlike the typical insurance company that has 10% equities to assets, Nippon has about *60%* equities to assets. And the equities don't come into the income statement. However, they do grow the book.

Therefore, the ROE doesn't reflect appreciation in the equity holdings, but it's building the book value.

OID: And the underlying value — absolutely.

Cates: It's kind of like Berkshire itself. I think Buffett's grown its book value by 24% per year, although its ROE has been much less — because the appreciation in Coke and Gillette and so on doesn't show up in the ROE.

Well, it's similar with Nippon. It shows an ROE of only 2% or 3% or something similarly pathetic. But you clearly grow your book at a double-digit rate if your equities rise 3-4% per year — which we think is reasonable.

OID: Could you run us through your assumptions for Japanese equities, etc. and the resulting implications for growth in Nippon's intrinsic value?

Cates: Sure. We think a fair assumption is for Japanese equities to grow 4% per year. And that may not sound like much, but remember that their cost of debt is only 1% or 2%. And if its equities appreciate 4% per year and its underwriting ratios don't deteriorate significantly, then the book values we're buying for only 30¢ on the $1 will grow 10-11% per year.

But once again, that's in yen. So we also have to factor in the benefit of Japan's very low cost of capital via the hedge. That lets us earn a few more percent of return. In other words, Nippon's adjusted book value should grow 10-11% per year in yen, but more like 14% in dollars.

OID: Whether you elect to take it in the form of the interest rate difference on your currency hedge or the likely appreciation of the Japanese yen against the U.S. dollar long term if you don't.

Cates: You can slice it a bunch of different ways. You can even assume an 8% equity gain. But that's right. Effectively, it's all the same math.

THERE ARE DEFINITELY TRAPS FOR THE UNWARY,
BUT IN MANAGEMENT AND VALUE WE TRUST.

OID: What about the argument that you're a stranger in a strange land — and that it's hard enough to understand the accounting and the corporate culture in the U.S., much less in a different country with a different language, different history and so forth?

Cates: Well, we've been through the balance sheets at length — every item. We've spent just *so* much time. Thanks to Andrew's presence in Tokyo, we have a far better handle on which managements are good and which aren't. And his hard work and relationships with managements have had an enormous impact for us there.

And you can see that impact in our portfolio activity. We've culled out a number of positions and added others. So that's been a *huge* benefit.

OID: Any more of that and we'll have to send you a

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classified advertising rate chart...

Cates: Plus, these Japanese non-life insurers' books are as hard as they get. I don't think we're missing a thing.

OID: That's what the folks at Cundill and Whitman tell us, too.

Cates: They're AAA balance sheets. You can just count those companies on your hands and feet over there. Finally, most people I know who are skeptical either make that ROE argument — which is just wrong — or they say, "So what if you're right? Even if you are, these guys are just going to squander the capital. Or even if they don't, they're just going to run it for the benefit of the employees — buy art and all of that."

And 90% of the time, that's true. But that's not true of the guy at Nippon. Ken's absolutely great. He's not going to squander his equity. And he knows how cheap his stock is. So we're thrilled. That's why we have it in two funds.

OID: Of course, anytime you invest outside the U.S., you can never get rid of the geopolitical risk entirely, can you?

Cates: No, that's true. However, given that reality, Ken is so concerned about doing everything right — from how he runs the business to capital allocation.

And that all sounds simple enough. However, compared to his peers, it's just night and day. He's buying in shares; they're not. He wants to do options; they don't. He cares about our opinion; they don't. He's progressive on the investment side; a lot of these guys do crazy stuff — like they'll book sales or security gains just to book the earnings and then go right back and buy the securities. So they take a tax hit just to dress up their books. Matsuzawa never does anything like that.

I think many Japanese managers are insular, in part, just because they've never left Tokyo. I suspect that's why so many of them behave that way.

OID: And here I thought it was the raw fish...

Cates: By comparison, Ken's been all over the place. So he's open, curious, progressive and trying to learn. And I could go on and on. We like him a ton.

NIPPON'S UNDERWRITING PROFITS? THEY'LL LAST. BUT IT WON'T SELL AT A 70%+ DISCOUNT FOR LONG.

OID: How do you value Nippon?

Cates: At book value.

OID: Because that's good enough?

Cates: What do you mean?

OID: If this were an American company, it sounds like you'd value it at more than 1 times book.

Cates: You're right. We do use a slight premium to book. But you can't just pick a premium to book in the case of an insurance company because they sound good or private deals were there. We've got to be able to back it up based on how much float it has, what its underwriting is, etc. So we do include some premium to book for its float, but not much.

Then, the other way we look at it is to put a P/E of 10 or 11 on their real economic earnings — including what Buffett has termed look-through earnings. And we get the same number — which is, again, a slight premium to book, maybe 1.1 to 1.2 times book.

OID: And what does that work out to be for Nippon?

Cates: About ¥1,200 per share. And the stock's trading at about ¥330.

OID: Wow.

Cates: Yeah. We're really excited about that one.

OID: If your figures are correct, then here's a $1 bill for 27-1/2¢. That sounds mighty cheap, all right.

Cates: Nippon's *incredibly* cheap. And the reason why the Japanese non-life insurers have stayed so cheap since you spoke with Cundill, Whitman and us is the very visible bankruptcies of huge Japanese life insurers and the distress of the banks. They've been taking charges and they've had to book securities gains. So they've been selling the wheels off all these non-life insurers.

OID: You mentioned that Nippon's combined ratio remains under 100.

Cates: Yep — just under 100. That whole industry has gone from the low 90s to the high 90s.

OID: Because it's transitioning from a market closed to foreign competition to an open market.

Cates: That's right. And I don't know exactly where it'll shake out. Again, the combined ratio has risen a little, but it won't get over 100. They will not lose money on underwriting.

OID: How can you say that with such conviction?

Cates: That's where the win/win is here. To date, Japan's auto insurance market has changed very little. And a few players who started to put their toes in the water have even pulled back out and gone back home.

However, our view is that the only way that the combined ratios get very bad for Japanese non-life insurers is if the foreign competition heats up like crazy. And the only way that it can heat up like crazy is if foreign entrants *buy* their way in.

OID: Just what the folks at Whitman and Cundill say.

Cates: It's true — for several different reasons. First, Japanese consumers pay about a fourth of what we pay — because they don't have as many wrecks and they don't have the lawyers. They know how to drive better than we do and they aren't plagued with ambulance chasers. So Japanese auto insurance premiums just aren't a big deal. And therefore, the servicing is very important to them. Thus, it's not enough to say, "I'm a direct marketer here in Japan. I don't have any claims centers here. So I can't get to your car and service you very well if you wreck it in Tokyo — but I'm cheaper." That won't cut it.

OID: So until the lawyers arrive in Japan in force,

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foreign insurers are going to have to buy their way in.

Cates: Exactly. So the direct guys have made just a tiny, little dent. They're just not going to be able to build it from scratch. Anybody who comes in will have to buy.

Therefore, one of two good things is going to happen: Either foreign competitors won't make any headway — which is basically what's happening now — which will leave the existing status quo and the non-life insurers continue to earn an underwriting profit or, alternatively, those competitors will buy into the market in which case these stocks won't sell at 30% of adjusted book for long.

HUGHES CREATED TODAY'S BUYING OPPORTUNITY, BUT IT WILL PROVE TO BE VERY SMART LONG TERM.

OID: I see you've also been buying General Motors — and that it's gone down since. I guess it's very cheap.

Cates: Correct, correct and absolutely.

OID: Even so, it's hard to imagine you or anyone else turning us into believers there.

Cates: We *love* General Motors [GM/NYSE]. All you read is what knuckleheads they are and how their market shares are going down. But what you never hear is that they have a fantastic board — guys like Bill Marriott. You never hear about how they've done the right thing at every turn, how they've been buying in tons of stock and how they've gotten rid of companies like Hughes and EDS when it made sense and gotten all of that value to their shareholders.

If you step back and evaluate it objectively, we think they've actually been very shareholder oriented.

OID: You almost make it sound well managed.

Cates: At the board level, they are. I believe that — I really do. In terms of allocating capital, just look at what they've done. They've distributed pieces of the company at great prices. They've done a great job for shareholders there. They've bought in tons of stock at the right price. They killed three birds with one stone with what they did with Hughes. They got rid of it at a good price, bought in shares and avoided any tax issues in the process.

[Editor's note: As *Value Line* describes, GM offered its shareholders 1.065 shares of Hughes Electronics for each share of GM tendered. Investors bid up shares of GM planning to tender. But the offer was oversubscribed — i.e., more shares of GM were tendered than the company was willing to exchange for Hughes shares. And the subsequent selling of the leftover shares led to a decline of nearly 40% to date in its stock price from this year's high.]

Cates: But this exchange really screwed 'em up in the short term — because the exchange is what's gotten GM's stock killed here recently. Too many people got hung with their GM shares after the exchange — and dumped it. However, we believe that hanging on to them will prove to be very smart long term. We like it more at today's price — and we know that the company likes it more.

OID: That sounds all well and good. However, what makes you believe GM's a bargain?

Cates: If I run you through each of the pieces, I think you'll agree. First of all, Hughes reports no earnings because they make no money.

OID: Good reason. In fact, one of the best...

Cates: But that's because all of the cash that they make from DIRECTV subscribers is plowed back in to the $500-600 they spend to add a new subscriber. So if you strip out their marketing — which is really an investment — you see that they're making huge money. But that's not the way it gets reported. So the figures in *Value Line* incorporate nothing for Hughes. But it's a huge value — and it's growing like crazy.

So we value their remaining stake in Hughes at $25 per GM share. And that's actually way lower than the one comp we could find — which was EchoStar. Hughes is nothing more than DIRECTV at this point. They've sold all the other stuff. And if we were to use an EchoStar-level valuation, the Hughes stake would be worth closer to $40 per GM share. But we just use $25.

OID: Which do you think is closer to reality?

Cates: Ours. I think EchoStar is overvalued. That's why we don't use it. But it's interesting nonetheless.

EVEN USING CLEARLY CONSERVATIVE ASSUMPTIONS, WE CONCLUDE WE'RE BUYING GM AT 40¢ ON THE $1.

Cates: Then, if you value GMAC at 1.3 times book — which, incidentally, is equivalent to a P/E of 10-1/2 — we arrive at a valuation of $29 per GM share.

Next, GM has net cash of around $15 per share. Therefore, before including any value whatsoever for the car and truck business, we're up around $68. And the stock currently trades at around $60. So we're getting the truck and car company for free.

OID: Actually, less than free, but who's counting? But who says it's worth more than nothing?

Cates: We do. For one reason, it's currently earning around $5 billion — net.

OID: That sounds like quite a few reasons right there.

Cates: And we value it at about $40 billion.

OID: And GM's shares outstanding?

Cates: Good question. Their shares outstanding figure has moved around a ton with all of these exchanges and what not. But we're assuming 580 million shares outstanding — including options and shares that are going to be issued to Fiat. Thus, dividing the $40 billion by GM's 580 million shares outstanding, we figure that the truck and car area adds another $70 per share.

OID: So you value GM at $139 per share?!

Cates: More. GM also has a bunch of equity affiliates — like Subaru, Isuzu and Commerce One (which is the B2B exchange). And all of those random investments are worth another $10 or so per share. So our total value is

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up around $150.

OID: Not too shabby on a $60 stock.

Cates: It works for us. Plus, they're buying in stock like crazy. For example, in the Hughes exchange, they bought back almost 20% of their shares. And they'd been buying back a ton for cash before that. So they've reduced shares outstanding by well over 25% the last two years.

OID: Wow.

Cates: And they're gonna *keep* doing it. You have to think at an even lower price, with even better cash resources — because the cash is still coming in the door in a huge way from the business — that they would certainly ramp it up.

Plus, I assign no value to OnStar. And it's going to be a big deal.

OID: Onboard navigation?

Cates: It's much more than that. There's a phone piece which could be increasingly attractive if cellular gets in trouble — for people talking on cellular handsets and having wrecks — because OnStar has 5 times the power of cellular and therefore provides much higher quality, hands free.

OID: Wow, again.

Cates: And you can have digital satellite music on it. Plus, if your car gets stolen, it tracks it down immediately. And it's a security product as much as a navigation product. Who doesn't want their wife and kids to feel safe?

OID: It sounds pretty wild.

Cates: OnStar's a very cool product. Subscribers only pay about $20 per month. And they expect to have a million subscribers by year end.

OID: It's easy to understand why. It sounds like a very compelling price/value proposition.

Cates: *Very* compelling. And it's another fee business that requires very little in the way of incremental capital and generates excellent marginal returns.

EVERYBODY SEEMS TO HATE GENERAL MOTORS,
BUT IT LOOKS LIKE A VERY STRONG CASE TO US.

Cates: You usually might point to their $5 billion of net income and say, "So what? That's peak earnings. And it's a car company."

OID: The thought had crossed my mind.

Cates: And of course, GM's truck and car segment has been way underperforming Chrysler and Ford. But there are two reasons why. And we think they're both going to change. The first gets down to mix. Its sales mix currently breaks down 50/50 between trucks and cars. And the way the business works is that you make all of your money on trucks and lose money on cars.

OID: I don't know about the first part, but the second part sounds very similar to investment publishing...

Cates: Chrysler and Ford sell a lot more trucks as a percentage of their sales and, therefore, they have much better gross margins. So the question boils down to, "Can the sales mix get better?" And GM's track record in trucks is pretty good. So we think it can.

The second thing is attrition. Just through attrition, the waves of people that they hired during the 1960s are now retiring. And that's a massive ongoing cost benefit. So their costs are going down a lot, although none of us are very excited about their top line.

Also, their foreign affiliates and operations are all in the ditch. But we think they'll come back and make a lot of money. And everybody thinks they're morons because their margins are so bad. But as I see it, that suggests a lot of opportunity. Hell, one Saturn model alone is losing a billion dollars. How can that *not* get fixed?

OID: Some companies seem to always find a way...

Cates: So there's still a lot of upside in its earnings. And if they keep making $5 billion of net income per year, then I don't think our $40 billion valuation is so crazy.

OID: Although I imagine you'd acknowledge that it's a lousy business — requiring huge capital expenditures, large inventories, and is subject to huge writeoffs, etc.

Cates: Many countries are going to subsidize cars. Many countries are going to have a car manufacturer. And car manufacturing is a worldwide business. So what you say is certainly true within General Motors' auto segment.

But I'm not sure whether it's true in trucks. Interestingly, trucks are virtually a U.S.-only business. You don't see Yukons in Europe or Asia — and you won't. We're by far the most gas guzzling country in the world. Therefore, I don't think the Europeans or Asians will be as good as we are in trucks for many years. Because the margins are so high, of course, they're trying. However, U.S. companies enjoy a home field advantage in that area.

OID: Very interesting.

Cates: Second, that's one reason why GM's President and COO, Richard Wagoner, is betting so heavily on the web. What they're trying to do is look more like Dell. And if they're successful at lowering their costs and inventories via the web, which is not illogical, the consumer gets the benefit of a better price and a better selection — and GM will take tons of inventory out of its business.

OID: And the returns...

Cates: Would be better. But don't get me wrong — it's a tough business. I would never pretend it's not.

OID: Even so, some would suggest that the business is little more than a profit pass through mechanism run for the benefit of the company's unions.

Cates: I wouldn't disagree there either. That's one of the reasons why the returns have been so low. But the unions are embedded in the $5 billion they earn today. Plus, the $5 billion includes the losses associated with the company's web initiatives and OnStar. So their earnings may hold up better than people might expect.

OID: And of course, your multiple of 8 times earnings

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isn't exactly discounting perfection into the hereafter.

Cates: And North America is making all $5 billion. So when we have our recession here and that $5 billion goes down, hopefully Europe, Asia and/or Latin America will kick in.

OID: Good answer. I think you've actually made a pretty good case.

Cates: It looks like a very strong case to us.

OID: And yet one group that doesn't appear to be convinced is insiders. There seems to be a whole lot of insider selling and almost no insider buying.

Cates: Yeah. Some shareholders have been irate about it. We haven't been happy about it either. In fact, we have talked to management and other shareholders at length about it. But they haven't been shrinking their net share positions in most cases. As is often the case, these insiders are mostly selling shares to pay their taxes and, thereby, be able to retain other shares. Also, the chairman and CEO aren't shrinking their ownership.

OID: Maybe they're not that brave. But if you're right about the values, etc., why wouldn't they go out and buy shares in the open market? The virtual absence of insider buying in a company this big is pretty wild.

Cates: You're right. I'm not trying to explain it away — because we *hate* seeing that. And even if it is just option selling, we hate that, too.

OID: On the other hand, one of our favorite contributors tells us that in some of the best bargains he's ever come across, even the insiders can't imagine buying the stock.

Cates: Yep. We saw that at FedEx a few years back. When it was most washed out, we had the same frustration — because insiders didn't yet believe. We didn't understand why there was no buying. And I don't know why there's no insider buying at General Motors.

OID: If your investment rationale is on the mark, maybe it's just that buying General Motors shares has been such a bad idea for so long...

Cates: That's certainly been the case in the past. But we don't believe it's going to stay that way for long.

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And we even like the fact that everybody hates it so much because that only serves to highlight just how cheap it is. It's *so* out of favor.

AT DELTIC TIMBER, THERE'S QUITE A LOT TO LIKE — THE ASSET, THE DISCOUNT AND THE MANAGEMENT.

OID: You've also been buying Deltic Timber [DEL/NYSE]. Might we ask you the attraction there?

Cates: It's just a case of where we can buy a $1 bill for 50¢. Based on comparable sales, it's worth about $45. And it's trading around $21 today.

OID: And yet we don't typically think of timber as the kind of classic, high return business that you look for.

Cates: We like the asset. Mason's actually our timber expert. It's been his family's business for decades. We think of timber as the highest quality real estate possible because you get a sizeable cash coupon every year as the timber regenerates.

Second, the outlook for timber's really good — because there are environmental constraints on supply while demand worldwide continues to grow. So you can make a very strong case for real growth in timber prices over the long term.

Third, timber is a renewable resource. And what's happened historically is that even though you're harvesting the "sustainable cut" — which implies that you're going to cut what you can and that you'll never do better — thanks to ongoing advances in technology, you can actually *grow* the yield. Therefore, it's like an office building that grows a few percent every year.

OID: Fascinating. So they're not growing older — they're growing better...

Cates: So between the coupon, the improved pricing and stumpage or volume growth, timberland typically generates a total return of 13-14% per year.

OID: Not bad.

Cates: Not bad at all — especially when you consider that 13-14% may be way conservative because we're starting from such a depressed price for the commodity today.

And something else we like about timber is that you have flexibility to harvest when you want. Therefore, if timber prices are bad one year, you don't have to cut. You can simply let the value grow on the tree — and then, when prices are good, you can cut heavily.

OID: That sounds like quite an advantage, all right.

Cates: And we like Deltic Chairman Bob Nolan a lot. At our annual meeting, John Buford read a quote from Nolan's letter to shareholders from his latest annual report in which he, in effect, said, "At these prices, our best investment is to buy back our own shares." As you know, we like it when our managers think and behave that way. Plus, we like the fact that those share buybacks probably stand to add another several percent to our returns.

[Editor's note: Plus, they're putting their money where their mouth is — or more of what's not there already. Insiders have been adding to their 34% stake (and there's

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been no insider selling whatsoever) during the past year.]

Cates: Incidentally, the returns have historically been better than what I described. In fact, they've nearly *always* done better than that. But they also enjoyed a gigantic environmental tailwind. And they still do. Only it's not like when they shut down timber harvesting on the government lands in the Northwest during the early 1990s.

OID: Which explains all of the "Nader for President" posters and buttons around your office.

Cates: And that's another reason why we like it.

UCAR MAY BE A $1 BILL FOR 50¢ — OR 40¢ — OR LESS. BUT IT'S JUST TOO SOON TO SAY.

OID: Believe it or not, we're pretty much out of time and pages. However, we couldn't help but notice the huge insider buying at UCAR [UCR/NYSE].

Cates: I'm not the primary cover on UCAR. That's John Buford — and he left town.

OID: So he's incisive and decisive. I'm impressed.

Cates: Plus, there's a huge swing factor — which is this Graftech IPO. UCAR is delicate because they're trying to get that thing off the ground as we speak. And there's no way of knowing how that's going to turn out.

Also, UCAR itself is a very hard thing to get into and explain — because Graftech has never been part of our core valuation. We just view it as gravy.

OID: Could you give us the thumbnail version?

Cates: Sure. Graftech's the part of UCAR that's going to make the graphite part that goes into fuel cells for Ballard Power Systems (BLDP). Ballard is the Amazon.com or Cisco of the fuel cell world, but it's not earning very much money yet. And that's why we've always assigned Graftech a value of zero.

However, most people in the business seem to think that Ballard has real technology and a real business. Its market cap was up around $7 billion the last time I looked. And if Ballard's worth $7 billion, then Graftech's worth a lot, too — because a Graftech product will go on everything it makes.

OID: Fascinating.

Cates: UCAR's core competency is graphite and carbon electrodes and other graphite products.

[Editor's note: From *Value Line*: "Graphite electrodes are used in the production of steel in an electric arc furnace [and] the refining of steel using ladle furnaces. Carbon electrodes are used to produce silicon metal used in the production of aluminum. In addition, UCAR manufactures cooling systems for steelmaking furnaces and other [uses]."]

Cates: UCAR is doing this IPO because it makes the graphite for the fuel cells. And it could be a huge market cap. To give you some idea of how much, at the planned IPO price, we'd get a $10 kick. And that's on a $14 stock. So there's just a big swing factor in the mix.

OID: Might we ask you the rough valuation range that you come up with here?

Cates: Around $30. But that's assigning no value whatsoever to Graftech. So it's a 50¢ dollar even without Graftech. It's *ridiculously* cheap.

We look like an idiot so far because it's done so badly since we bought it. However, it's such a compelling value. Once the IPO is under our belt, we'll feel more comfortable about being able to assign some kind of value to it.

But John's not around to explain the core value. And Graftech is still a question mark.

OID: Although there doesn't seem to much of a question mark in the minds of company insiders...

Cates: UCAR's management is wildly optimistic.

[Editor's note: Based on a July 10th newswire, Graftech's refiled initial public offering memorandum (which had been withdrawn originally for tax reasons) specified a projected range of $15-18 per share — which would imply a market cap of $450-550 million — or approximately $10-12 per share of UCAR.]

OID: How many shares does UCAR have outstanding?

Cates: UCAR's share base is tiny. The company only has a little over 45 million shares outstanding.

OID: It looks like there's quite a legal story here, too. Based on UCAR's SEC filings, it appears that they've reserved $340 million for potential liabilities and expenses associated with antitrust investigations and related lawsuits and claims — all but $131 million of which they've already paid out.

Cates: Yes. And we've taken that $3 per share out.

OID: Even more interesting, it looks like they're suing their former parents — Union Carbide and Mitsubishi — for $1.5 billion associated with the same matter. Might that be one of the reasons for such intense and widespread insider optimism?

Cates: I can't comment on that.

OID: Sissy boy.

Cates: I wish I could.

OID: However, we gather that you believe UCAR's value is at least $30 — and possibly $40 or more.

Cates: Correct.

OID: Which given the current $14 stock price would imply a discount of at least 50-60%.

Cates: You've got it. It's a shame John's not here to tell you about it. He's picked a lot of winners for us. And I think UCAR's going to prove to be a winner, too.

OID: That's OK. We know when we're beat. You really do have more intriguing ideas than we have pages. Thanks for sharing some of them with us.

Cates: My pleasure.

—OID

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the equivalent of committing hari-kari business-wise — because if they don't tell clients what they want to hear, they'll go to any of the myriad of others who will. Therefore, they don't. But they know it.

It's his thesis, further, that we're in the midst of the greatest financial bubble in American history. And he goes on to present parallels with financial bubbles of the past, some long-term historical perspective on valuations and even the specific ingredients required for a bubble — all of which, incidentally, as he points out, are present today.

We're pleased to bring you excerpts from his April presentation in Atlanta before the Investment Counsel Association of America and, at Grantham's suggestion, his November appearance at a *Grant's Interest Rate Observer* Conference in New York and excerpts from his subsequent market commentary and several followup conversations. We hope you'll find his perspectives as thought provoking as we do.

FINANCIAL MARKET INEFFICIENCY ISN'T GOING AWAY. AFTER ALL, THAT'S THE WAY WE'RE HARD-WIRED.

The market is gloriously inefficient and becoming *more* so.

Jeremy Grantham: I used to think financial markets were approximately efficient and getting more so. I was touchingly naive. I had a blind faith in this march of science. In the old days, there were gentlemanly hand holders from Morgan Guaranty Trust. I thought that they'd been replaced over time by CFAs and MBAs — well educated young tigers — and that information that used to be spotty is now profuse and that the net effect would inevitably be behavior that was more sensible, more logical and more closely approximating Economic Man.

Well, it simply hasn't happened. Today, I believe that the markets [for] all asset classes are gloriously *inefficient*. Far from markets being approximately efficient and getting more so, the market is bloody inefficient and, if anything, getting less efficient every day.

More specialization = More segmentation = Less efficiency.

Grantham: I've come to realize that the main reason is the professionals. When I started in the business, it consisted of 35% professionals and 65% amateurs running their own money. Today, it's the other way around with about 65% of money in the hands of professionals. And what happens when you put money into the hands of professionals, as we all know, is the focus gets transferred from *real* risk to *benchmark* risk.

Also over the years, the definition of what your job is has become more specialized. Thus, today, we have small-cap Japanese stock funds where if you buy large-cap Japanese stocks, you're accused of "style drift" — and very quickly shot. Small stock managers can't buy big stocks; German managers can't buy U.S. stocks; and, above all, equity managers can't buy fixed income instruments.

The arbitrage mechanism has weakened, and will continue to weaken as long as the benchmarking grip tightens — as long as the percentage of money flowing to professionals increases. And I think that's about as certain as anything that [I can think of.]

Therefore, we just have to live with the fact that we're likely to have a weaker and weaker arbitrage mechanism. That means longer and bigger deviations from trend line value, greater opportunities to make money and greater career risk in trying to take advantage of them — until we have truly legendary opportunities that no one will dare accept. And we are well along that path already.

The basis of inefficient markets is built into our wiring.

Grantham: Underneath the move to inefficiency, among other things, is the need to conform. Homo Sapiens have a terrific need to conform. The anthropological basis of the need to conform is obvious and understandable. Among other things, it's based on hundreds of thousands of years of hunting. Primitive Man all hunted together in groups. If you were uncooperative, they kicked you out, you had to try to catch a giraffe on your own and starved. Even today, the bushmen know you have to hunt in a pack — you have to do it together. Thus, in order to survive, you'd better be one of the boys.

Over time, this stuff gets programmed into our genes. For example, there's a wonderful movie on old grainy film of an anthropologist in New Guinea during the '20s talking to a tribe up in the mountains. They've never seen anyone like him before. Thus, he's very, very powerful medicine. Now while he's talking, he rubs his right foot on his lower left trouser leg and the entire tribe does the same. Later in the film, he scratches his ear and all of the members of the tribe present scratch their ear together. They want to be part of his tribe. After all, he's a big dude. And that is simply part of the baggage — what we have to cope with — as members of the species we belong to. We just have this programmed, prehistoric need to conform.

Contrarians meet an evolutionary need....

Grantham: What my Australian fellow at work would say then is, "How come there are us contrarians?" Well, it turns out that 1% or 2% of us are mutants — with probably most of the them here in the audience today. And we have this knee jerk uncontrollable reflex that when a large group of people say, "Let's go hunt a giraffe," we say, "No, let's go hunt an elephant." That's just my nature. As soon as I feel any consensus at all, I need to attack it. It's not about being a bear, it's about being a contrarian.

We've decided — this Australian, Jack Gray and I — that there's a need for such contrarians in the species. So after the group's tried three times to catch a giraffe and failed and is on the verge of starving, someone will suggest an alternative. Thus, the contrarian has a gene that's useful to the community. Therefore, we survive — but only just.

IT AIN'T THE INVESTMENT MANAGERS' FAULT. AFTER ALL, THE CLIENTS CALL THE TUNE.

Managers must dance to the clients' tune or be fired.

Grantham: There aren't a lot of thinkers in the investment business that I admire, but there are a few —

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and I'd like to share a few of them with you. One of them is Andrew Smithers in London who's a real ace economist. He has a great new book out about the market [*Valuing Wall Street: Protecting Wealth in Turbulent Markets*].

He also writes for *The Evening Standard* in London and had, I thought, an enviably well-written little piece [recently]. It's in response to a famous quote in London about the managers behaving like lemmings ready to run off a cliff. And his reply is basically (to paraphrase), "Hey, it ain't the *managers'* fault. It's the *clients'* fault." The managers know very well that if they don't get on the lemming team — if they don't buy the stuff that's moving — they're fired. And he goes on to say that, therefore, they're forced to buy the momentum stocks.

The fund manager's biggest need today is for excuses....

Grantham: Says Smithers: "It's not easy to make a rational case for buying shares that have gone up a lot unless there's some new information to justify the price rise. But all too often, the only new information is that the share price has risen. If fund managers don't buy shares that have already shot up, they fear they will underperform and lose their jobs. On the other hand, if they do buy and the market crashes, they fear they will be blamed for recklessness. Thus, there's a huge, new demand for excuses. It's a form of insurance. The fund manager's biggest need today is for reasons to justify the unreasonable. Supply has risen to meet this demand and the number of irrational arguments must be approaching a world record. The moral is simple: If you want to invest, don't be rational. And if you want to be rational, don't invest."

And that pretty well sums it up.

A microcosm of the technology mania....

Grantham: I've been following a little stock called Puma Technology because one of my partners invested \$35,000 and got 70,000 shares five years ago as a venture capital project. And he recently found it up from 50¢ to \$45, tried to sell it and couldn't find the certificate. Well, by the time he did, it was \$140 last year. So, therefore, I have been following it quite closely. He gave it to his children when he thought he was giving \$200,000. It turned out he gave at the peak \$9 million to his kids.

Anyway, ... Puma came into this year at \$140 and he still hadn't sold it. Finally, the certificate came through in early February — and the stock melted away. He sold some in the \$80s, some in the mid-\$70s and some in the high \$60s. He [sold at an average price per share of] \$81 — which wasn't too bad. It bottomed at \$63. Then it turned around and in March went to \$202 — and split.

On Terrible Tuesday, the day the NASDAQ dropped 13% before closing down 2%, Puma rallied 60% in the last two hours to close down 1% for the day! It fell 40-odd% in the morning and rallied 60% in the afternoon on *no* information. That's efficient.

Keynes was way ahead of me.

Grantham: One of the other people I admire is Keynes. He understood in 1934, unfortunately for me, a whole lot more than I did about the stock market. I think I've finally caught up to him — with his help. Says Keynes:

"A conventional valuation which is established as the outcome of the mass psychology of a large number of *ignorant* individuals is liable to change violently as the result of a sudden fluctuation of opinion since there will be no strong roots of conviction to hold it steady."

That, ladies and gentlemen, was Puma Technology....

KEYNES UNDERSTOOD HUMAN NATURE — AND THUS THE PLIGHT OF VALUE MANAGERS.

"Investors" today have carried Keynes' idea to an art form.

Grantham: Never let it be said you didn't learn something useful. So part of my thing will be just to read you something I was reading on the plane last night. You understand [Keynes'] idea of the beauty contest: You're not trying to pick the stock you think is best. You're trying to pick the stock that the other guys think the other guys think will be best. "And" [Keynes says,] "there are some, I believe, who practice the fourth, fifth and higher degrees [of this art form]."

Value investing flies contrary to human (i.e. client) nature.

Grantham: "...[I]t makes a vast difference to an investment market whether or not [the long-term value managers] predominate in their influence over the game-players. But we must also add that there are several factors which jeopardize the predominance of such individuals in modern investment markets. Investment based on genuine long-term expectation is so difficult as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave.... Moreover, life is not long enough; human nature desires quick results. There is a peculiar zest in making money quickly...."

To be great (as a value investor) is to be misunderstood.

Grantham: "[I]t is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behavior that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

Keynes foresaw periods of "Casino Capitalism" — like today.

Grantham: And finally: "Speculators may do no harm as bubbles on a steady stream of enterprise [— value investing]. But the position is serious when enterprise

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becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

And that, as far as I'm concerned, is where we're at.

Modigliani knows about more than economics....

Grantham: Another hero of mine is Modigliani. Modigliani alone in 1982 as an academic came out and said, "Hey guys, the market's crazy. It's selling consistently, year after year, *way* below fair value."

"And people say it's because of high inflation. Inflation doesn't matter. Inflation is a pass through. If it were not, corporate earnings would now be nil. Inflation has been around for hundreds of years. And of course, corporations are a real asset with real factories — and their products rise with inflation, as do their earnings. It's a pass through. Therefore, the market should sell close to replacement cost. What's it doing down here at half price?" That's what he said so nobly in 1982.

Well, the Nobel prize winner showed up in Boston the week before last. I was happy to ... sit there as he described exactly the opposite: "Of course, low inflation has nothing to do with the evaluation of stocks in serious economic terms any more than it did the other way around. And of course the market is *hugely* overpriced and is in fact a *bubble*..." — his terminology.

Robert Shiller, a professor at Yale, has a fine mind. And he has a great book out called *Irrational Exuberance* which I absolutely recommend to you. And there is another fine book out called *The Devil Take the Hindmost* [by Edward Chancellor] which is a review of all serious bubbles which I also warmly recommend.

ENORMOUS INCENTIVES DICTATE A ROSY VIEW —
FOR POLITICIANS, MANAGERS AND EVERYONE ELSE.

There are huge incentives. But what exactly are they for?

Grantham: What we have a hard time understanding, I think, is the idea of vested interests. I believe that we're in the middle not only of a bull market, but what I call the "great bull market conspiracy." The great bull market conspiracy this time is far bigger than ever before because of stock options. Stock options don't threaten to make senior managers rich. They threaten to make them *disgustingly* rich. Hundreds of millions of dollars, even *billions* of dollars, are transferred from the shareholders to the top management these days.

And they do it through stock options incorrectly accounted for. The accountants tried to account for it correctly, but the corporations lobbied against them and it was not allowed. So options are not deducted from earnings at the correct value — which is the value of the transfer — but they are deducted at their full value from taxes. So clearly, one believes that they're a real cost — because otherwise, the IRS wouldn't accept it.

Stock options have produced for the first time in history, as Warren Buffett has pointed out, an *enormous* incentive to overstate your earnings and manage them to the Nth degree — which is exactly what is occurring. It's overstatement and management, overstatement and management, etc., all the time. The biggest overstatement is stock options. And the second biggest is what we call in house "recurring, nonrecurring charges" — which, if you amortize them, is about 11% of all earnings.

So corporate officers want their stock price to be high. "Why pay dividends? Let's buy the stock back." It has very much the same effect as dividends — except it tends to push the stock higher.

Almost everyone wants the market high — even Greenspan.

Grantham: Politicians, of course, want to have the stock market be high. They want to see that as a reflection of their greatness. They want to be held *responsible* for a bull market. It was their good work. And whenever given a chance, they will have self-congratulatory gatherings.

The Federal Reserve boss, above all else, is the great bandleader — a little bit of this, a little bit of that and plenty of moral hazard. "It is my duty to prevent a bubble from breaking causing damage to the U.S. economy," he says (paraphrasing). "But, of course, it is not my responsibility to interfere with the bubble." If that doesn't make us feel that speculation is somewhat underwritten, nothing will. This is absolutely outright moral hazard. It is a major league error which, if he's lucky, his successor will pay for. But he will if he's unlucky.

When Galbraith wrote his book in 1957, he asked the question, "What were the causes of the Crash?" Well, now we know a little bit about what causes a bubble to form. And surely, the next time, reasonable people would expect that powerful people would go to the authorities and beg for interference. "Please stop the bubble from taking place, because the breaking is so painful."

But as Galbraith said in 1958, "Forget it. That will never happen. The Fed Chairman will always be a cheerleader — as will the authorities — because", as he put it, "no one wants to be the guy holding the pin".

"Stockbroker economics" is king. Optimism sells shares.

Grantham: Next on the list of vested interests is the industry itself. Andrew Smithers, a little crueler than me, refers to "stockbroker economics" — that is to say, everything written about economics by people who have a vested interest in bullishness and keeping the market rolling and everyone optimistic.

Of course, the very big houses have a vested interest in the bull market continuing — because, very simply, a bull market is good for business. Optimism sells shares....

If someone who's a bear happens to wander to the top, he'll take an extended leave of absence or be retired early — as was Merrill's chief economist. And he'll be replaced by a hairy-chested bull — as again was the case at Merrill.

The vested interest of analysts is so high now that the SEC boss, Arthur Levitt, said the other day that basically they've become shills for their investment banking departments and never put out sells anyway.

There's no reason to let facts get in the way of pabulum....

Grantham: And the hairy-chested bull had this disgraceful, little piece published in *The New York Times* (they should know better) that claimed that the '90s was the greatest decade in history in economics.

If it is, he didn't reveal what data he was looking at.

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Based on productivity, inflation, corporate profits — anything you want to consider, right or wrong — the 1920s was the greatest decade of the 20th century by a *large* margin. In 1929 itself, inflation was *zero*. Productivity [growth] was 5% per year. Read it and weep. Therefore, real GNP [growth per year] was 5%. The last five years of the '20s was the greatest five-year period in history — double-digit, real growth in corporate earnings for the entire decade.

In second place, albeit far behind in second place, is the 1960s. The 1960s was a great decade. In honorable third place is the '90s.

HERE ARE THE INGREDIENTS YOU NEED FOR A BUBBLE — AND WE HAVE ALL OF THEM (IN SPADES) TODAY....

Psychology determines everything....

Grantham: ...Booms and busts determine everything. They interact with psychology and are all people need to get their brains aroused. It is absolutely no coincidence the great speculative bull markets of the 20th century occurred in 1929, 1972 and the year 2000. They fell exactly where you'd expect they would.

Why? Let me describe the nature of a bubble: First, a *real* bubble needs above all to get rid of the old fogies. You can't have a bubble five years after a bust. Japan couldn't have a bubble five years ago — five years after the great collapse of 1990. A bubble needs to rotate serious investment professionals out of their jobs so there's no arbitrage and no one screaming "this is irrational."

Once badly burned, twice extremely shy....

Grantham: So the market in 1932 breaks. And because the Depression's so long and severe, you get a generational swearing off of speculation and a reaction ... towards fiduciary responsibility: value, conservatism, prudence, price to book, P/E, yield. All behave impeccably. It's mean-reverting heaven — a value manager's paradise: It goes up a little above trend, then down it goes. It goes down and back it goes. Everything is well priced. There are no sector deviations. From 1934 to 1954, you *can't* have a major break.

Next, it reinforces itself. Wealth effects recycle. And the government and everyone else goes along. And that takes you to the next bubble — which typically lasts only 3-4 years — for example, from 1968-1972. Then, the market breaks down again for 2-3 years. And so, from 1974 to 1994, value investors enjoy another generation of mean-reverting heaven.

In 1974, we were sitting there (I was anyway) with 50% paper losses and 62% real losses in our portfolio — not that much worse than the 1929 break. So we all swore off speculation and became wonderful value managers.

From 1974 to '94, you simply couldn't *have* a bubble. It doesn't compute. I never realized how lucky I was to be a value manager during that meat and potatoes part of mean-reverting heaven. It was such a large part of the basis of our success.

I invested internet style before the internet was cool.

Grantham: It seems like I was *just* in the last great speculation of 1968-'69. And I made a fortune in two years out of business school — enough to buy a $650,000 house at today's price and a BMW. I did that in two years from a standing start — from a position of having been in debt.

That wasn't bad. It's par for the course today. But in those days it was pretty cool. However, 18 months later, I'd lost everything. And not only did my stocks go down, the companies went out of business lock, stock and barrel. Every single one of them ceased to exist within three years. I used to say that I was wiped out before everyone else knew the bear market had started.

Anyway, that was my first year in the business. Now I'm 61. And I'm just hanging in by my fingernails — hanging around — for the next great bubble. That's the nature of the beast.

Next you need changes that allow psychology to take flight.

Grantham: Okay, Condition #2: You've got rid of the old fogies, but that's not enough. It's a necessary condition, but it's not sufficient. What you need now is a long string of fairly handsome economic conditions — a pleasant surprise or, better yet, a string of pleasant surprises [like] 1926, '27, '28, '29; 1965, '67, '68, '69; 1995, '96, '97, '98, and '99. That way, no one can remember what it feels like to be bust. They can't even remember the bad times. "Therefore," people start to think, "it *must* be a new era."

And in the late '20s and the late '60s — but particularly in the late '20s — you had magnificent new era thinking: "We are electrifying the countryside. We are introducing telephones. We are introducing cheap automobiles for the middle class. We have radios so that everyone — even the poorest farmer — can know instantly what is cooking." These are really powerful, life-changing developments.

Today's technology rage is nothing new....

Grantham: The 1929 bubble in particular was a technology-focused rampage. Only the exciting, high-tech stocks of that era did well. The high-tech stocks in 1929 were above all radio. Radio sales were growing 45% a year — slightly faster than PC sales. Then there was GE selling electrical equipment during the electrification of America. And of course, there was AT&T since everyone was getting telephones in the middle class, and GM because cars were high tech in those days. Those companies' stocks dominated the market....

It's not that those developments *justified* the bubble. It was an absolute necessity to *have* a bubble. People have to get their teeth into it. They're not complete idiots. They *need* to see spectacular changes. The stock market is not about spectacular changes justifying economic progress; it's about spectacular changes enabling crowd psychology to take flight. Those are precisely the conditions required to justify a bubble.

And that's exactly where we find ourselves today — with the economy having once again put together a string of three, four or five terrific years (although the ones in the late 1920s were substantially better in every conceivable way than the one we've just experienced).

But still, that's exactly where we are today — for the third time. We've just experienced the greatest bull market in American history. And therefore, I'm sure that it's going

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to be followed by the usual consequences.

Also, you need the laws of nature to turn upside down....

Grantham: Other conditions of the great bubbles: A long period where blue chips dominate little companies — like 1925-'29, 1968-'72, 1995-'99 — four years of *complete* domination on the upside of blue chips over the high-beta, small caps. That is not the law of nature. That is not meant to happen. And that's Condition #3.

Small caps have a beta that's 10% or 15% higher. But in each of those four-year periods (and *only* those three four-year periods) they nonetheless rose at only about half the rate of the blue chips.

And often in those periods, their returns actually had the wrong sign. We ranked every twelve-month deviation since 1925 — looking for periods during which blue chips went up and secondaries went down. And these are the #1, #2 and #3 greatest deviations ever:

In 1929, small caps were down badly before the Crash for the year-to-date. The S&P was up 35% and small caps were down 25%. March through March from '98 to '99, small caps were down 18% and large caps were up 25%. In 1972, the S&P was up 17% and small caps were *down* 17% before the crash. And that's an interesting liquidity-driven phenomenon.

So anyway, today the money is pouring in and pushing up the liquid stocks by and large — which is another characteristic of great bubbles. Incidentally, the Nifty Fifty, for all the talk about one-decision stocks like Eastman Kodak and Avon, was actually a piker by the standards of the '20s. The '20s was the real McCoy for Nifty Fifties.

But we're very close today. From March of 1998 to March of 1999, we had the second biggest deviation ever. Trust me, this is an interesting sign indeed....

Next you need speculation. And boy do we have that....

Grantham: Finally, there's ineffable speculation: The greatest speculation hitherto by far had been 1929. Goldman Sachs' closed-end trust came out. Three months later, in '29, they came out with a second closed-end trust whose job was to own the first one, other stocks and debt. And two months before the Crash, they came out with a third one whose job description was to buy the first two and have *another* 50% in debt. When asked [where the first trust was trading] in a Congressional hearing in 1932 — bear in mind that it had peaked at $150 [after coming out at $100] — Mr. Sachs [replied], "at $1-7/8".

There was wonderful closed-end trust leverage speculation in 1929 — 90% margin. However, frankly, it is completely *dwarfed* by the speculation we are all seeing around us today. The madness in the NASDAQ and the madness in the internet is all completely without precedent. The internet market cap is just over $1 trillion.

That's two weeks ago. So it's ancient history. However, two weeks ago, it had a market cap of $1 trillion with net earnings of minus $7 billion. This is indeed quite a healthy exuberance — a willingness to project futures into the deep, deep future.

THE INTERNET IS A PROFIT *CREATOR*?! IT'S ACTUALLY A PROFIT *DESTROYER*.

The internet of the 1800s was railroads — side by side.

Grantham: Of course, there is a capital spending boom. In periods of euphoria, there always is. In 1837, the euphoria for the railroads in Great Britain was so great that *21%* of the GNP was sucked into building railroads. The rest of the economy couldn't get any money — and after a couple of years, it fell into a recession for lack of cash. They were so busy building railroads, in fact, that on at least two occasions, they built them side by side between the same two cities. Since they formed a stock company to do precisely that, they felt that they had no alternative.

Overwhelmingly, the return on capital to the railroads was negative. And the poor old Brits got wiped out in South America — and North America as well — on most of the debt that they put up.

Capitalism competes advantages (and returns) away.

Grantham: That's really par for the course. The airlines famously have still not made any money net-net since their inception. And they've changed our lives wonderfully. It isn't about bad productivity. Railroads were hugely productive, as are airlines ... and, of course, air-conditioning and so on.... It isn't about that.

What it's about is an efficient capitalist system. Capitalism competes advantages away if they're held by more than one player. If Microsoft has a monopoly, great — they'll make tons and tons of dough.

But let me give you a thought experiment about productivity and corporate earnings: Let's assume that two seed companies come out with an incredibly productive seed that doubles corn-growing capacity — and they sell it at the same price because there are two of them. And everyone in the world buys it. What happens to the price of corn next year and the profits of the corn growers? They all get wiped out. Why? Because it's freely available. If they were only to supply it to Illinois farmers, they'd *drown* in profits. But because it's freely available, they'll drown in *losses*. However, the consumer will win big.

The internet is a profit *creator*? It's a profit *destroyer*....

Grantham: Now the internet, above anything that has ever been, is democratic. It is just *itching* to make its services available to the smart programmers in India, to small companies to simulate the behavior of big companies and to German companies to quickly get up to speed and look like American companies. It eliminates the frictions of wholesaling and retailing.

By the way, ladies and gentlemen, you are in the country where wholesaling and retailing is the model. There is very little blood left to be gotten out of that stone. In England, let alone Japan, there are *prodigious* savings to be had. Of course, the internet, in its function as a cost-squeezer, is going to provide the rest of the world with a wicked advantage as it strives to close the gap with the ultra-efficient distribution of the U.S. And that will be a *threat* to U.S. profits.

The internet is a profit-destroyer — it's a cost-destroyer. It's wonderful for [consumers]. However, profits are a cost.

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It is not wonderful for corporate profits. It is wonderful for productivity. It will cause the world to grow a little bit faster. And over the long run, profits will grow with that. However, that is a tiny 15-20 basis point a year effect — enough perhaps to offset the general decay in long-term growth over the next 20 years that comes from an economy slowly maturing.

EVEN ASSUMING AN OVERLY ROSY SCENARIO, THE RETURN OUTLOOK FOR BIG U.S. STOCKS STINKS.

Take a new trend line of 17-1/2 times earnings, please.

Grantham: I know some of you are certainly not in the investment business. So if you're not — if you're in the finance end of your companies — please just ignore this question. But for anyone who's ever managed a portfolio, here's a simple question....

I've been a bear now for several years — ever since the P/E on the S&P went through 17-1/2 . The average historically has been 14. It began the 20th century at 12. And I believe because of liquidity and lower costs, the market deserves a modestly higher trend-line P/E over time. Thus, I've marked it up to 17-1/2 — just out of the goodness of my heart, if you will. In other words, I assume that 17-1/2 is the new trend line.

Whatever managers may say, here's what they believe....

Grantham: And I have a question I ask roomfuls of eager-beaver, 35-year-old portfolio managers. I'm going to ask you the same question: Since I became cautious with the P/E having risen above 17-1/2, how many of you who've managed money believe that over the next 10 years, the P/E on the S&P 500 will never get as low as 17-1/2? Those of you who think it will always stay above that, please raise your hands. There's one person. You get points from Keynes for being eccentric and other good things — which is a great investment asset in the long run.

However, I have asked this five times — including the initial time at ... a very good course in Princeton given by a Harvard Business School professor, strangely.... They do three business school cases designed for professionals each day.... I asked them this same question. And no one

(continued in next column)

put their hands up. I went into a complete state of shock. I said, "What do you mean? You're *bulls*. How can you *not* put your hand up?" So I rephrased the question the other way so that everyone would put their hand up and they did — so I knew they understood.

Every professional except one (you're my first one) ... believes that the P/E on the S&P will decline to 17-1/2 times earnings sometime during the next 10 years. This is not about the great bull market conspiracy. This is not what they have to put in print. This is what they believe.

Here is the P/E exhibit. And it shows how reasonable a P/E of 17-1/2 is: **(Chart 1)**

Actually, were it to revert to the mean — to what the P/E has actually averaged over the past 70+ years — we would be looking at a P/E of only 14 times. As you see, the P/E has literally exploded upwards during this bubble of the last few years.

Managers don't expect margins to stay at historical high.

Grantham: I asked another question. I didn't get to put it to all of the groups because I started to ask it later. However, I did get to put it to four groups. And here it is:

Profit margins have averaged 5.0% of sales. OK? They peaked during the 1960 good period at 7.2% just as they peaked two years ago at that same 7.2%. [Now] they're coming down a little. **(Chart 2)**

So I asked, "Who believes that in the next 10 years, the profit margin on sales — in effect, under the power of the most efficient competitive market ever recorded — is [not] going to be bid down to 6%? Again, 5% is the average. I just use 6% out of the kindness of my heart. And 100% of professionals, maybe with one exception, agree with me.

Using the managers' assumptions, stocks would fall 50%.

Grantham: So virtually 100% of professionals whom I've asked agree with me that profit margins are going to decline at some time during the next 10 years to 6% and that the P/E is going to decline to 17-1/2. Now there may be stockbrokers who *don't* agree with these assumptions — with this data. However, professional portfolio managers and analysts do.

And if so, then here are the implications: We assume a P/E of 17-1/2 (up from the historical average of 14) and a profit margin of 6% (up from the actual historical average of 5.5%). Incidentally, we've assumed annual sales growth of 4% per year, although we actually believe the figure will be closer to 2%. The long-term trend has been only 1.8%. We're putting in 4% only because our clients can't stand anything less. **(Chart 3)**

I've also used another generous assumption — namely that my already optimistic P/E doesn't occur until the last day of the 10th year. And every professional to whom I've posed the question believes that it will hit it sooner than that and, therefore, that there'll be *more* pain. For example, if it sells at 17-1/2 times earnings tomorrow, there would be a decline of almost 50%.

Using optimistic assumptions, returns will average -1.9%.

Grantham: So, anyway, here's how it works out [using those assumptions] in terms of compound return per year. The loss from the contraction in the P/E ratio: 6% per year. The loss from a contracting profit margin:

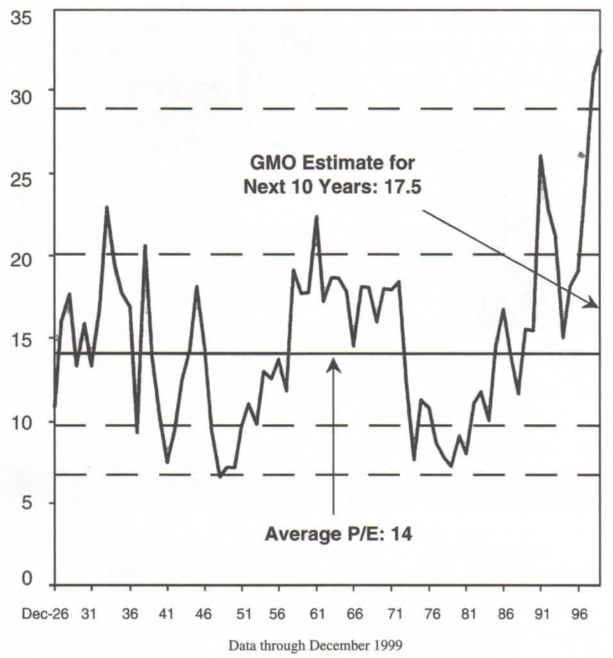
(continued on next page)

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

1.8% per year. And again, that's if it hits it on the last day of the 10th year — which is certainly friendly. The

CHART 1

U.S. Equities: Building a 10 Year Estimate
Price to Earnings Ratio of S&P 500



Source: Grantham, Mayo, Van Otterloo & Co. LLC

contribution to return from growth in sales per share is an unrealistically high — even loony — 4% per year. The return contribution from the yield is 2.2% per year — which is simply a matter of doing the math. **(Chart 4)**

Thus, netting out the gains and losses using assumptions which nearly all of you agree are reasonable — and which I think, if anything, are overly optimistic — the compound return on the S&P 500 in the next 10 years should average a negative 1.9% per year.

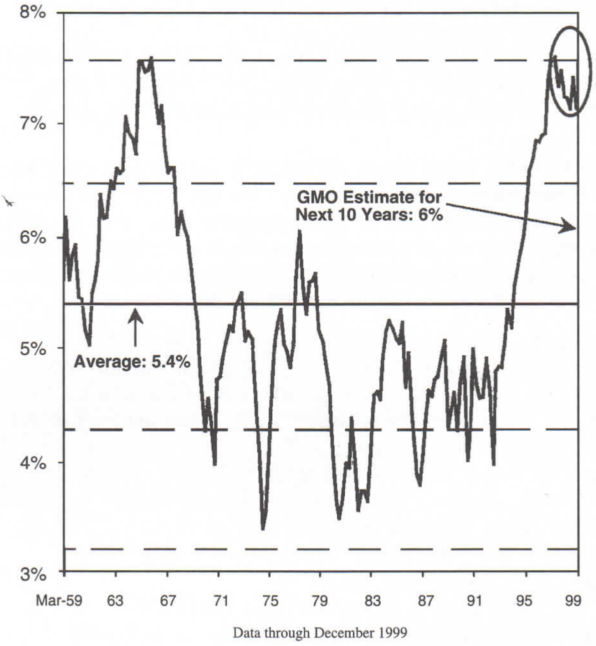
And I challenge anyone to tell me with a straight face that I'm using seriously bearish assumptions — because I'm most definitely not. My assumption of a 17-1/2 P/E is above average. My assumption of a 6% profit margin is *way* above average. And 4% sales growth is so high — so optimistic — that it's loony. And yet it still only gets me to a total return of a negative 1.9%. For example, if I assume 2% sales growth instead, I arrive at an estimated return of a negative 3.9% per year. That starts to get more like it — closer to reality.

Recent rapid sales growth is nothing more than a fiction....

Grantham: And on this next [slide], we show

CHART 2

U.S. Equities: Building a 10 Year Estimate
Profit Margins of U.S. Corporations



Source: Grantham, Mayo, Van Otterloo & Co. LLC

historical, long-term sales growth. The long-term average is a remarkable 1.8% per year. That's all — only 1.8%. How many professionals know that? I'll tell you right now that it's not many....

During the last 10 years of this *incredible* progress that we've gone through — this *ineffable* productivity — sales growth has been a mere 1.0%. These are the facts. It's actually been slightly below trend, although not enough to bother about — a single standard deviation. However, sales growth per share of U.S. corporations that are listed in our database have only grown at 1%. **(Chart 5)**

So what's the likelihood of sales per share growing 4% per year during the next 10 years — where that arrow is floating off in space? I'll tell you what it is — slim to none.

The odds of the S&P earning normal returns? *Minuscule.*

Grantham: What kind of sales growth would it take to give us historically normal returns — say 7% in real return — over the next 10 years if we believe a 17-1/2 P/E and a 6% profit margin? Well, it turns out that it would take 12.8% per year sales growth — a level of sales growth which is represented by the arrow at the top right. And it's not entirely impossible. It could happen. However, statistically, I can't tell you what the odds are — because that would be a 12 deviation event and our computer refuses to answer it. But I understand the odds for an eight standard deviation event are one in 27 quadrillion. So the probability for 12 is certainly less than the chance of you or I personally being hit by a meteorite.

There is such a profound gap between what professionals know the data to be saying and the bullshit

(continued on next page)

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

that floats around in the ether. And that's the nature of the beast — a lot of ignorant people, as Keynes said, behaving on *very* little information like a pack of hysterical sheep and the vested interests pumping out good news, good news, good news, however overstated it has to be.

Dow *36,000*?! More likely is Dow *3,600* — maybe even *less*.

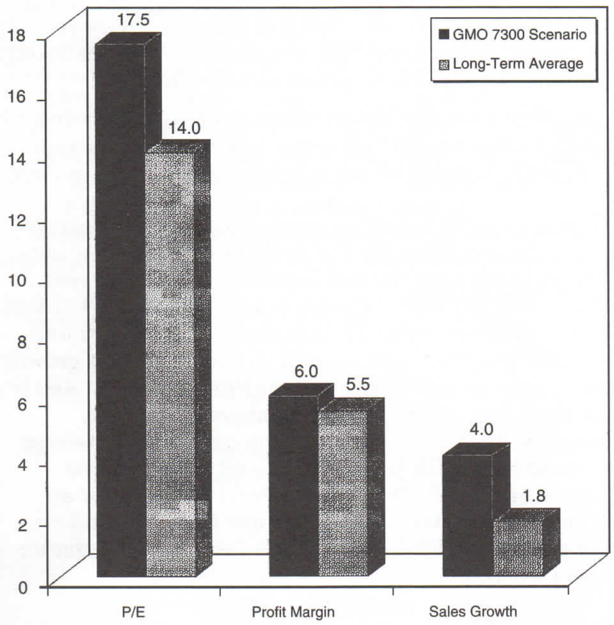
Grantham: Now, in response to the argument some make that the Dow would be more fairly valued at 36,000, I've prepared a chart that shows what it would take for the Dow to trade at only 3,600 — at 1/10th the 36,000 figure. And here's what it would take: **(Chart 6)**

Again, mind you, we're talking 10 years from now. The P/E would have to be 12.6. The profit margin would have to be 5.2%. And sales growth would have to be 1.6% per year. How unlikely is that? Well, I was around in '82, as most of you were, when the P/E was 8. And I was around in '74 as some of you were when the P/E was 8. Next, profit margins: Yes, they've averaged 5.5%. However, in 1982, profit margins were down around 3.5%. Times were tough — a recession. Perhaps we'll never have another one. Let's hope so.

For sales growth (note the right-hand corner of the chart), my assumption of 1.6% per year sales growth is less than the historical average of 1.8%. However, in 1982, it was only 1.0%. Again, even during the last 10 years, sales growth averaged only that same 1.0% — perversely. So I would submit to you that my assumption of 1.6% per year sales growth is actually a pretty friendly one. And again, those assumptions, sad to say — believe it or not — give you Dow 3,600.

CHART 3

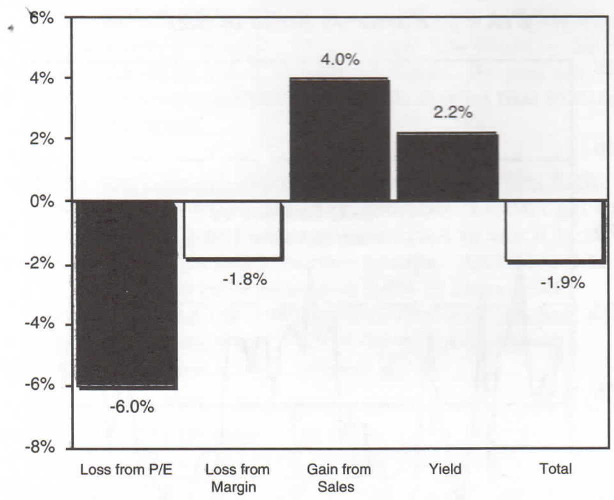
U.S. Equities: Building a 10 Year Estimate
GMO Scenarios vs. Long-Term Averages
(Dow 7300)



Source: Grantham, Mayo, Van Otterloo & Co. LLC

CHART 4

U.S. Equities: Building a 10 Year Estimate
Components of Annual Return to S&P 500
Regression Over 10 Years



1926-1999 Averages		Starting Levels:		Assumptions:	
P/E	14.0	P/E	32.5	Terminal P/E	17.5
Profit Margin	4.9%	Profit Margin	7.2%	Terminal Profit Margin	6.0%
Real Sales/Share Growth	1.8%	Trailing 10 yr. SPS	0.9%	Real Sales/Share Growth	4.0%
Yield	4.3%	Yield	1.2%	Average Yield	2.2%

Source: Grantham, Mayo, Van Otterloo & Co. LLC

Actually, were we to return to the figures that prevailed in 1982 — perish the thought — we would be talking about a Dow Jones Industrial Average of only 1,450.

The likely returns from U.S. large-cap stocks are *negative*.

Grantham: This is our 10-year forecast. It shows our total return expectation per year for a range of asset types. The bar on the far left-hand side of the table represents our expectation for U.S. large-cap stocks. **(Chart 7)**

Incidentally, note that our expected annual return for U.S. large-cap equities rallied to a negative 1.5% [from the negative 1.8% that I mentioned earlier as of the time we prepared this chart]. However, it's back to 1.8% again today. As you see, the outlook for most equities is unattractive.

THIS ONE MAY INDEED TURN OUT DIFFERENT.
BUT I WOULDN'T RECOMMEND YOU *BET* ON IT.

Valuations have spiraled up, up & away by every measure.

Grantham: The next four slides all demonstrate the same thing. This one is standard operating procedure.

(continued on next page)

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

First is Tobin's Q. **(Chart 8)**

Andrew Smithers' book after 330 pages will convince you that Tobin's Q is the only thing that matters. It's price to replacement cost. The whole market to replacement cost done by the Federal Reserve has been mean-reverting around a figure of 1 all the way back to 1925. And then the last four years, in this wonderful bubble, it freaks out.

The next chart shows the ratio of stock prices to 10-year average real earnings. **(Chart 9)**

It's Shiller. I used him long before his book [*Irrational Exuberance*]. I have the trend line for average P/E — which is the solid, almost straight line — trending up, because I think it deserves it. Note the actual historical experience is mean-reverting around that — which makes me think that I may be right. But it's also spiraled up, up and away.

Whatever yardstick you choose, the conclusion's the same.

Grantham: This next chart displays the ratio of market cap to GNP. **(Chart 10)**

And finally, there's dividend yield — which I just throw in for fun, although I know it's a nonstarter. **(Chart 11)**

Please note all these charts are completely different. But note that they show exactly the same thing. And interestingly, when you look at standard deviations, the similarities are *overwhelming* — which warms the cockles of any quant's heart. However you look at this market, if you want to be serious, every data point agrees. In effect, the bulls have faith and the bears have facts.

High markets lead to lousy returns — & this one's absurd.

Grantham: The next exhibit, Shiller's Tobin Q, shows what happens when you divide every month [to come up with the average P/E] and then, based on that P/E, see what the average subsequent 10-year real return has been. **(Chart 12)**

Not surprisingly, if you buy when the P/Es are cheap, you get an average compound annual real return of 11% during the subsequent 10 years. This is what happened in 1982. Conversely, if you buy when P/E multiples are most expensive — in the upper 20% of historical experience — you get an average real return for the subsequent 10 years of *zero*.

That's been the experience when you average in the subsequent experience following *all* of the times that stocks have been in their upper quintile of expensiveness since 1925. There's been no real returns for 10 years.... And today's P/E is far higher still than it's ever been during any of those prior periods.

Actually, this market peaked on or about April 12 at a P/E of about 32 — which is more than 50% above the area where stocks have historically earned no return at all.

And these are facts, by the way. It's a fact that 20% of the time, you simply don't make money in the market — despite all the B.S. that is written about it.

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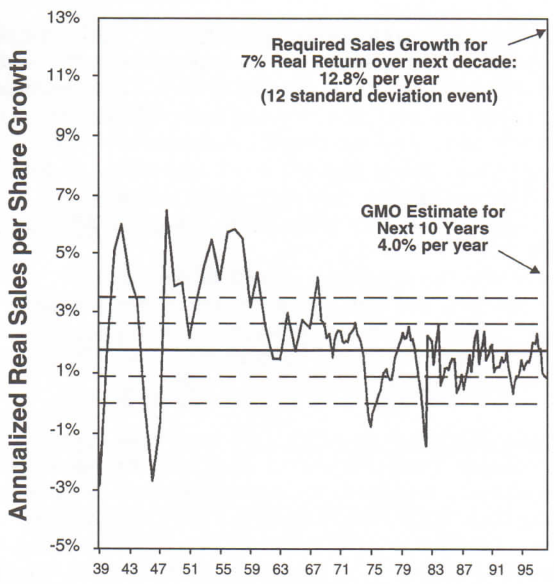
CHART 5

U.S. Equities: Building a 10 Year Estimate
10 Year Real Sales/Share Growth for S&P 500

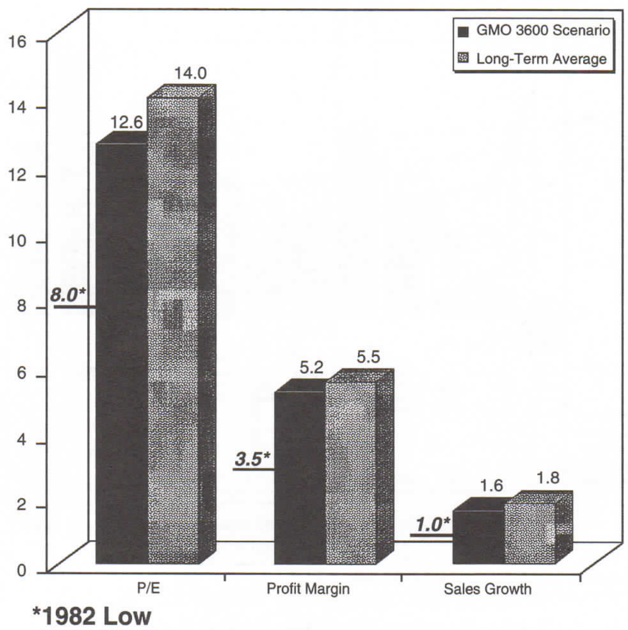


Data through December 1999

Source: Grantham, Mayo, Van Otterloo & Co. LLC

CHART 6

U.S. Equities: Building a 10 Year Estimate
Dow 3600 Scenario vs. Long-Term Averages



*1982 Low

Source: Grantham, Mayo, Van Otterloo & Co. LLC

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

THIS BUBBLE HASN'T BEEN ABOUT FUNDAMENTALS.
BUT THAT'S BEEN TYPICAL OF PAST BUBBLES, TOO.

About 60% of this bull market's returns were from P/E.

Grantham: Behaviorism is everything in the market, and fundamentals matter very little, in terms of explaining the P/E. Remember that the contribution of the P/E to this entire bull market is 60% of all of its gains since 1982. The P/E's gone from 8 to 32 — which is a quadruple. So that's been the engine of this bull market.

What determines P/E? Here are the things that matter....

Grantham: So you need to understand P/E. P/E is explained by factors related to comfort and confidence. And we challenged that notion. We tried a dozen things that have at least a mild correlation with P/E and anything to do with comfort and confidence. And we determined that three factors drove everything else out:

First was stability of GNP. Investors don't care about the growth rate. They care about stability. And it's never been more stable on a five-year moving average basis than it's been recently.

Second is inflation. They like low inflation. We live in a real economy, of course. These are real companies. And of course, they pass through inflation. However, investors have felt uncomfortable during periods of higher inflation. They like low inflation.

Investors don't care about sales growth. That's fortunate.

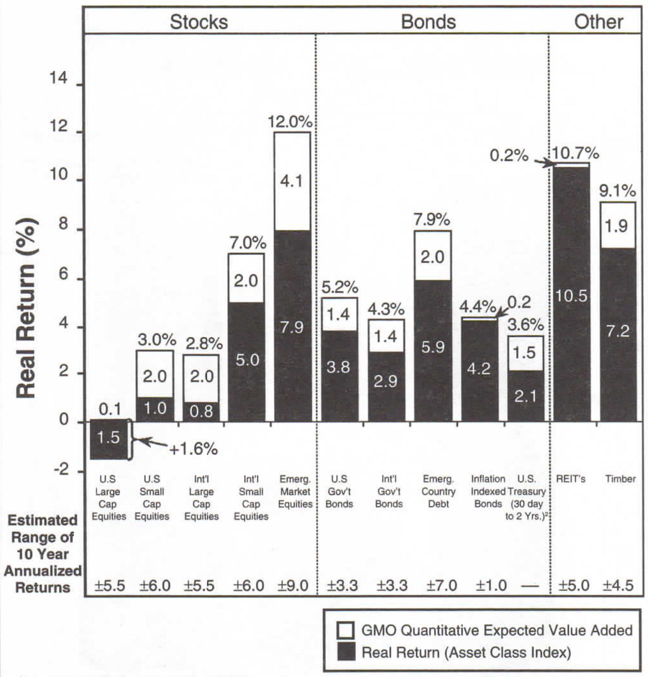
Grantham: Third, they like high real profit margins. They don't care about sales growth — which is fortunate. And indeed, the sales growth rate in the last 10 years has been way below average. They're interested in profit margins, stability and low inflation.

Those factors are represented by the dotted line on this next slide. Note the incredibly good fit — fully 86%. And note that it catches 1929. It catches 1972. And it certainly caught this last one. **(Chart 13)**

This market has gone far above the explained level. However, still, the normal response of ordinary human beings doing their behavioral thing is to have had in this cycle the highest P/E in history. And, by the way, if you run the real discount rate as an explanatory factor for P/E, which is what Finance 101 would suggest, it has a slightly negative correlation with P/E. So there's nothing about this whole process that really relates much to Finance 101.

CHART 7

GMO Ten Year Asset Class Return Forecasts[1]
As of March 1, 2000



[1]Long-term inflation assumption: 2.2% per year.
[2]Transported alpha from global equity management.

Source: Grantham, Mayo, Van Otterloo & Co. LLC
Forecasts do not represent guatantees of future performance.

STOCKS DESERVING THEIR SKY-HIGH VALUATIONS
WOULD BE THE GREATEST BEAR CASE OF ALL....

There's a difference between justifying and explaining.

Grantham: The trouble with this comfort model — and the comfort model is used by people like Abby Cohen — is they say, "Well there you are, of course the market should be high. It has all of these wonderful comfort factors. So what are you talking about? That explains 1929. It explains everything. So why are you complaining?"

Well, I'm complaining because there is a difference between justifying and explaining.

There's an inverse correlation between comfort and returns.

Grantham: The comfort model explains why P/Es are high, but it doesn't justify it. To justify high P/Es because of comfort requires that they're going to be followed by good performance. And the trouble with comfort, like everything else in life, is that it's mean reverting. Stability is followed by instability. And high profit margins — PLEASE — are followed by lower profit margins. After all, that's what capitalism does.

And this is the predictive quality of our comfort model. If you buy when people are comfortable, you earn a real return of a whopping 1% per year. In contrast, if you buy when people are most *un*-comfortable, you earn *11%*. And that's the name of that game.

Stocks deserving sky high P/Es is the best bear case of all.

Grantham: Okay, argument #3 is the new paradigm. We've listed every argument for a new paradigm 'til we're blue in the face. And a lot of them are pretty impressive. The world, of course — as it is during every great bubble — is in wonderful shape. And we list about 20 factors. Some of them are real. Some of them are half real. But most of them are optical illusions. Enough of them though are real

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GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
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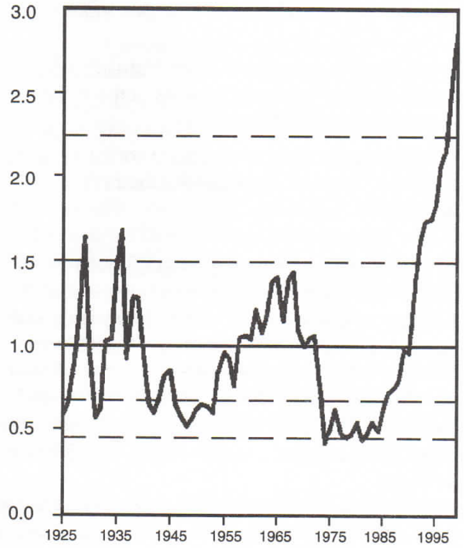
CHART 8

Tobin's Q



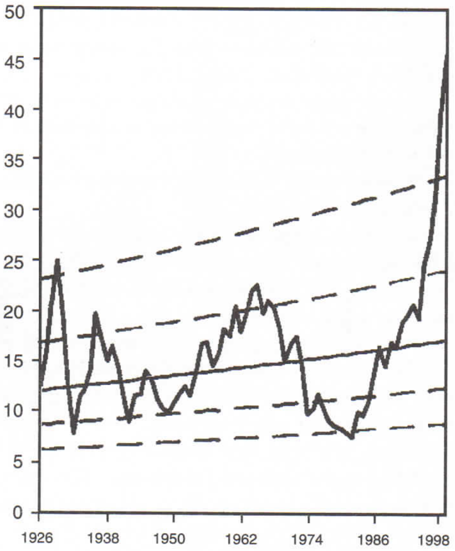
2.2 Standard Deviations Expensive

Data as of December 1999
Note: Tobin's Q renormalized to average one.

Source: Grantham, Mayo, Van Otterloo & Co. LLC

CHART 9

Price / 10 Year Average Real Earnings



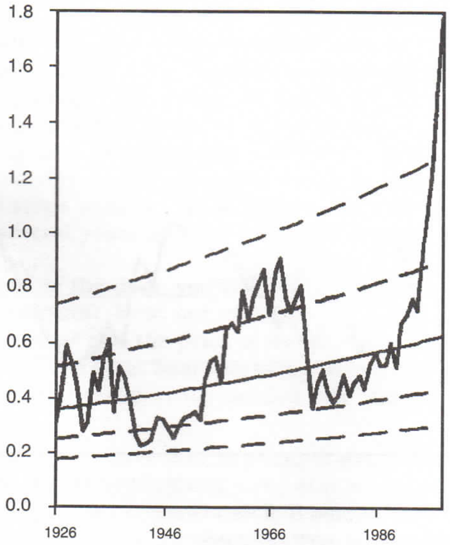
2.5 Standard Deviations Expensive

Data as of December 1999

Source: Grantham, Mayo, Van Otterloo & Co. LLC

CHART 10

Market Capitalization vs. GNP



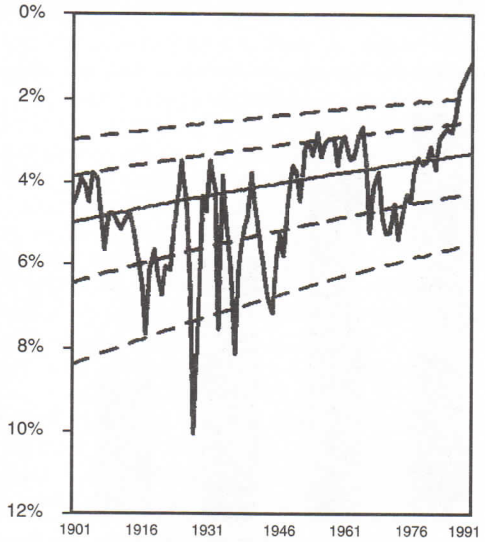
2.7 Standard Deviations Expensive

Data as of December 1999

Source: Grantham, Mayo, Van Otterloo & Co. LLC

CHART 11

Dividend Yield



2.8 Standard Deviations Expensive

Data as of December 1999

Source: Grantham, Mayo, Van Otterloo & Co. LLC

GRANTHAM, MAYO, VAN OTTERLOO'S JEREMY GRANTHAM
(cont'd from preceding page)

to give some teeth to the new paradigm argument.

However, the counter-argument isn't to fight every one of these 20 things individually. (We could do that, but we'd spend a lot of time in the process.) Rather, the argument is to say, let's assume that they're all right. Let's assume every one of the 20 cases is right. And the market does deserve a premium valuation — say 32 times earnings. Say it deserves an earnings yield of 3%. You're so wonderfully comfortable — you need so little return because stocks are so safe (safe as bonds or safer) — that you don't have to be bribed.

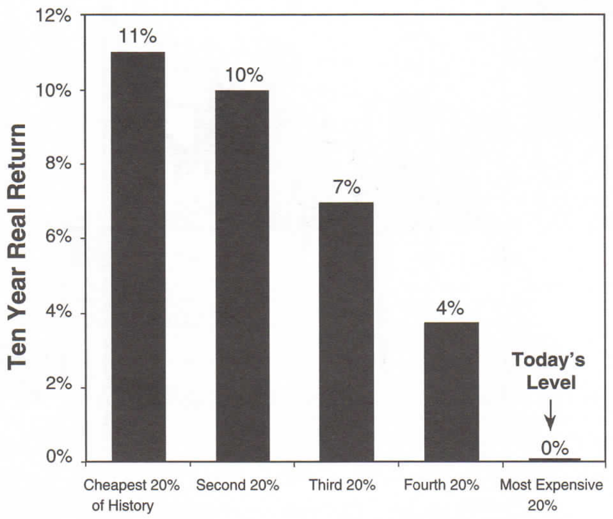
So the discount rate has dropped down to an earnings yield of 3%. You get all of 3%.

Well, to me, that's the greatest bear case of all: The new paradigm is correct, it's a wonderful place. It's going to be 32 times earnings forever and you're going to have to learn to live with a 3% real return.

Well, not only is a 3% real return simply not enough for most people, it's a terrible mismatch with expectations of 15% a year shown in surveys and it's less than a host of other attractively-priced asset classes. If one thing is absolutely certain, it's that this bubble is not Japanese style. Everything hasn't gotten blown up. It's not like Japan with Tokyo real estate at 70 times downtown Manhattan and golf club memberships costing $1 million. This cycle in the U.S. is only the blue chips. Everything else is much less unreasonable. And some asset classes are downright *attractive*.

CHART 12

Quintiles of P/E to Predict Ten Year Returns



Source: Grantham, Mayo, Van Otterloo & Co. LLC

OUTLOOK FOR ALL CATEGORIES ISN'T SO BAD. IN FACT, HERE ARE A FEW THAT ARE QUITE GOOD.

Two asset categories with not-so-bad return outlooks....

Grantham: For example, our forecast for international small-cap returns isn't bad. In fact, the emerging market returns should be pretty good, but risky. Fixed-income returns ... are all very reasonable indeed — all on trend line or better. The inflation-protected one is even a real return of a wonderful 4.3% per year.

And small value stocks are almost reasonably priced.

Grantham: In the interest of time, let me just briefly touch on the next [slide]. **(Chart 14)**

This slide tells you that the value stocks and the small stocks are much less expensive. In fact, small value is almost reasonable.

The real estate market's in the sweet spot....

Grantham: And the REITs are *cheap* — really, seriously, absolutely cheap — in the biggest bull market for blue chip equities in history. They sell at a 25% discount from real estate — which is itself priced fairly. There are no cranes all over America. The market's in the sweet spot. Bankers aren't lending ridiculously. Real estate's a good solid asset with a good solid return. Yet REITs trade at a 25% discount.

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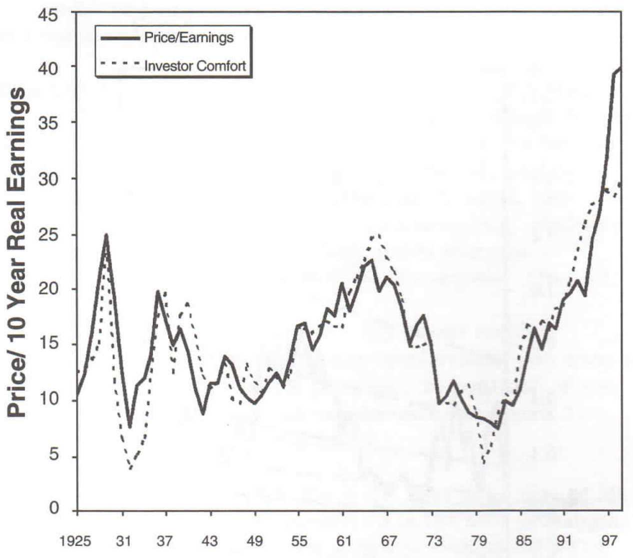
CHART 13

Explaining the P/E Ratio of the S&P 500

Using Independent Variables: Volatility of Corporate Growth, Corporate Profitability and Inflation



Adjusted R of Regression: 88%

Present Level of Price/ 10 Year Real Earnings:	39.9
Present Prediction:	29.9
Prediction if profitability factor were to drop halfway to normal:	23.9 (down 40%)
Prediction if profitability factor were to drop to normal:	18.9 (down 53%)

Source: Grantham, Mayo, Van Otterloo & Co. LLC

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

They yield 8.8% [currently 7.2%]. They have a history of increasing their real return at about the same rate as the S&P 500. It's *truly* ridiculous. Yet some say it's an efficient market. In my view, it's a complete joke.

Bad memories = wonderful returns (in real estate & timber).

Grantham: Why? Because the real estate industry's in a completely different part of its boom/bust cycle. Seven or eight years ago, we had the bloodiest break in real estate history. Every real estate developer was either bust or kept in business to help the insurance companies out. And they still talk very, very seriously. "Oh yeah, don't tell me the REITs are cheap. You gotta remember this and that. You ought to be conservative. You should have seen them five years ago when they were 30¢ on the dollar."

When you talk to real estate people today, you're talking to serious people in mean-reverting heaven — within the prudent part of the cycle. The bankers won't lend to real estate people like they used to because they remember how burnt they were. And the consequence will be *wonderful* real returns.

An asset class that's outperformed the S&P: timber.

Grantham: Ditto for timber — it's one of my favorite asset classes. We expect it to enjoy *huge* returns.

This slide shows the real growth in timber prices, S&P earnings per share and the value of the S&P from 1910 to the present. It shows that real timber prices have compounded at 3% per year. That's greater than the 1.4% real increase in S&P earnings per share. And it's even greater than the 2.2% real return the S&P managed during that same period. **(Chart 15)**

Just as an aside, the earnings line and the price line cross 14 times. And if you believe it won't be 15, that's your right. But in either case, timber has actually beaten it *without* yield. The yield on timber today is — and always has been — about 6%. The yield on stocks is down from 4.5% to around 1.2% today. So you've got a price series that's won *and* a yield that's hugely higher.

Of course, the main risk in timber is that we suffer through a very prolonged period where it stops raining or the sun stops shining. So if we have the meteorite hit and we get several years of dust, we could be in big trouble.

If you believe the data, you've *got* to own timber.

Grantham: Now, out of that series, I've looked at the price of timber and the price of the S&P during this century's three great bear markets. Remarkably, as you see, when you really, really needed help, timber provided it. **(Chart 16)**

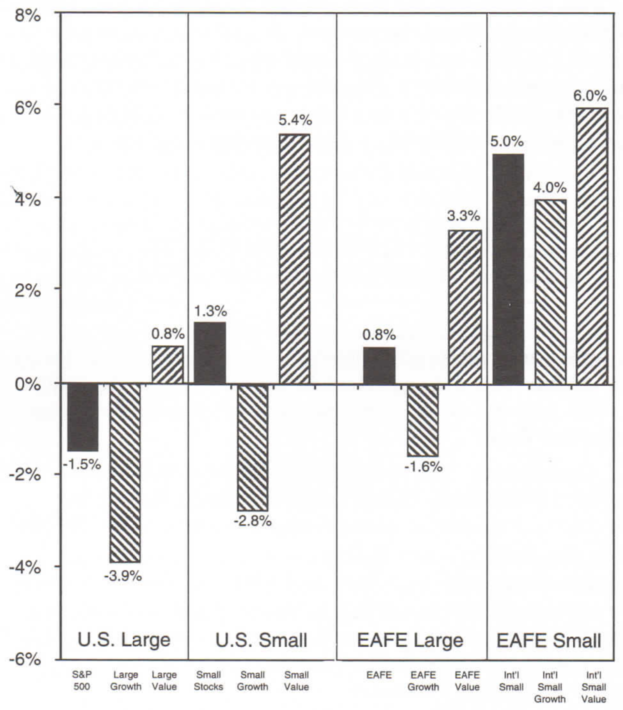
Now some clever Dick is going to ask me why that happens. And I'm not going to be able to say. (This data, incidentally, comes from the U.S. Forestry Service.) But if you believe this data, you have to own timber. Of course, you may not believe the data. However, again, if you do, then you've got to own it — and I do.

By the way, timber also has the great virtue of making people think long term. That's another reason why I like it.

CHART 14

Ten Year Asset Class Forecasts

As of March 1, 2000



Source: Grantham, Mayo, Van Otterloo & Co. LLC

BUBBLES ALWAYS GIVE BACK EVERYTHING.
THERE HAVE BEEN *NO* EXCEPTIONS — *NONE.*

What goes up must go down (and down and down...).

Grantham: This is the killer of all exhibits. In fact, it's so good, I couldn't let you have it. We've been through every conceivable bit of data we can get on currencies, commodities and stock markets — some we have 200 years of data, some we have 20 years. And we've looked for the following definition: Define long-term trend and look for a breakout on the upside which is a 1 in 40-year event. These are the most important: Gold, crude oil, etc., dollars, pounds, the S&P in '29 and '65, Japan 10 years ago and the S&P 500 today. We have, in addition to the 12 on this exhibit, about 36 or 37 such events in total.

And every single one of them gave back *everything*. There are no new eras. Every one of them — most of which were *felt* to be new eras — gave everything back to trend. There were no survivors.

And in the stock market, the subsequent declines never stopped at the trend line. They all went slicing through fair value like a knife through butter. This one may indeed be different ... but don't bet on it....

And no one's been able to come up with an exception.

Grantham: Lest you think I'm overstating, I've spent the last year asking groups of financial professionals, "I

(continued on next page)

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

beg you, please give me one example... Irritate me. Stick your hand up. Prove me wrong! If you're timid, send a fax or e-mail". Well, not a single example's been forthcoming. And I've been talking to groups — 140-senior-portfolio-manager-stuff. No one has come up with a bubble that didn't break completely.... That's pretty sobering....

TODAY, HOWEVER YOU SLICE IT,
PRICES HAVE GOTTEN *BEYOND* RIDICULOUS.

Ten years ago, we forecast decent returns, but not insanity.

Attendee: Jeremy, if we backed up 10 years earlier to 1990 and did all of your charts, what would they have suggested then?

Grantham: Ten years ago, you'd have found we were, I believe, moderately below long-term trend-line value. You'd have expected a decent return — not the return you got in the bubble — for stocks.

Starting about four years ago, you crossed over into overpricing. Three years ago it began to look ridiculous, two years *very* ridiculous, and a year ago — which is about the same level as today, by the way — it got *transcendentally* ridiculous.

However, it looked pretty good 10 years ago.

We've looked at it upside down, sideways — you name it....

Attendee: You've used the S&P 500 as your proxy for the market. Have you used this on an unweighted basis or used something like the *Value Line* which is an unweighted index to look at some of your valuations?

Grantham: To be quite honest, I have quite a lot of help — and my only job for four years has been wallowing in why I'm a bear. So I've looked at everything upside down, sideways, equal-weighted and underweighted. And the [result] of the exercise is always the same....

The NASDAQ has to go down 70% just to trade at fair value versus a meager 53% decline for the S&P 500. So the NASDAQ is *seriously* worse — 1.4 times as bad — as the Big Board.

So in that sense, we've broken out a lot of the smaller, different, more aggressive ones. And the 18% of stocks listed on the NASDAQ whose companies have no earnings, we believe, are another 1.3 times more expensive than that.

No need to adjust for S&P composition. It's *self*-adjusting.

Attendee: When you look at valuations in the context of history, for example, in the case of the S&P, how do you adjust for the change in the composition of the S&P today versus the companies that it contained 20 or 30 years ago?

Grantham: The S&P has always run 80%± of the total market cap of the whole U.S. economy. And it's always changing: Heavy in railroads, heavy in chemicals, then heavy in the Procter & Gambles and the Avons and

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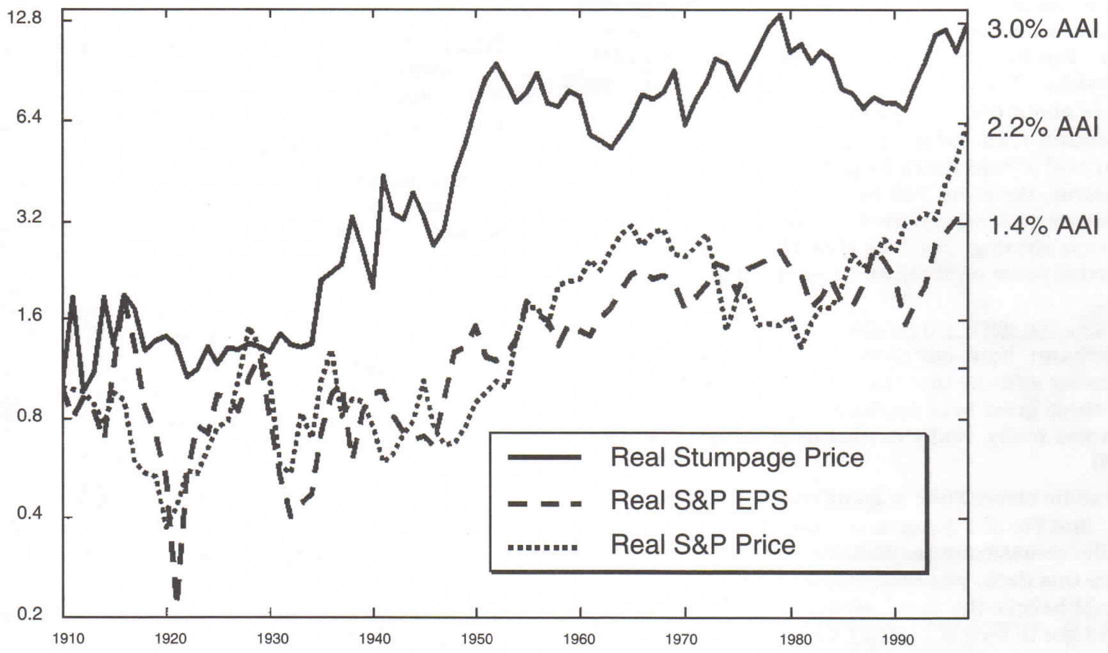
CHART 15

Real Growth in Stumpage Price vs. S&P 500



Source: U.S. Forest Service and Standard & Poors

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

IBMs in the '60s and then heavy in the blue chips again. And, most recently, it had a 32% weight in technology. So it's always rotating. And it always represents 80% of the total value of the marketplace, give or take a little. So it is a very fair reflection of the total.

And of course, if you add in the NASDAQ which we try to do, then you get up very close to 100%. So it does reflect the whole economy. Therefore, I don't think that you *have* to adjust. It's *self*-adjusting.

THE SAFEST ASSET ALLOCATION STRATEGY TODAY? REITS, REAL ESTATE, TIMBER & EMERGING MARKETS.

After all, portfolio managers aren't paid to buy bargains.

Attendee: With secondary stocks so cheap, don't you think that the fund managers will start looking there?

Grantham: No. I just think the dominant fund flow is in the hands of mutual fund and institutional managers. And they're not paid to do that. In fact, they're *shot* for doing it.

Sadly, the closest you get to cheap is 15-20% overpriced....

Attendee: Doesn't that make it better for the individual investor? How do you respond to the idea that most stocks are reasonably priced and what we have here is a bubble within a highly concentrated group of stocks?

Grantham: I really *dearly* want to believe that because I'm a value manager. I want to believe that value's going to be hugely resistant — and it has been historically. And I really *want* to believe that value is spectacularly cheap in an absolute sense.

However, the truth is that the value stocks are very cheap *relative* to growth stocks, but still overpriced. They will be lucky to beat T-Bills in the next 10 years. That's the tough news....

The cheaper end of the market today — small stocks and value stocks — are not *absolutely* cheap. And that represents a terrible drawback. For example, the P/E on small stocks is up around 17-1/2 times earnings. By comparison, the P/E on small stocks in other bubbles was probably only 13 or 14 — and their long-term average P/E only about 12 times.

The closest you get to [cheap] is global small value which is only 15-20% overpriced. Therefore, in a decline, these guys will very quickly be selling below fair value. But they aren't yet.

The safest asset allocation today....

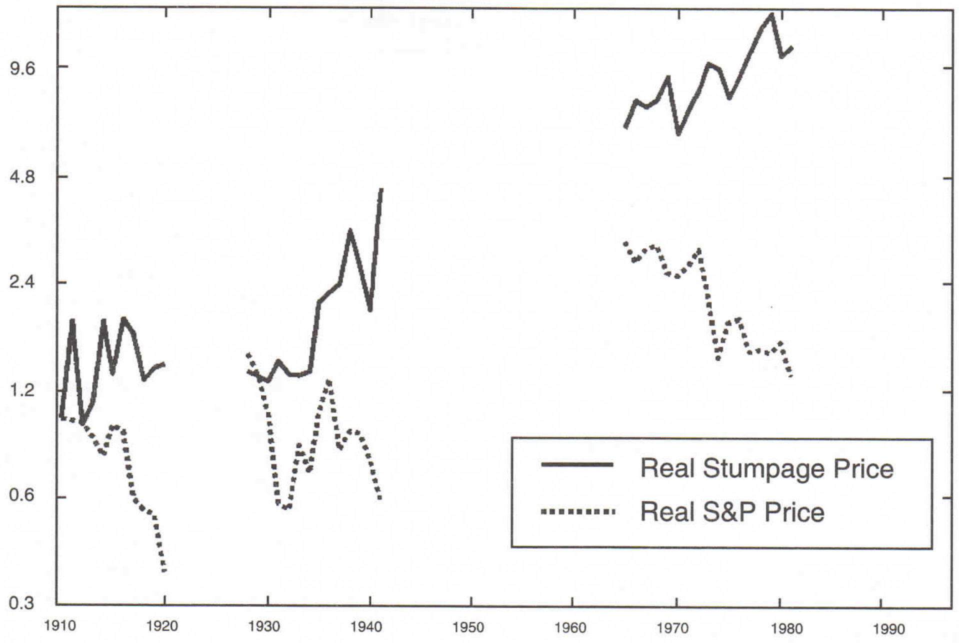
Attendee: Should we all sell our other stocks and buy REITs?

Grantham: The safety strategy today is to buy as many REITs as you can, to buy direct real estate, [to buy timber,] to buy as much fixed-income as you can, particularly inflation-protected bonds, and as much emerging equity and debt as you can stand to spice up the risk profile.

(continued on next page)

CHART 16

Real Growth in Stumpage Price vs. S&P 500 in Bear Markets



Source: U.S. Forest Service and Standard & Poors

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

You can get a much lower risk portfolio mixing those three — and you can get a perfectly high return. You can get estimated 10-year real returns of 5-6% per year in those asset classes if you simply mix REITs, inflation protected bonds, regular bonds and emerging equities.

Here's how we're protecting our clients....

Attendee: Jeremy, how are you running your own portfolios knowing that the end is nigh?

Grantham: You've heard our forecast for the S&P.... And I'm also in the business. We run 90% equity portfolios globally. Fortunately, we foresee a lot of return for emerging market debt and equity, good returns in fixed income and other asset classes. And we can tilt our portfolios as much as we dare to small and value — which we do. And we sneak in REITs and pretend that they're stocks.

I find it very interesting. Using traditional assets in a nontraditional way, you can take the risk outright from a traditional portfolio with 2% real return and high risk to a real return of 5% to 5-1/2% and much lower risk. How? By mixing huge quantities of low risk, fixed income instruments including TIPs with high return, high risk emerging equities and REITs.

Lest you have any doubt, we're also shorting the S&P.

Grantham: But still, we're stuck heavily in stocks by the nature of our book of business. So obviously I want to insure more heavily than anyone in the audience. And what I have is this portfolio: more than 10% in forestry, 10% in an emerging debt LP, 15% with a short seller who's got a terrific record, 15% in emerging equity and the rest in fixed income.

Then, just in case you had any doubt, I short the S&P against my entire portfolio. So what I'm doing with the S&P shorting is hedging out some of the business risk....

THE GROUND FEELS LIKE IT'S BEGINNING TO SHAKE.
BUT IT'S NOT TOO LATE TO SEEK HIGHER GROUND.

The Premature Death of the Value Manager.

Grantham: ...There were victims to the atmosphere of irrational exuberance. As technology stocks continued their dizzying ascent, the pressure on value managers intensified. The first quarter was brutal for investors who paid attention to things like company fundamentals, price earnings ratios, book value, dividend yields — indeed, any of the basic yardsticks that have been used historically to provide a measure of value. All an investor needed to do to invest profitably during the first quarter was optimism.

The first part of 2000 has been remarkable in that some of the country's — in fact, make that the world's — most prominent value investors threw in the towel. This illustrious group included George Vanderheiden (Fidelity), Gary Brinson (Brinson/UBS), Tony Dye (Philips and Drew) and, most recently, Julian Robertson (Tiger) who, having been significantly underweight in technology stocks, finally closed his remaining hedge funds. It would appear that value managers are fast becoming a rare species....

[Editor's note: We would also include in that illustrious group FPA Paramount's Bill Sams.]

The beginning of the revenge of the ~~nerds~~ value managers?

Grantham: ...The ground certainly feels like it's beginning to shake. The NASDAQ as of this writing is off by a third. Industrial stocks, especially value stocks, are also off — albeit by much less.

It is impossible, in our view, to predict whether we are at the beginning of a long-term recovery to value. However, at least we see how air has rapidly deflated from the internet bubble. If history is a guide, then we would expect to see a long-term relative return to value of more than 80%! The following chart shows theoretical and actual returns to value stocks in the U.S. when they were cheap by historic measures. **(Chart 17)**

The theoretical return incorporates both the expected return from a reversion to average price-to-book and a return of 3% per year as an imbedded component to investing in value stocks.

In each of the cases shown on the chart, value stocks returned to fair value, providing an actual return close to or significantly better than the theoretical return. Most importantly, value stocks in each of these instances actually overshot fair value, providing an even greater relative return.

The Fed Chairman may finally be taking away the booze.

Grantham: While we have had "false starts" to a value rally before, there is a difference this time. Alan Greenspan, who previously championed the expansion of the stock market bubble by keeping money loose and taking no actions adverse to the market, such as increasing margin requirements, has been much more proactive recently in trying to deflate the bubble. Five interest rate increases, with more to come, may finally put the brakes on this runaway market.

[Editor's note: Make that six (and counting).]

With personal savings so low, interest rates must rise.

Grantham: We believe as fervently as ever that this recent market turmoil has *not* created a long-term buying opportunity for equity investors. While the timing remains uncertain, there is no doubt about the ultimate outcome. The savings rate, currently less than 1%, must eventually increase. Higher interest rates will eventually lead to a lower trade deficit and higher savings rate. **(Chart 18)**

We're not just predicting rain. You can take steps, too.

Grantham: A less benign economic environment will surely envelop us, although we hope and expect it to be merely subaverage rather than disastrous. However, it is not too late to rebalance portfolios in favor of value stocks, small stocks, REITs, bonds, emerging equities, and (where portfolio liquidity constraints allow), timber.

Market-neutral, long-short investment strategies are also a compelling alternative. Our long-term outlook remains intact.

(continued on next page)

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

ANOTHER REASON PROFIT MARGINS ARE SO HIGH — BUT THE ONLY QUESTION IS *WHEN* IT ENDS....

What's holding this bull market up? It's profit margins.

Grantham: ...For a while, we seemed to have the great bull and the NASDAQ on the ropes. And it seems to have slipped away. We're dancing around the ring again.

The last great bull market in the 1960s did not hurry to give up the ghost.... The result was that both the bulls and bears felt disappointed for an extended period of time as they both have in the last year. And perhaps if there is not a crisis — an unexpected crisis — exactly the same unpleasant cycle will take place this time.

And I think ... that the villain is profit margins and profits in general. They're just so strong that even with rising rates, it's hard for me to see the market and the growth stocks getting hurt badly as long as profit margins remain good.

In technology surges, U.S. gets the early adopter benefit.

Grantham: We've mentioned before several times the normal factors that prop up profit margins — particularly the very low savings rate, the high consumption rate and the very high capital spending and a peak full employment economy.

But interesting to me, some of our research into booms and busts has shown an additional factor. In each of the three great bubbles of this century — and I include this one — there's been a technology surge. And each one in turn led to overconfidence, extrapolation of unsustainable growth rates, overinvestment — particularly in technology — and an eventual down cycle.

However, there was in each case a secondary effect which I had missed — and that is a U.S. edge. And the best description that I can come up with for that is the early adopter advantage. It just seems culturally that the U.S. can move more quickly, is inclined to move more quickly, is more aggressive in terms of investing and so on. We get a jump on the Europeans, Japanese and others.

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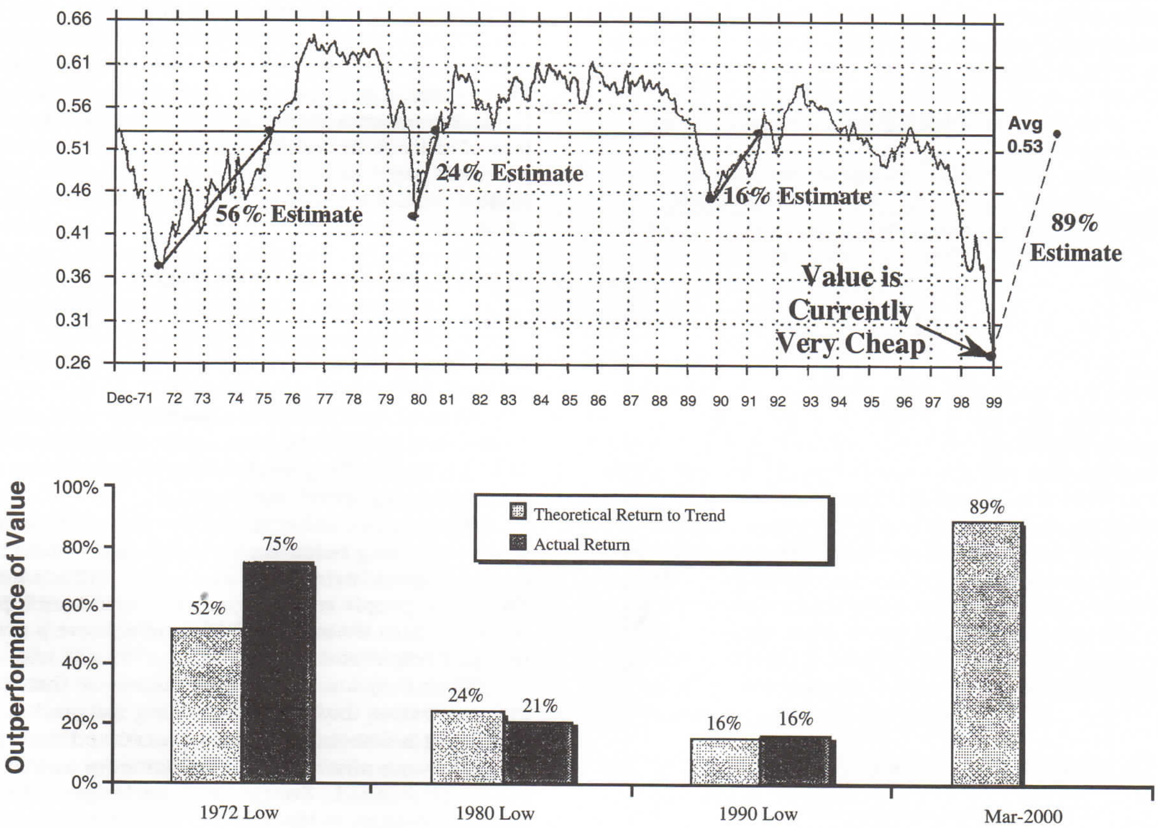
CHART 17

U.S. Value Opportunities

Relative Valuation of Low Price/Book Stocks Compared to the S&P 500



Source: Grantham, Mayo, Van Otterloo & Co. LLC

GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

But all good things end. The only question is when?

Grantham: But later, they catch up. They learn from our mistakes. They're less penalized by overinvestment. And the Nokias and Sonys exploit the secondary effects rather well. In the long run, of course, historically, they've had slightly *higher* GDP growth rates and slightly better productivity growth. But they have not done so in the technology surges of the 1920s, the 1960s and the 1990s.

So another key question is when is the maximum U.S. advantage reached? When does this technology surge begin to end. Anecdotally and looking at the data, it's still late in the cycle. But how can one be sure? In the meantime, this early adopter factor just seems to be another ingredient in a very complicated puzzle.

PART OF THE TECHNOLOGY BUBBLE HAS BURST, BUT THE REST OF THE STORY IS LITTLE CHANGED.

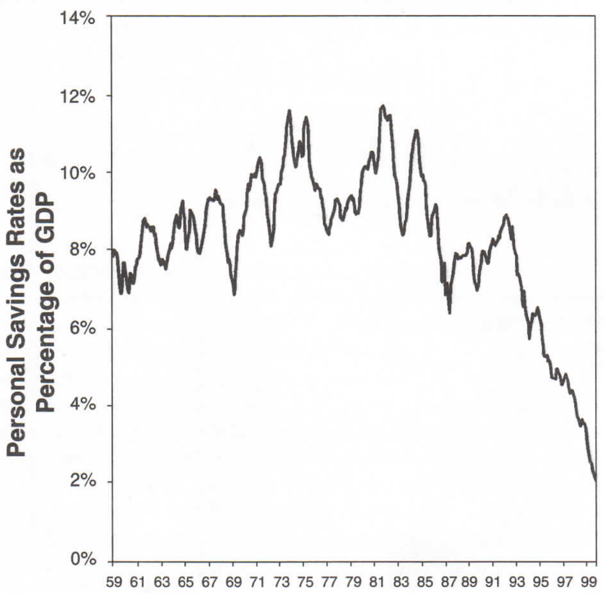
OID: How much have things changed since you prepared the charts for your speeches?

Grantham: Not much. The yield on REITs has dropped a little, but certainly not remotely enough to change the argument. The yield on emerging debt has gone up, in contrast — making it even *more* attractive. The prices of emerging equities have come down making them more attractive. And interest rates in general have gone up — which makes the fixed income area more attractive.

The exception has been that the return on our inflation-protected bonds has come down a little bit — which lowers our expected real return from 4.3% to 4.1%.

CHART 18

Personal Savings Rate



Data through November 1999

Source: Grantham, Mayo, Van Otterloo & Co. LLC

OID: What about your broad arguments — in terms of the technology area, small-cap stocks, value stocks and the S&P 500?

Grantham: Contrary to what the paper has said, there hasn't been a value rally. What's happened is that the technology bubble has come down. Since April 1999, it looks like the market's been in a slow topping out process ex-technology stocks. More stocks are down than up. And the broad levels of the market ex-technology have tended to drift down for the year.

Superimposed on that, uniquely, has been the spectacular technology/internet bubble — which started to lose air in April and has given back about half of its gain. But underneath the surface of that strange technology bubble, if you look at the balance of stocks which represent about 70% of the market's total capitalization, value stocks have not outperformed the rest of the market. In fact, it's either a wash or a slight tilt the other way. In other words, the Coca-Colas and the Procter & Gambles of the world have been gaining.

The only reason why the value funds look good is that the internet declined 23% relative to the market from such a big base that it meant the entire rest of the market had to gain against the market by 11% just to balance it out. So the one third that's technology declined by 23%. The two thirds that isn't gained 11% on a relative basis. Well, the hard value didn't even gain 11%.

Everything else actually did better that value. The recent market moves have resulted in large growth stocks pulling ahead of large value stocks year-to-date. So we haven't yet seen a value rally. What we've seen is just a loss of altitude in technology stocks. Therefore, all of the potential gains in value are pretty well intact. All you have to do is adjust for the technology effect.

POCKETS OF OPPORTUNITY REMAIN — ESPECIALLY TIMBER AND REAL ESTATE.

OID: How do the current discounts on REITs compare to their historical valuations?

Grantham: Forest REITs are very new. Equity REITs have ebbed and flowed from about a 25% discount to a 10% premium. They were selling at a premium not that long ago — say three years ago.

What happened is that the underlying real estate was so cheap — way below replacement cost — and the underlying real estate was in a major bull market. Therefore, people realized that they could stick portfolios together, turn them into REITs and achieve a price closer to replacement cost. So they did.

Then they found that they could use their paper to go buy real estate that was still lagging the market and trading at a discount. And that increased their earnings. So that was a nice self-fulfilling game for awhile. And that got people excited. So the REIT stocks got bid up to a decent premium to the value of the underlying real estate.

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GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
(cont'd from preceding page)

OID: What about prior cycles?

Grantham: The industry was so small prior to the most recent cycle that I don't think it's relevant. But I would think that that would happen once in every cycle. When real estate is very depressed and starts to recover, that's a natural time for REITs to sell at a premium. So four years ago, REITs were sexy. Today, they're boring. They were at the opposite end of the spectrum from internet stocks, for example.

OID: Assuming what you say is correct, wouldn't the real estate industry be much like the airline industry — with fixed capacity becoming excess capacity and choking off profits in economic downturns?

Grantham: I don't think so. First, the real estate market is not really crushed by ordinary recessions. An increase of 2-3% in unemployment is not that big a deal. What kills real estate is overbuilding. For example, during the last great boom, they overbuilt office space by 17%. Well, you can imagine what kind of recession it would take to have that kind of impact on demand. So a recession is a pretty mild event by comparison to overbuilding.

The other thing is the lag in rent. For example, we're sitting here paying two thirds of the going market rate on our rent here in our space. And in a couple of years, we'll have to roll it over at the current market. Well, even if it's a recession at that time, we may be able to roll it over at a rate somewhat below today's going rate. But we won't get to roll it over at anything other than a big increase to what we're paying today. So that lag cushions profit declines in a way that doesn't exist generally in the corporate world.

OID: Gotcha.

Grantham: And equity REITs have a long history of increasing their payouts a little faster than inflation. And contrary to popular belief, the S&P doesn't increase its payout much faster than the rate of inflation either. The long-term increase in dividends since 1925 has been 1.8% in real terms. REITs, during their relatively brief history, have increased their dividends at a rate of around 1% in real terms.

So you have to work backwards. It's a new industry. It's tied to one of the blue chip asset classes in the world — diversified U.S. real estate. Therefore, the question becomes at what yield given good inflation protection through rent and modest real growth would equate with other alternative assets. My guess is that figure would be around 5% or 5-1/2%. Well, it currently yields 8% — after peaking at 8.8%.

OID: I thought the idea was to buy $1 bills for 50¢.

Grantham: There's no real economic rationale, when you look at other asset classes, for REITs to yield 8%. Also, if you take the 8% and the 1% real dividend growth, you've got 9% real growth right there. That's even before including anything for the capital gain — because a 9% real return is ludicrously high.

It's ludicrously high against anything. Even my favorite — TIPs — only yields a 4% real return. And investors will be lucky if stocks provide any return at all. So why should REITs be out there yielding 8%? I think it's absolute nonsense. So, again, I think a fair price for REITs would be to yield 5% to 5-1/2% — which would give them a pretty good capital gain from today's prices. On the other hand, in my opinion, a fair price for stocks would be perhaps 50% below where they trade today. So I think it's nothing less than an amazing paradox that REITs are cheap in the most overpriced blue chip market in history.

WHATEVER FINANCIAL PROFESSONALS MAY SAY,
THEY EXPECT A SUBSTANTIAL BEAR MARKET.

OID: Any final thoughts?

Grantham: There are two points I find most powerful for the bear case. First, every bubble in history has burst. And when challenged, large groups of professionals have steadfastly been unable to come up with a single exception. That is really quite a shocker.

And the second also reflects where professionals are coming from: Every professional I've spoken to before with only a single exception believes that the P/E multiple is coming down to 17-1/2 and that profit margins are going to decline. So basically all professionals believe in data that guarantees a substantial bear market.

You would never know that from what is said by those same professionals to their clients, of course.

OID: Of course.

Grantham: But when they're sitting around talking off the record, virtually every one of them agree. I've asked seven different groups this question. And I've gotten only a single dissenting vote — one. It's not good business for them to tell their clients what they think. But that is the view that professionals have. They have the data.

It's quite a shock — because I think the vast majority of nonprofessionals believe that the view is quite mixed among professionals. That simply isn't the case.

And it's not even a case of incentive-caused bias. Their knowledge is clear. So they're generally not lying. It's just that they're refusing to talk about it — because it's so shockingly bad for business.

OID: Absolutely.

Grantham: And even when I talk about it (and we're an outlier and a privately owned firm) I get a *lot* of grief. It's generally *not* good for business. I concede that point completely. And I don't blame them for keeping quiet. But I'm sorry for the poor general public who believe in the nitwittery that gets passed around by the bulls and is so well promoted in the press. From the press, you'd think that it must be three quarters bulls and one quarter bears in the professional community — when, actually, professionals are, when you get right down to it, *overwhelmingly* bears.

Most of the bulls who get quoted in the financial press aren't professionals at all — like the Dow 36,000 folks. They're just propaganda merchants.

OID: Thanks for sharing your thoughts with us.

Grantham: My pleasure.

—OID

GAMCO INVESTORS' MARIO GABELLI ET AL.
(cont'd from page 1)

The excerpts which follow were excerpted from their remarks and from their answers to shareholder questions during GAMCO Investors' annual meeting on May 13th and Gabelli Equity Trust's and Gabelli Global Multimedia Trust's annual meetings on May 15th. Gabelli and crew always bring clients their unique blend of special situations, undervalued bargains and cutting edge insights into the latest developments in media — both from the perspective of new technology and personalities and human interplay.

We always manage to pick up a new insight or two — and usually a few interesting ideas as well. We appreciate the opportunity to share them with you — and hope that you'll find them as valuable as we do.

IN THE LAST DECADE, WE ENJOYED A TAILWIND. DON'T EXPECT ONE DURING THE NEXT DECADE.

During the '90s, appreciation outstripped earnings growth.

Mario Gabelli: What kind of returns will GAMCO deliver to you over the next 10 years? ...Let's address some ... of the elements that go into determining rates of return short and long term. What kind of returns do we generate?

From 1927 to 1999, if we owned the entire stock market, we would have generated a return of 12.5% per year. In the '90s, that return was closer to 20%, [although] American GDP didn't grow that much more quickly [than it has historically] — even though it did the last two quarters. What happened was that return on equity, return on sales and asset turnover of American corporations was energized so that they grew even faster, profitability increased and multiples expanded.

Appreciation won't outleg earnings in the next decade....

Gabelli: If we look out over the next 10 years, I can almost guarantee that's *not* going to repeat itself. We have argued and continue to maintain that over the next 10 years, the market will, at best, match the growth in earnings.

Then how fast are earnings going to grow? First of all, consider Gross World Product: Ever since the Berlin Wall came down, we've focused on Gross *World* Product, not Gross Domestic Product. And we think real growth will be around 2.5% for the developed countries and a little higher for the rest of the world — call it a blended rate of 3%.

Inflation is the wild card. But if inflation runs at 3% or increases and Growth World Product is 6% and margins improve a little bit — giving you some cash flow benefits and some dividends — we as investors should be able to earn compound annual growth of 8-9%. That's not bad, but it's not the 18% we enjoyed in the decade of the '90s.

A REFRAIN WE HAVEN'T HEARD FOR A LONG TIME: "THERE ARE *LOTS* OF REASONS TO RAISE PRICES."

A major undervalued opportunity in Euroland & small cap.

Gabelli: The places we think we'll make extra returns for you will be in the small companies. The S&P earnings, by the way, for ... this year will be up about 10-11% depending on whose numbers you use. And we're in the camp that believes they'll have double-digit returns in 2001. But over the next 10 years, they'll be up 8-9% at best. By comparison, we think returns for the Russell 2000 — which is a surrogate for the smaller companies — will be in the vicinity of 30% both this year and next. And we see lots of opportunities there.

What about geographically? Where can we make money? Twenty years ago, it was Japan. This last ten years, it was the United States. The U.S. will be terrific [for small caps] in the next ten years....

We think you'll make a lot of money in Euroland. There's been a little problem short-run in the process. And the problem has been due to the Euro — it's dropped from 1.09 to .91 [to the dollar]. But we think investing in that part of the world is going to be terrific....

So we see a major undervalued opportunity in the global marketplace in Euroland and small-cap companies — and that's where we're working. And economy-wise and earnings-wise, we see a reasonably good outlook for the next 12 months.

Liquidity moves in both directions....

Gabelli: In October 1999, the Fed flooded the system with liquidity in expectation of Y2-*something*. Remember all the questions we had last year and two years ago about Y2K? Well, now the Fed is pulling that money back. *Plus* they want to slow down the economy. So they're taking out liquidity and causing rates to rise.

On the other hand, we still think earnings will be quite good. Thus, the market has a ballast of a rising floor.

Escalating labor rates aren't yet reflected in the indices.

Gabelli: As far as interest and inflation, our model is not complicated. Labor costs were held in check by an *incredible* GDP in the fourth quarter and the first quarter through what is called productivity gains. However, if any of us are employers (and many of us *are*) and as many of us track companies and talk to friends, we know that we're at the inflection point with regard to labor rates going up.

Every company that I've been listening to on conference calls in the last six weeks says, "We can't find employees. They're getting poached. Rates are going up." I was recruiting at the Columbia Business School the other day. The average starting salary was $140,000 — up from $110,000.... This doesn't show up in the indexes....

In fact, there are *lots* of reasons to raise prices....

Gabelli: The second part is healthcare costs. I was in Minneapolis [recently] talking to a couple of companies. [Healthcare costs have risen] not 5%, 6%, 7%, 8% over the last four or five years. They're up *30%*. And it's getting baked into expectations regarding rate increases.

And we know from the companies that we talk to ... that there are *lots* of reasons — fuel and packaging, among others — to raise prices. We haven't heard that for a long, long time. And the Fed understands that.

So we think interest rates and inflation — and the wild card being the balance of payments and lots of other things [such as whether] we'll have $3 corn or $5 corn — [could potentially have a big effect on returns]....

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GAMCO INVESTORS'
MARIO GABELLI ET AL.
(cont'd from preceding page)

We're hoping for a sideways market. If so, we'll do fine.

Gabelli: And then, obviously, the next dynamic in the market is what we call the flow of funds — "Mr. Market". How do we earn a return? Will the environment for the next two or three years be as powerful in takeovers and transactions?

Last night, you would have seen Hussmann up 100%. That stock, with 50 million shares outstanding trading at $13 — a $650 million [market cap] at 5 times EBITDA — was taken over by Ingersoll-Rand at about 9 times EBITDA.

The point we're making is that the *public* price is not a barometer of the intrinsic value of many of the companies we own in your portfolio. And over the next two or three years, if the market moves sideways — which we hope it does — [we think we'll do fine]....

WE DON'T LIKE THE SIZE OF TIME WARNER/AOL, BUT WE'LL CONTINUE TO OWN IT VIA LIBERTY.

We don't like the size of Time Warner/AOL, but we'll stay.

Gabelli: The company you most requested us to talk about was Time Warner. Well, Time is merging with AOL. AOL and Time Warner will have a combined company of 4.4 billion shares with a price of $60, let's say, on AOL. That's $260+ billion.

It's a marriage of distribution and content. Will we continue to be willing to pay $20 a month to AOL in subscription revenues? That's the question. And will they be able to add the powerful content of Time Warner, marry it up and have a great distribution company?

Then the next question is whether the fight with ABC over carriage creates a political turmoil that will cause a Washington backlash. We're watching that carefully. And we don't like the *size* of the combined AOL/Time Warner. However, we will stay with the stock.

But we may lighten up and own it via Liberty Media.

Gabelli: Actually, we'll start looking at a surrogate. Liberty Media [LMGA/NYSE] is driven in the public markets by its Time Warner ownership — because they do own 10%. Thus, while we may lighten up on Time Warner, we clearly are getting a surrogate play by owning Liberty Media — which is a terrific content and creativity [company]....

Liberty Media has approximately 1.3 billion shares outstanding. The stock closed at $46 [pre 2-for-1 split] — down from $60, but up from $25. It's a tracking stock of AT&T. If you take its public holdings which are primarily Time Warner, Sprint PCS, TV Guide plus a bunch of other stocks, mark those to market — Time Warner's at $82; so you multiply the stock price by the number of shares they own, etc., and [do the same with] its 49% ownership of the

(continued in next column)

Discovery Channel, its stake in Black Entertainment Network and of all these other companies — and total the value of each of its stakes, we conclude that Liberty Media's value is in the mid-$50s to mid-$60s. And it's down, but that's only because the stocks of these other companies have come down, too.

Liberty Media's at the center of the media universe.

Gabelli: John Malone, who runs it, is an extraordinarily gifted individual — a combination deal man, entrepreneur, Renaissance person and merchant banker. He creates enormous value for the shareholders. We think this stock is a terrific deal before us over the next five years. [They're] located just outside of Denver. I tend to go there once a year to visit them and they come to New York two or three times. And we see each other out in Sun Valley where I go to the Allen & Company lovefest in July....

Liberty Media is a tracking stock of AT&T. A year from now, they'll spin that off as a stand-alone C-corp — or will they do it earlier? And the reason for that is that John Malone is still feared in Washington by the regulators. So we think all this works to our benefit because he's a terrific dealmaker. He's got the company skinnied down to where 39 individuals run it.

It's the most powerful company in media in the world. And it has the ability to deal with all the companies we're interested in. So it's truly kind of the hub of everything that goes on in the universe that we're looking at....

THE ECONOMIC LOGIC OF TV STATION MERGERS WILL HAVE A DRAMATIC IMPACT ON OUR PORTFOLIOS.

Viacom/CBS could take us out of BHC & United TV....

Gabelli: Viacom and CBS: Mel Karamazin [at CBS] and Sumner Redstone [at Viacom] are both AA-type personalities. Therefore, I think you've just married a AA and a AA and got a AAAAA personality running Viacom.

[We all know] Viacom — and we all own it. It's a company that will have a market capitalization of around $85 billion with $6 billion of EBITDA. So it's selling at a big multiple. But we think it can generate 20%-type growth.

Plus, we hope and expect that Mel will call Herb Siegel at Chris-Craft [CCN/NYSE] and say, "Let's make a deal." Herb will get a call from Mel Karamazin. The question is bid/ask. And the answer is $80-100. I think we could structure a deal by getting Herb a job. They'll spin off some TV stations. Herb will have those as an option. And that will, hopefully, take us out of BHC and United Television....

We're focused on one thing at Chris-Craft, Siegel another.

Gabelli: Herb Siegel has got to make up his mind. He's got to get off his duff, finally. The stock's at $62. There's 40 million shares.

The problem is simple. If Herb gets $80 a share — and he owns 8 million shares — he gets $640 million. If he pays the 20% long-term capital gain, he only nets out about $520 million for himself. All he is then is a rich guy. And that doesn't excite him because he's 72 years old. There are only so many lunches and dinners he can have at Harry's....

Given new regulatory standard, marriage makes great sense.

Gabelli: So Karamazin and he are having a tug of war.

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And we hope we can get that. That's what the debate is. I think now that the FCC approved the Viacom/CBS merger, this notion of marrying and partnering their stations in major markets and having what are called duopolies — two stations to a market — makes enormous economic sense. And with Viacom's stock being materially undervalued and rising somewhat, we'll have a transaction, hopefully, sometime during the next six months.... That's going to have a *dramatic* impact on our portfolios.

We also own BHC, which is 81%-owned by Chris-Craft, and United Television [which is a majority-owned subsidiary of BHC]....

GRANITE'S MANAGEMENT HAS BLUNDERED, BUT THE VALUES ARE STILL THERE.

Duopoly ruling greatly increases value of TV stations.

Gabelli: Next, Laura Linehan is going to talk about Granite Broadcasting [GBTVK/NASDAQ]. (Laura is our research director and runs the Mighty Mites Fund which invests in small, tiny companies that are not visible.)

Laura Linehan: Well, we talked a little bit before about duopolies — which is a new ruling put forth by the FCC back in August of last year. That greatly increases the value of major market independent television stations. And Granite has two that are particularly interesting. They're both WB affiliates — one is in Detroit and one is in San Francisco. So the duopoly ruling looks exciting for Granite, as well as Chris-Craft and Paxson.

Granite cut a deal with NBC whereby in the year 2002, they have a San Jose station that is going to become the San Francisco NBC affiliate. And that will give them a duopoly in San Francisco — because they already own the WB [affiliate] there.

Granite's management blundered....

Gabelli: Unfortunately, Granite is actually paying for the NBC affiliation. And due to the structure of the deal, its stock has moved back. The market hasn't reacted well to it.

Here's a simple way to look at it: Let's say you owned a TV station and 10% of your revenues came from carrying the network's signal. That's called network comp in its simplest form. Well, Bob Wright at NBC and Bob Eiger at ABC and Mel Karamazin — and we could go back to Larry Tisch when he had CBS — have always wanted the TV station to pay them for carrying the signal. That was the business model that the affiliates always resisted.

But what Cornwell [Granite's Chairman & CEO] did, much to everyone's shock, was to say to NBC, "Give us your franchise and we'll pay you $35 million a year." It was structured poorly, it was conceived poorly and it was executed poorly. Granite's management blundered.

We're hoping NBC will take its foot off its affiliates' throats.

Gabelli: And I think that NBC itself now has its foot to the throat of their affiliates. But there's a possibility that it will be lifted. The speculative challenge would be as follows: Young Broadcasting bought, from the Chronicle family, KRON in San Francisco for about $760 million. Their stock's tumbled from $60 to $20.

But there's an outside chance that the deal does not go through. And if it doesn't, then there's a possibility that Bob Wright at NBC will go back and say to the family, "We'd like to have KRON as our affiliate because we have better coverage. It's been an NBC affiliate for a long time." If they do that, they'll restructure the deal with Granite.

[Editor's note: Young Broadcasting's acquisition of KRON was completed on June 26th.]

We're trying to persuade management to modify the deal.

Gabelli: And we think that Madigan at Tribune, after the successful consolidation of Times Mirror, will then buy Granite at about $20 a share. And the stock is at $7. That's a long-winded answer. But it's bothered all of us in the broadcasting industry and all of us who cover the industry that someone could make a decision as uninspiring as that.

Laura and I have been dealing with Don Cornwell trying to convince him to restructure the transaction. Laura has a model that we tried to present to the management which would change the way they structure the deal to have at the end of the fifth year a balloon payment based on a multiple of the station's EBITDA. And that would really change the internal dynamics of the transaction without tinkering with anything.

Management has blundered, but the values are still there.

Linehan: In any case, the deal will greatly increase the value of Granite's San Jose affiliate. And fortunately, the San Jose/Monterey market is a much smaller market than San Francisco [where another of Granite's 10 TV stations is located]. So the values are still there. And it has a good opportunity for that duopoly situation in San Francisco in a couple of years.

WHO SAYS TELEPHONE IS BORING? WE FIND THESE TWO COMPELLING.

TDS — wonderful opportunities and a 50%+ discount....

Gabelli: Telephone & Data Systems [TDS/AMEX]: Last night, Roy Carlson was celebrating his 85th birthday and joined us. Roy is the chairman of Telephone & Data Systems which we all own in our portfolios. In fact, the Carlsons and GAMCO are TDS' largest shareholders.

It has 60 million shares outstanding. So 60 million shares times $105 per share makes the value $6.3 billion. What do we get for $6.3 billion?... We think the stock is worth twice where it's selling.

TDS owns telephone businesses in rural America and has wonderful opportunities — because if you own a system outside Buffalo, you then can migrate into Buffalo and become a system operator there.

They also own a public company called U.S. Cellular. U.S. Cellular closed on Friday at $68. In simple math, you get about 1.2 shares, (it used to be 1.15, but they're buying back both TDS and USM). So 1.2 times $70 is $84. And in addition, you acquire a company called Voicestream which they merged Aerial into. Voicestream operates cellular licenses under what they call GSM. In Europe, that's the technology standard. And we think those licenses have a

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value probably around $200 per share....

Our analysts believe that ... TDS is worth about $225 in a takeout. And we think that's going to happen....

[Editor's note: GAMCO EVP Doug Jamieson estimates that the private market value of TDS next year should be close to $275.]

For $42 per share net, you get $140 per share of net assets.

Gabelli: When we buy Telephone & Data Systems, we're getting for free $4 billion worth of Voicestream stock — a company that somebody else will want to buy. There's 6/10ths of a share of Voicestream per share of TDS. So when Voicestream closed at $105 on Friday, there's $63 per share of value. So you buy TDS at $105, but you get $63 of Voicestream. So you're really only paying $42. And for that $42, you acquire another $140 worth of assets. And we like Voicestream....

Incidentally, we owned a lot of Voicestream because I wear a hat as the chairman of another company called Lynch Interactive which spun off East West which merged into Omnipoint and merged into Voicestream. So we've been there. We've ridden this thing up and down....

An extraordinarily attractive business and price....

Gabelli: TDS is an *extraordinarily* attractive business and an *extraordinarily* attractive company. Wireless mobility and movement of data on the internet: Movement of data on the internet is the growth driver of the future. We are buying that — and getting $4 billion of value for free.

And for the first time, Roy — who you can't squeeze a nickel out of (he's even cheaper than your CIO) — has spent almost $1 billion buying his own stock back. So you know that *something*'s going on.

Century Telephone is extraordinarily compelling, too.

Gabelli: Century Telephone [CTL/NYSE] is the other company. As you know, we sued them and lost. The suit took place in Monroe, Louisiana. So imagine Mario Gabelli going to sue an old boy company — or old girl company — in Monroe, Louisiana. They basically changed the voting mechanism. What a surprise.

But we like the company. We're buying it back. We had lightened up a lot on it. The stock had a little hiccup in the first quarter results when they announced to the surprise of everyone that they were spending money in anticipation of buying one million customers from GTE. The stock's at $26. We think it's worth $55.

We think Glen Post, who's running it, will try to get out of our Hall of Shame and into our Hall of Fame. And the way he can do that is by picking up the phone and calling Mr. Ford at Alltel and saying, "Buy us."

Will that happen — or will some other form of engineering happen? It doesn't matter. The stock at these levels is extraordinarily compelling. And we will buy it.

SOME COMPANIES WE THINK YOU SHOULD OWN — THAT SHOULD DO WELL IN ALMOST ANY MARKET.

I strongly encourage you to own Liberty Corp....

Gabelli: Now, let me give you my list of stocks — which I always do. And I want you to write these down....

Liberty Corp's [LC/NYSE] in Greenville, South Carolina. There are 20 million shares outstanding.... Hayne Hipp runs the company. And it's two businesses. One business at Liberty Corp is the insurance business. The other business is that they own Cosmos Broadcasting. Liberty Corp sells at $32. About a year and a half ago, Liberty Corp did a self-tender — that is they bought stock back at $52. At that time, the management thought the company was worth $60 to $70. Today, they believe the company's worth *more* than that $60 to $70....

They had a [recent] conference call. And I was on it. Very few analysts were on it. And they said, "Yes, we are going to create a transforming transaction." I can't tell you, because I don't know, whether that means spinning off Cosmos Broadcasting from Liberty Corp or doing some other event. But we know that at $32, LC is an extraordinarily attractive stock. We can't buy any more. We own 20% already.... So I *strongly* encourage you to buy that one.

There's some financial engineering going on. And the values were reaffirmed [recently] when Lee Enterprises announced that they're selling their broadcast properties to Emmis for 14 times EBITDA. We think something is going to happen quickly on that — which could mean this year.

[Editor's note: In mid-June, Liberty sold its insurance operations to Royal Bank of Canada in order to focus on its broadcasting subsidiary. Liberty currently trades at $36.44.]

In Cablevision, we make 60-70% whatever the market does.

Gabelli: Other companies we've talked about: Cablevision [CVC/NYSE], Chuck Dolan's stock. Cablevision operates one system in New York with 2.9 million customers. It's come back down in part because of concern over DSL (digital subscriber lines) — that's speed — and concern over satellite distribution at GMH. But on balance, at $62, with an intrinsic value of close to $110 and two more catalysts coming — one of which will be if Armstrong gets approval to do MediaOne [he has] and then starts trading assets with Gerry Levin and Chuck decides to sell — we'll get $100. And that value is growing.

Secondly, they're taking a company public called Rainbow [Programming]. It has American Movie Classics and Bravo. Plus, they own Madison Square Garden, the Knicks and the Rangers. So there will be a transaction....

[Either] Mike Armstrong ... at AT&T, Cox Broadcasting,

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Comcast or AOL/Time Warner will want to own Cablevision. And Chuck Dolan will sell. So at $62, we're going to get 60%-70% higher within a year or two [even] in a flat market or a down market....

[We also like] a small company ... called Hector Communications [HCT/AMEX]. Hector's selling at $12 — it's worth close to $35-$40. And we think you should buy it.

Southwest Gas is terrific. But we're at our limit.

Gabelli: In the gas and electric area, there's a company that we own 20% of ... called Southwest Gas [SWX/NYSE].... The company operates gas and electric systems in Phoenix and Las Vegas. There are 30 million shares outstanding....

Southwest Gas closed at $20. [They] had a deal at $31. We think it's worth $38-42 based on recent transactions — and the stock should be able to be sold out within a year. Woody Ives would have said, "If I were in business, I would pay you $40." We think that deal will happen.

They had new members put on the board — in part, because we sent them there. We had cumulative voting — and you and I elected them. So I want you to buy some Southwest Gas. I can't buy any more because we're at the limit. Southwest Gas is terrific.

Buying back shares at 70% of book doesn't sound so crazy.

Gabelli: For those of you who are from Cleveland, Ferro [FOE/NYSE] is a specialty chemical producer. Its stock's at $23. There are 38 million shares outstanding. This is one that we're accumulating as part of what we're buying in the specialty chemical area....

And I'm still intrigued by one of the banks out in Wyoming called the Crazy Woman's Bank [CRZY/NASDAQ]. The bank's located out in Buffalo, Wyoming. The stock sells at $9.75 — book is $14. They tell you every day that they're trying to buy it back — and we're trying to get there ahead of 'em....

You'll do quite well with Standard Motor Products.

Gabelli: All roads will lead to Standard Motor Products [SMP/NYSE] which is a $9.00 stock.... Again, we can't buy any more.

Plus ... there's a convertible bond on Standard Motor that sells at 60¢ on the dollar with a 7% [yield]. You make 12% cash [$70 interest ÷ $600 cost]. I want you to write down Standard Motor Products Convertible Bonds and Standard Motor. You'll do quite well with this one. I can't buy any more because we're at ... our poison pill limit....

SPS Technologies is an extraordinarily loaded laggard....

Gabelli: We own 25% of SPS Technologies [ST/NYSE]. There are 11 million shares outstanding. Charlie Grigg is an extraordinary manager who runs Standard Press Steel. SPS makes nuts and bolts for airplanes.

Boeing had a hiccup when Malaysia, Indonesia and China had problems about two years ago. They lost a lot of the orders from that part of the world. But we think Airbus and Boeing will start getting a rising backlog in the next 12 to 18 months. Vendors will improve.

We think this company can earn close to $6 — and sell at close to $100 a share. So SPS at $32 [now $44.88], while its been down this year, is an *extraordinarily* loaded laggard.

We'll get more than table scraps with these....

Gabelli: Now, on my takeout list, obviously in the food area, for those of you who still have cats or dogs is Ralston Purina [RAL/NYSE] — one that we're accumulating. Ralston is $18-1/2. Obviously, Bestfoods is under the gun of Unilever. To the degree that Nabisco comes under somebody else's sweet tooth, I think Nestle will then buy Ralston — and the price is close to $30 per share.

We also think there will be financial engineering: General Motors spinning off GMH — that's a subset of financial engineering. Ralston Purina spinning off Energizer.

Thus, in a flat market, we should be able to earn 15-20%.

Gabelli: So you can see that we have lots of ideas — some of which we can buy, some of which we *are* buying and some of which we'll be harvesting for you on a regular basis at irregular intervals.... So we think in a flat market over the next two or three years, we'll be able to deliver on the value side of the house, a 15-20% risk-adjusted return — not as good as in the past 20 years, but still substantially better, after tax, on a risk-adjusted basis than you can do in other alternatives....

BCE IS *EXTRAORDINARILY* CHEAP — AND AWFULLY INTRIGUING.

BCE is *extraordinarily* cheap.

Shareholder: Would you please comment briefly on BCE Canada [BCE/NYSE] ex-Nortel...?

Gabelli: Dimitry, you can bail me out at any point. And if I can call a friend in, I'll call in Ivan Arteaga — our analyst on BCE Canada. It was trading at $110. And for every share, you received 0.78 share of Northern Telecom. That created a company — ex-Northern Tel — that's trading at $26.

Northern Tel is a supercharged, terrific company like Siemens and Nokia. However, we're not going to hold it. So we're taking BCE stripped of Northern Tel at $26 — which is Bell of Canada in Toronto and Montreal. They have a terrific franchise that we think is worth $45-$60. So at $26, it's *extraordinarily* cheap....

This isn't your father's BCE.... It's awfully intriguing.

Gabelli: Southwestern Bell, SBC, owns 20%. When the Canadian rules change that allow Canadian companies to own American companies and vice versa, we think it'll be merged into one of the American global companies or a Canadian global company will buy an American company.

So we think you have to own it and stay with it right now — there's a lot of activity.... If you owned BCE before, you couldn't own Northern Tel. But when the dust settles in a month or so, BCE should be awfully intriguing. It's not the BCE of the past.

Our short-run focus is event driven....

Gabelli: Our primary focus short-run is to buy companies like TDS and Century where we think we'll have an event — a takeout or a restructuring of the company.

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BCE is in the process now of taking on new companies and buying them with a strategy of either going towards Telus in Western Canada or south into the U.S. looking for a backbone company — either Electric Lightwave or...

And here are some upcoming events....

Gabelli: What do you have on the shopping list, Dimitry, that you'd like to sell 'em?

Dimitry Khaykin: Well, Electric Lightwave is an 81%-owned subsidiary of Citizens Communications — a CLEC [Competitive Local Exchange Carrier] out on the West Coast. But in terms of the national backbone companies, we have the former Cincinnati Bell which is now called Broadwing, we have Level 3 out West and we have Williams Communications.

At some point, when these networks are complete, they will have to open up with customers and the traffic. And they will either have to make acquisitions themselves or sell them out to companies with the customers.

At BCE, there's a serious discount and a real catalyst....

Gabelli: Further hitchhiking on that, we saw British Telecom buy the Irish telephone company, ESAT....

Ivan Arteaga: I still like BCE very much after the spin-off of Northern Telecom. I think the company's assets are worth about $47 per share. And the company's selling at about $26 right now. They're the dominant provider of telephone services including wireless and land line in most of Eastern Canada and they're expanding west right now.

[As you mentioned,] there is also a 20% stake held by SBC which is becoming one of the dominant global providers of telephone services. And we believe over time there's a very good possibility that ownership restrictions in Canada that preclude further investment will go away. And that should happen in a near-term time frame....

Gabelli: Ivan, right now, an American company can only own what percent of a Canadian company — 25%?

Arteaga: Right now, it's about 33%. But there's a possibility of owning more if it's structured the right way. However, it's less than 50% — which is control....

WE THINK DIRECTV WORKS TODAY. AND YOU AIN'T SEEN NUTHIN' YET.

We're very excited about satellite technology....

Shareholder: Would you give us your thinking on the wireless revolution both in the short and long term?

Gabelli: Barbara? Howard?

Barbara Marcin: Sure. We're very excited about satellite technology. It's really only been in the last year or so that these companies, which were spending so tremendously to put their systems in place, started to reap the cash flow benefits. We think a lot of the capital spending is behind them. And it's starting, of course, to build on DIRECTV services. They're starting to offer internet services. So we're excited about those companies — Hughes Electronics and others....

Gabelli: Yeah, we're starting to take a fresh look at General Motors Hughes [GMH/NYSE] now that the arbitrage with GM is out of the way.... It's 1.065 shares of GMH for every share of GM up to a cap. That's been putting some technical pressure on the stock — which we like....

DIRECTV works today — and you ain't seen nuthin' yet....

Gabelli: How many of you have DIRECTV? Let's do it the old fashioned way — by a show of hands. Terrific. I happen to have one of those in a log cabin out in Moose, Wyoming. It's a *terrific* opportunity. I can shut it down or activate it within five minutes. And I don't have to pay snowbird fees — or sunbird fees — the rest of the season. So I get what I want when I want it for $36 per month — which I don't think is outrageously expensive. It's very good value added. So we're buying it. We think it works....

Incidentally, Howard and I sat through a meeting on GMH — and they'll be doing two-way this fall.

Howard Ward: Yes, the DirectPC two-way interactivity will begin in the fall. And then in about two years, Spaceway — that's the name of the product — will be launched. And that will be much faster speed — real broadband speed — with two-way interactivity between the PC in your home and the satellite. So you'll have your choice between DSL, cable modems, traditional copper wire or satellite....

WE WANT TO OWN WIRELESS GLOBALLY — LIKE CENTURY TELEPHONE, UNITEDGLOBAL, ETC.

We want to own all of the wireless companies.

Gabelli: The wireless area is an area that we want to be in. We want to own it anywhere you go so that when you're driving, you can have and see data.... We want to own all the wireless companies. We have this vision that [includes] Wireless Application Protocol (WAP) which is already popular in Japan. This is extraordinarily popular in what they call the Imo phone which they basically use as a way to get voice and data. And what it does for the operators of the phones is that it gives them extra revenues per month.

So from our end, we're buying Century Telephone in the U.S. And in Europe, TIM — Telecom Italia Mobile — is an extraordinarily attractive stock. It trades at about 9.92 euros. It's been hurt because of the euro — and there's been profit-taking in European markets. We're buying [NTT] DoCoMo which is a Japanese company. We're buying SK Telecom [SKM/NYSE] which is the Korean wireless company. And we have a very good position in most of the global telecom companies.

UnitedGlobal is very cheap — especially down nearly 60%.

Gabelli: UnitedGlobal [UCOMA/NASDAQ] is a company I visited 30 years ago in Denver. It started it Casper, Wyoming in 1985 as a cable company by a guy by the name of Schneider. His son now runs it — and it's located in London. This is the global version of a cable operator. They've been buying up most of the cable systems in Vienna. I went to visit that system. I was in Amsterdam visiting their system (I think they're in Rotterdam).

And UnitedGlobal is a very cheap stock. It's dropped from $110 to $45 in the last three or four months. But it's

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a good play. Microsoft owns a piece of it. Liberty Media owns a piece. And it's runs by individuals that we know quite well....

LOWER REIT PRICES + HIGHER REIT VALUES
= OPPORTUNITY IN REAL ESTATE.

We think Catellus is an incredible bargain.

Shareholder: How do you view REITs today?

Gabelli: Several years ago, Wall Street, in its greed, sold real estate investment trusts [REITs] to investors. They got tons of money. So they went out into the world and overpaid for transactions. The stocks then came down substantially. So REIT companies came down.

However, the underlying value of real estate went up *sharply*. For example, in San Francisco, the real estate market is *extraordinarily* hot. There's a C-Corp, Catellus [CDX/NYSE], which we own in the portfolio where the underlying real estate values have grown sharply. The stock has done nothing. In fact, it's come down. So we think there's been an incredible bargain created there.

Peter Monk has just taken advantage of that [anomaly] by selling off some sizeable properties and going into the market at Trizec [Hahn] and buying back stock....

So we see substantial opportunities in real estate. The prices we would buy buildings at have gone up so much and the stocks have come down [so much] that terrific bargains have been created.

There are *lots of* ways to make money in real estate....

Gabelli: On the value side of the house, we've been buying Florida East Coast Railroads [FLA/NYSE]. And we're going to look at St. Joe Paper [JOE/NYSE] which has sizeable land in Florida. It's owned by the Du Ponts. St. Joe Paper bought land about 100 years ago. And there's Consolidated-Tomoka [CTO/AMEX] — which is a spin-off. And in our Mighty Mites Fund, Laura has Gyrodine which owns this wonderful real estate near SUNY in Stony Brook.... So there are *lots* of ways to make money in real estate today.

Hilton is worth substantially more than the current price.

Shareholder: ...Can you comment on Hilton?

Gabelli: Many companies in real estate management have not done well in the market because of a concern in terms of where interest rates are headed and [where] capacity dynamics are likely to lead us. In the case of Hilton [HLT/NYSE], Steve Bollenbach, who took on the company about three or four years ago, then bought Goldberg's company, merged them and then spun it off. What we expect to happen there over the next couple years is a merger between Hilton International and Hilton U.S....

With interest rates rising, not much incremental capacity is coming on. Thus, RevPOR (revenues per occupied room) [will continue to rise], multiples will start stabilizing and the market will see renewed opportunity.

The stock's at about $7-1/2. With the merger with Promus and the brands they've put into place, we think that we can see a value of twice the current level. And the stock in the public market should come closer to that on a going-forward basis.

[Editor's note: According to Longleaf Realty Fund's, C.T. Fitzpatrick, at it's current price of $10.25 per share, Hilton is still a 50¢ dollar.]

Paper companies are not one of our themes today.

Shareholder: Do you have any interest in other paper/corrugated box companies given the bid by IP [International Paper] for Champion? With its $75 bid for Champion, IP beat out UPM.

Marcin: I don't have any of those in the portfolio right now. The paper stocks have responded somewhat to the recent takeover activity. But you almost have to own one that's going to be merged or acquired. It's not an area where I have a major weighting at this point.

But Greif's special. Its land is extraordinarily undervalued.

Gabelli: [Something we have in] some of our portfolios — and we'll probably add a little bit more — is Greif Brothers [GBCOA/NASDAQ]. Greif's out of Delaware, Ohio. It's migrated more into container board in the last couple of years plus their packaging. The stock closed at $29. We think it's worth close to $50.

Mike Gasser, who took it over, is conscious of the cash that is cascading into his portfolio. Our interest in it is in part driven by the 350,000 acres of land that they have in Alabama, Georgia and other parts of the world where the timber rights are extraordinarily undervalued. We think they can monetize that.

It's creeping into our portfolios. We've owned it for a long time....

THE IDEAL SITUATION: AN OLD ECONOMY STOCK
WITH A NEW WORLD OPPORTUNITY FOR FREE....

Dana and Modine are *extremely* cheap and *so* unloved.

Shareholder: What's the situation with the radiator company, Modine, which has traded down to $23-24?

Gabelli: Barbara, do you have any thoughts on companies in the automotive area — you know, the Danas of the world.

Marcin: Dana [DCN/NYSE] and Delphi Automotive Systems [DPH/NYSE] are trading *extremely* cheaply. They've been just *so* unloved over the last year or so. And I think they have terrific opportunities to continue to participate in some of the value-added services that are being added into cars in the next year or two — the parts that are starting to include the phone, the internet and directional tracking systems. So I think there's opportunity there..

Gabelli: We think Modine's [MODI/NASDAQ] stock at $24 falls into the bargain category. Earnings should start recovering at an accelerating rate over the next two years. They've built up their second R&D center. They've got some new products in the heat-transfer business coming along. So we are very encouraged by what we see.

Genuine Parts will do quite well.

Gabelli: Plus, there's another round of consolidation. Arvin just merged with Meritor — a transaction that made limited sense. And you will see other rounds of transactions.

(continued on next page)

GAMCO INVESTORS'
MARIO GABELLI ET AL.
(cont'd from preceding page)

Barbara and I have spent a lot of time, along with Peter Zaglio, on Dana and several other companies — including Genuine Parts. And Genuine Parts is an example of a company that has an internet component — that's going from *bricks* and mortars to *clicks* and mortars — and where you don't pay for it. The *ideal* world is to find an old economy stock with a ... new economy stock buried in it — where we're not paying for it. And if we can surface that — much like the Incredible Hulk — that's where we can earn *exceptional* values without undue risk.

So Modine is very attractive in that regard — one that's totally out of favor, but which we think a year from now, risk-adjusted, will do quite well.

Carter-Wallace isn't talking, but we suspect good things....

Shareholder: What about Carter-Wallace?

Gabelli: Carter-Wallace [CAR/NYSE] is a specialty company that doesn't talk to analysts — [or] to *anyone*.... We do send an analyst to the meeting every year. Ethel Hill has been going dutifully for the last two years. The stock's at $22. We believe in today's world it's worth about $40-45.

They have a pipeline of activity in the R&D area. There's been some speculation in the trades that they have a cancer drug. They don't talk about it. But if you read the annual report, they break out their gross margin by five lines — which they had not done before. It reminds me of General Housewares. Clearly, there is potential activity in that....

SEQUA'S PRICED RIGHT AND POSITIONED RIGHT. AND STRATEGIC BUYERS WILL HAVE WHAT IT TAKES.

A good one to forget....

Shareholder: How patient should we be with Sequa?

Gabelli: As you know, last year I had a problem with Norman. Sequa [SQAA/NYSE] is a company we've owned for 10 years. Norman Alexander was also serving as the Chairman of Chock Full o' Nuts last year. He received a bunch of bids from Sara Lee that he didn't disclose — and went out and bought a half million shares of stock for himself. I sent a letter to him saying, "You should quit."

So anyway, Sara Lee wound up buying Chock Full. It was taken over at $11.35. If you don't remember, that's a good one to forget....

Defense companies' time has come. And their price is right.

Gabelli: How many think it matters who the next President is going to be? Bush, Gore — does it matter? Certain things are going to be put in place no matter what — like defense spending. Defense spending is going up, finally, after 11 years. The Pentagon is going to let defense companies be more profitable no matter *who's* elected.

And some of these firms are extraordinarily cheap.

Despite management, Sequa's priced and positioned right....

Gabelli: As you get a rise in prices for the stocks like Northrop, Lockheed, United Technologies, they'll have a currency to do strategic things. One of the strategic things that they're all interested in is jet engines — i.e., repair and maintenance. And the Chromalloy division of Sequa is still a very attractive business for someone to buy.

Norman has done his best to screw up the company in the last 10-20 years. I mean I could go through all the acquisitions he's made. For example, he sticks with a tuxedo company — he owns a company called After Six. He's got a whole bunch of bad businesses — or good businesses that he can't make a decision on.

Anyway, the stock closed at $50 and we think it's worth north of $100.

IT'S TRUE THAT THE INDICES ARE EXPENSIVE, BUT THESE TAKEOVER CANDIDATES ARE CHEAP.

Don't feel bad about getting burned. It's a good deed....

Gabelli: So the world is changing. Will it hurt? What does it mean to lose money on Martha Stewart or Street.Com? Remember when James Cramer went public at $18 and the stock opened at $60? Well, it's now $7.

How many of you lost money on Red Hat, Akamai and all of those others? Well, feel good — because it's part of the creative process. It's part of what Schumpeter wrote 50 years ago. He said, "Look, capitalism is the worst way to allocate money, but the best that we've come up with. It takes money from failing industries and reallocates it into new growth industries. And it's done by us."

So this process of IPOs — of losing money through the capital markets — is part of a process that Schumpeter wrote about. It's part of the creative destruction and part of what makes America great.

And I mention this every year — and I'll do it again: Every day you come in, you read about layoffs and companies taking restructuring charges. Yet we have the lowest unemployment. Why? Because we also have capital that creates new business.

Internet's life changing, but fundamentals are the same.

Gabelli: We all talked about the internet a year ago. That is doing extraordinarily well. It's changing our lives. It's one of the great inventions that has an impact. But it also has had an impact on valuations. How much should we pay for a business? How much is a business worth? Why was Hussmann selling at $13 and somebody comes along and pays $29? Why was Pioneer Group at $18-$22 and someone would be willing to pay $43?

We're investing in growth and value. And we think with either one, you must be stock specific to create wealth and maintain it. We have a lot of deals.... We've given you our list of holdings that are going to be taken over. And we think those transactions will happen.

The market's expensive, but some stocks are very cheap.

Gabelli: So, from my point of view, while the overall market has no margin of safety... — there's no margin of safety where interest rates are, where the level of earnings are and the trends of both — there are some very substantial bargains in the small company category....

Stocks you and I can buy well below what someone would pay to own the entire business. Therefore, if we can buy a piece of these companies in the public market at a big discount ... you have to do it.

—OID

RICHARD W., DANIEL AND RICHARD C. PERKINS, PERKINS CAPITAL MANAGEMENT

"We've put forth our opinion that the market today reminds us of the 1970-72 period which was a topping area — the culmination of the extended rise off the 1966 bottom. This resulted in extreme valuations of 'blue-chip' stocks — the so-called Nifty Fifty, which despite their extreme P/E ratios were looked at as one decision stocks which, although perhaps temporarily overvalued, would always grow and therefore could be held through thick and thin. Of course, it turned out that this was hogwash.... McDonald's went from an 85 P/E in 1972 to a 9 P/E in 1980 despite continuing rising earnings without any blips. This can all happen again, and in our opinion will....

"Markets, as we all know, (or should know by now) reflect the hopes and fears of investors as much or more than they reflect the underlying fundamentals. In other words, psychology is more important than physiology! Expectations take valuations far beyond what the fundamentals should allow and on the other side far below what the fundamentals should call for.... At times, everyone wants to own certain groups within the market. For example, in 1980-81, everyone wanted to own energy stocks.... We remember projections of $50-100 a barrel for oil.... At the same time, the crowd did not want to own consumer growth stocks ... which had declined dramatically in price following the 1972-73 top because expectations had been lowered by many years of poor price performance. All of this action was a set-up for a 'sea change' in the market, where what everybody owned and expected to do well (e.g. energy) did poorly for years, while what investors had given up on and expected to do poorly (e.g. consumer) was the best place to be for several years to come.

"It seems to us that it is time for another major shift and that the winning sector of recent years, namely large-cap technology, Internet and communication stocks, have reached peaks in valuation (not necessarily earnings) which may stand for many years to come. Once again, we think it is time for a major valuation shift, perhaps to a group of 'old economy' stocks, but almost certainly to small and micro-cap stocks, which have been tossed aside during this five-year flight to large-cap, high-tech, Internet and communications stocks.

"Another way of looking at overvaluation other than P/E ratios or dividend yields is a comparison of the total stock market capitalization to gross domestic product. [Ed. note: They include a chart which shows that as of March 31st, the current stock market capitalization represented an estimated 170.8% of GDP versus 86.5% at the peak in 1929 and 79.2% at the peak in 1973.] [Similarly,] Andrew Smithers and Stephen Wright have written a new book titled *Valuing Wall Street*, in which they ... calculate that the overall market is 2.5 times its average value.... Likewise, Robert Shiller's book, *Irrational Exuberance*, argues that expectations today are so optimistic that stock valuations are easily at their highest in the last 150 years....

"The May increase in the discount rate gives us pause. History clearly shows that whenever the discount rate has gone to 6% or higher, the market's taken it on the chin.... Considering our previous dissertation about the overvaluation in the market, we think there's considerable downside risk staring at us in the overvalued sectors we've previously mentioned. The market's valuation today is well above where it was at the high point in 1929. Yet the excuse for today's overvaluation is the same as then — that companies where earnings can continue to increase should be owned regardless of price." [Editors note: Includes a section from the 1934 edition of *Security Analysis* (from which we've excerpted below).]

Letter to clients of Perkins Capital Management — July 25, 2000

BENJAMIN GRAHAM AND DAVID DODD

"By 1929, book value had practically disappeared as an element in determining the attractiveness of a security issue.... Thus the prewar approach to investment, based upon past records and tangible facts, became outworn and discarded.... A new conception was given central importance — that of *trend of earnings*. The past was important only in so far as it showed the direction in which the future could be expected to move. A continuous increse in profits proved that the company was on the upgrade and promised still better results in the future than had been accomplished to date. Conversely, if the earnings had declined, or even remained stationary during a prosperous period, the future must be thought unpromising and the issue was certainly to be avoided....

"The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd. Yet the new era theory led directly to this thesis.... An alluring corrolary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy 'good' stocks, regardless of price, and then to let nature take her upward course. The results of such a doctrine could not fail to be tragic. Countless people asked themselves, 'Why work for a living when a fortune can be made in Wall Street without working?' The ensuing migration from business into the financial district resembled the famous gold rush into the Klondike, with the not unimportant difference that there really was gold in the Klondike."

Security Analysis (1934) by Benjamin Graham and David Dodd

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