Outstanding Investor Digest

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

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Volume XVI Numbers 4 & 5 Year End 2001 Edition

FAIRHOLME CAPITAL'S BRUCE BERKOWITZ
"OUR INSURERS SUCCEEDED IN TOUGH TIMES.
AND NOW THE WIND WILL BE AT THEIR BACKS."

We learned that Fairholme Capital's Bruce Berkowitz has a remarkable knack for investing back when he was a broker managing separate accounts more than a decade ago — when he began telling us about one wonderful bargain after another. And since he founded The Fairholme Fund (on 12/29/99) its shareholders have learned the same thing. They've earned a compound annual return of 24.85% versus -10.3% for the S&P 500. That's not dissimilar, incidentally,

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LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
"WE'RE FINDING SOME THINGS TO DO IN THE U.S.,
BUT THERE'S *LOTS* TO DO ELSEWHERE."

Longleaf's Mason Hawkins and his associates have made a habit of handily outperforming all relevant indices for pretty much whatever period you might want to choose. For example, Longleaf Partners has earned a compound annual return of 17.3% after all fees and expenses versus 12.9% for the S&P 500 for the 10 years ended 12/31/01. And since its inception (10/26/98) Longleaf International has earned an incredible 22.1% per year versus -2.9% per

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT AND CHARLIE MUNGER
"THE INCENTIVES IN HEDGE FUNDS ARE AWESOME,
BUT DON'T EXPECT THE RETURNS TO BE TOO SWIFT."

If there's ever been a more respected money manager tandem than that of Berkshire Hathaway's Warren Buffett and Charlie Munger, we don't know who it might be. However, ironically, they say they'd prefer not to own any stocks at all. As Buffett describes: "Our first preference is and has been for many decades — although I'd say most observers didn't seem to realize it — to buy outstanding operating businesses. And

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WEITZ FUNDS' WALLY WEITZ
"I'M NOT NECESSARILY FINDING ANY GREAT SECRETS.
I JUST HAVE A HIGHER TOLERANCE FOR BOREDOM."

The performance of Wally Weitz's longest-lived fund, Weitz Partners Value, places it among the top 1% and 3% of *all* funds followed by *Morningstar* for the past 10 and 15 years, respectively. Within its category, it ranks in the top 1% of funds for both periods.

Both Weitz Partners Value and Weitz Value Fund have earned compound annual returns for shareholders in excess of 20% for the past five years — nearly double the average

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FAIRHOLME CAPITAL'S BRUCE BERKOWITZ
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to the kind of returns he's been earning for his clients since 1988. (All figures provided by Fairholme Capital.)

Over the years, we've learned that Bruce has wickedly keen insights into the inner workings of financial stocks and ice water running through his veins. For all of those reasons and more, we're very pleased to bring you his latest letter to clients of Fairholme Capital — dated January 2002. We hope you find it as interesting as we do.

OUR INSURERS SUCCEEDED IN *TOUGH* TIMES.
AND NOW THE WIND WILL BE AT THEIR BACKS.

Overall, there's still too much greed and not enough fear.

The bursting of the technology bubble caused major market averages to suffer losses in 2001. Many investors suffered permanent loss of capital after departing from sound investment principles during the 1998-2000 boom.

As 2002 begins, Fairholme continues its strategy of being fearful when others are greedy and greedy when others are fearful. Overall, there is still too much greed and optimism given that interest rates are unlikely to fall much further, overall stock market values are still high, and loose accounting is making corporate America appear healthier than is the case.

Accounting remains a minefield for the unwary. In recent years, stock option exercises reduced tax rates and pension credits increased income. Acquisition accounting hid unfavorable trends in core operations; and huge write-offs of goodwill are looming. Some prominent companies will suffer as a result. We are constantly mindful of these issues in our research.

Our companies' progress isn't fully reflected in their stocks.

Despite our skeptical outlook for markets and a mistake in 2001 with USG Corporation, we are optimistic about our future. The modest absolute performance (and significant relative performance) generated for the year does not reflect the economic progress made by our companies. They are well positioned to profit from the current weakness, emerge as stronger competitors and earn attractive returns.

P&C insurance pricing had been improving since mid-2000.

We began to increase our commitment to the P&C industry in 1999. Irrational industry competition was beginning to wane, many of the stock prices were cheap and good long-term economics existed for strong players. The tragic events of September 11th and their aftermath require that we review our current thoughts.

Insurance is critical to the smooth functioning of the world economy. Businesses cannot operate without coverage against the unexpected and most capital transactions cannot be financed without insurance.

In the last few years, underwriting losses costing the industry billions of dollars were tolerated because of unusually high investment returns. By mid-2000, however, accumulated losses, inadequate reserves and negative equity investment returns led to the failure of several poorly managed companies and caused the industry to pay more attention to core underwriting activities. While demand remained firm, supply began to contract as insurers exited unprofitable lines of business and reduced the amounts of coverage offered. Pricing, although still inadequate, began to improve.

With 9/11 and its losses came a lesson in insurance risk.

Then came September 11, 2001, with estimated insured losses of $40 to $70 billion and perhaps more. This largest-ever loss (in insurance jargon: a 1-in-100-year event) has shown long held underwriting assumptions to be flawed. Insurance companies now realize that risks previously thought to be unrelated are *highly* correlated. Few insurers imagined that they would be liable for huge workers compensation, business interruption, aviation, property and investment losses from the same event.

Basic economics tells us that prices should continue to rise.

Supply of coverage has now diminished further, while demand has increased. And basic economics tells us that prices should continue to rise. Aviation insurance pricing is up multiples. High-rise property owners have seen insurers price their risks sharply upwards. Reinsurance premiums for property risks in urban areas have been rising and coverage for terrorism is generally difficult to obtain. In some sectors, premium increases are dramatic; in others, they're modest. But industry trends are clear.

Companies with good underwriting skills and hefty balance sheets now enjoy a strong competitive position. For the first time in years, customers have been asking who is guaranteeing payment rather than who has the lowest price. Barring another huge catastrophe, most insurers will earn higher profits over the near term. After prior periods of industry stress, profits jumped for at least two years to new plateaus.

You ain't seen nuthin' yet....

If there is a risk to higher premiums, it is the inflow of new capital through the formation of new insurers and securities sales by existing insurers. Since 9/11, roughly $20 billion has flowed into the industry. We know that the industry was already under-reserved on old exposures and 9/11 losses are much larger than the new inflows. But new capital may cause rate increases to moderate, until the next event or until unreported losses become evident.

In any case, we expect a better environment than that which existed a year ago; and our strategy does not depend on sharply higher prices. Your insurance companies are disciplined underwriters and investors. They succeeded in times of declining prices. Now the wind is at their back.

While our early investment focus on the P&C industry has provided us with modest profits during a period of widespread losses, we anticipate further positive results over the next two years.

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CURRENT ENVIRONMENT PLAYS TO BRK'S STRENGTHS.
WE EXPECT A RAPID INCREASE IN ITS INTRINSIC VALUE.

Berkshire sets the standard for a Fairholme investment.

With its uniquely decentralized corporate structure, shareholder orientation, clear investment principles, emphasis on cash earnings and brilliant owner-managers, Berkshire Hathaway sets the standard for a Fairholme investment.

Berkshire owns many attractive businesses. Today, most important are its two large reinsurance businesses — Gen Re and National Indemnity. Despite over $2 billion in pre-tax losses attributable to the events of September 11th, both subsidiaries have the capital required to increase their participation in reinsurance markets at a time of increasing prices and a flight to quality.

We expect a rapid increase in intrinsic value at Berkshire.

Despite the many advantages of Berkshire's acquisition of Gen Re, it would be a mistake to minimize the cost of poor underwriting in recent years. However, under the new CEO, Joe Brandon, we expect Gen Re to start putting up the kind of numbers Warren Buffett expects. Gen Re and National Indemnity are now well positioned to capture business priced to yield attractive returns as insurers move toward reinsurers they know will pay, regardless of how large the loss.

As a result of the terror attacks, Berkshire's cost of float will prove unacceptably high in 2001. However, reduced industry competition and a flight to quality reinsurers should establish two positive trends: lower cost of float and a faster rate of growth in float. Taken together, the result should be a rapid increase in intrinsic value. Assuming no huge catastrophes, Berkshire may have the ability to recoup its September 11th losses within a year.

Today's environment plays to Berkshire's strengths.

Cash should pour into Berkshire at a time when public and private markets have been under stress. Despite low interest rates and overall high valuations in public marquee names, many private companies have recently sold for the lowest earnings multiples seen in many years.

Both private and public companies that incurred excessive debt during the boom are unable to refinance, as banks are unwilling to pass on lower borrowing costs and seek to selectively reduce their loan portfolio exposures. These conditions should allow Berkshire to continue to acquire businesses in mundane industries that generate substantial and recurring cash — at prices that will generate good returns to Berkshire stockholders.

MARKEL HAS A RARE COMBINATION OF VIRTUES
AND UNUSUALLY ATTRACTIVE OPPORTUNITIES TODAY.

At first, indigestion — but now a new worldwide platform.

Markel is a specialty insurer with operations in the United States, and worldwide as a result of its acquisition of Terra Nova in 2000. The company has a history of prudent underwriting and investing — a combination of skills rare in the insurance world. Over the last decade, net worth has compounded at a rate of approximately 20% per annum.

Like Berkshire's acquisition of Gen Re, the acquisition of Terra Nova caused indigestion at Markel. But these operations are finally starting to benefit from the adoption of Markel's conservative underwriting strategies. Since the acquisition, the Terra Nova operations (now called Markel International) have experienced a "three steps forward, two steps back" result. However, this year should mark the elimination of any backward strides and allow Markel to take advantage of a worldwide insurance platform.

Today's conditions also benefit its excess and surplus lines.

In the U.S., standard carriers sell insurance to customers using policies regulated by the individual states. Standard carriers must have changes in policy price and terms approved by state regulators. However, excess and surplus carriers like Markel write non-standard policies that are unregulated. Therefore, they can increase prices for terror-related coverage or exclude these risks.

Due to the failure of the U.S. Congress to provide government-sponsored terror insurance, many standard carriers have a problem. In states that have not allowed policy changes, these standard carriers face a tough choice — pay up for expensive terror reinsurance, reduce the amount of primary exposure they previously assumed or operate with much higher levels of assumed risk. These conditions will divert some standard business into the excess and surplus markets where Markel is strong.

And Markel has the wherewithal to take advantage of both.

The acquisition of Terra Nova did stretch Markel's balance sheet. Two equity offerings in the last year (one of which Fairholme participated in) and an upgrade of inherited reinsurers suggest that only modest risk remains.

Markel now has the wherewithal to bring the international business up to Markel's historic levels of profitability and take advantage of the strong conditions in excess and surplus insurance markets in the U.S. — which should continue even should a Congressional solution to terror insurance be found.

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WE BOUGHT IT WHEN PESSIMISM WAS RAMPANT, BUT TODAY MERCURY GENERAL IS BACK ON TRACK.

Joseph continues to take advantage of other's mistakes.

Over the past few years, extensive rate reduction in auto insurance resulted in some drivers paying lower rates than they had been charged a decade ago. As usual, bad underwriting and high overheads have come to haunt those who competed on price.

And also, as usual, Mercury General's low-cost, common-sense approach perfectly positions it to benefit as others withdraw from its markets or seek sharp rate increases. George Joseph, CEO of Mercury, has been adroitly taking advantage of the underwriting mistakes of other companies for more than thirty years.

After an earnings hiccup, Mercury's back on track.

Its core business in California, where it now holds over 7% of the market, has consistently generated underwriting profits. Its expansions into other states should pay off with profitable growth. And its sizeable excess capital allows it to implement long-term strategies that will ultimately benefit shareholders.

Mercury was purchased at a time when the industry's underwriting mistakes were becoming obvious, when Mercury's earnings were in temporary decline and when pessimism was rampant. Earnings are now heading higher and the company is back on a growth track.

LEUCADIA HAS ALL THE RIGHT STUFF — EXCEPT FOR MUCH INVESTOR INTEREST.

Steinberg and Cumming — one of the best records around.

Nearly twenty-four years ago, two young financiers turned an effectively bankrupt finance company, Talcott National, into Leucadia National. Since then, Joe Steinberg and Ian Cumming have built an enviable history of shareholder return by investing opportunistically and acquiring companies in distress. Since inception, Leucadia's compound growth in book value per share has approximated 25% per annum — one of the best records in American business.

Leucadia's storied history includes:

(1) an investment in the junk bonds of bankrupt Baldwin United — at the time the largest insurance company failure in U.S. history, which led to majority control of the successor company, PHL Corporation (subsequently merged into Leucadia);

(2) the purchase of Colonial Penn Insurance Company from Florida Power and Light in 1992 for roughly \$128 *million*, which was sold in 1997 for approximately \$1.5 *billion*; and

(3) last year's team up with Berkshire to become the senior lender and majority shareholder of Finova.

And Leucadia has enjoyed many other successes and had few failures.

Reported earnings or empire building? Forget about it....

Unlike most public companies, Leucadia is not interested in growing reported earnings. Instead, the company focuses on maximizing the after-tax value of its investments and therefore shareholders' equity. And unlike many of its public peers, Leucadia is not interested in empire building. In 1999, with little distress and inflated markets, the company returned capital to shareholders by paying an \$800 million capital gains dividend.

Leucadia has the right stuff for today, but nobody cares.

With roughly \$1 billion of cash and other sources of liquidity, the Company remains in a position to take advantage of today's financial troubles. Poorly considered business plans created during the boom are coming home to roost. Excessive leverage has left others struggling. In some respects, the current environment in over-leveraged companies resembles the real estate crunch of a decade ago, where overbuilding led lenders and investors to withdraw regardless of the economic returns available. In past downturns, the combination of cash and distress investing expertise has proven enormously valuable.

The recent Finova tie-up between Berkshire and Leucadia increases the likelihood of other large transactions using Berkshire's balance sheet and Leucadia's workout experience.

But despite its fabulous record of shareholder return, a favorable vulture environment and promising investments, there is little interest in Leucadia. Lumpy returns, with little profit in most years and extraordinary profit in others, and complex transactions requiring intensive analysis, keep most away....

OUR COMPANIES' PROSPECTS ARE EXCELLENT — BUT THEIR PRICES DON'T REFLECT THEIR PROMISE.

We're trying to buy the right companies at the right price.

Fairholme accounts have always been focused on few companies and fewer industries. Consequently our accounts have never mirrored broad market indexes. We aim higher by concentrating our efforts on misunderstood, quality companies within our circle of competence. Only by owning companies whose prospects are well above average and by buying them inexpensively can the investor earn high absolute returns over many years.

And we don't think their prices fully reflect their qualities.

Our companies today have solid balance sheets, shareholder oriented managers and strong competitive positions. Their market prices do not fully reflect these attractive qualities.... And we have the liquidity to take advantage of new opportunities. Louis Pasteur had it right when he said, "Chance favors the prepared mind..."

—OID

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year for the Morgan Stanley EAFE Index. (All performance figures provided by Longleaf Partners Funds.)

The excerpts which follow were selected from the prepared remarks of Hawkins, Staley Cates, C.T. Fitzpatrick, Andrew McDermott and Lee Harper and their answers to shareholder questions at their Longleaf Partners Luncheon for Advisors which took place November 7th in New York and a conference call which took place two days earlier.

Following that feature, we're pleased to bring you excerpts from a series of conversations that we had with Longleaf President and Co-portfolio manager Staley Cates which began around that same time and continued until shortly before we went to press. We've never found Hawkins, Cates or any of his associates lacking when it comes to in-depth insights and thinking out of the box. But they continually manage to exceed our expectations — and this time was no exception. We hope that you find their ideas and insights as valuable as we do.

LONGLEAF INTERNATIONAL IS CHEAP TODAY — AND WE'RE FINDING GREAT BARGAINS OVERSEAS.

September 11th created opportunity — especially overseas.

Lee Harper: ...I'd like to highlight a little bit about where the portfolios are currently — especially since 9/11. Things have changed so much. And it's important to let you know where we are.

Prior to the attacks on the 11th, we had a fair amount of cash in most of our portfolios. On average, we had somewhere between 15-20% — maybe even 25% in the International Fund. And we were having a *very* difficult time finding new names that qualified.

Well, the 11th changed that fairly dramatically. We found a number of new opportunities — especially, interestingly enough, in overseas markets. We found some new things to do in the domestic markets, but the overseas markets were even a little *more* volatile in their response. And because the markets overseas were opened more quickly, that volatility was a little more pronounced.

Our ratios suggest we should enjoy happy future returns.

Harper: So at this point, we're almost fully invested across the funds. We have price-to-value ratios across all of them that are pretty close today — the International and Small-Cap Funds are about 58¢ dollars and Partners is about a 61¢ dollar.

So we're very excited that our historic average price-to-value is 68% and we're at 60% or better in our funds today. That says a lot about what we think the future opportunity will be from here — especially in light of the fact that we're fully invested.

Now is a *particularly* good time to invest internationally.

Harper: So where do the best opportunities lie today? The majority — or certainly the *overwhelming* amount — of things that are coming up in terms of opportunities are still overseas....

So when people say, "Should we be sending cash? Is now a good time?" — now is a *particularly* good time in the international world. We feel good about where we are domestically. But it's not *as* overwhelming in terms of the new opportunities. So that's where we are....

It's gratifying to see rationality rewarded for a change....

Mason Hawkins: We have a number of incredibly good and supportive long-term partners.... And we are very appreciative of your support. It allows us to behave rationally as investors. We have sought from day one to have great partners in the Longleaf family because stable cash flows and intelligent partners are just as important as ever — *more* so given the volatility that we've experienced.

Investing based on businesses, people and price for absolute returns and, hopefully, low risk is rational and makes great sense. However, it's been important more so I think in the last couple of years than at any point. And it's also been kind of gratifying to see rationality get rewarded — because we think the opposite was the case until about March of 2000.

Now is a great time to invest in Longleaf International.

Hawkins: I want to amplify Lee's point. We believe that Longleaf International is one of the best investment vehicles in the world. And we have over the last 12 years been indifferent in many periods to new cash flows. But we want to be very clear — we're *not* indifferent today. And we're not indifferent as *owners* of Longleaf International — or as its managers.

And I want to emphasize that distinction. Probably 99.9% of investment management firms that sponsor mutual funds are there to take your money for management fees. Historically, we've taken the approach that if we do a good job of managing these portfolios and we're the largest shareholder in the funds, the performance will take care of Southeastern's revenue growth — i.e. the funds will grow and happy shareholders will add more capital and eventually the word will get out and others will partner with us.

But we're making a pitch for new partners and new cash flow streams from existing shareholders today simply because we can buy companies that are cheaper than our composite average of 58¢ on the dollar. So if we buy the next marginal investment at 48¢ on the dollar, our entire portfolio becomes more discounted and the prospective returns are going to be higher. End of story....

So we've got very interesting investments to make at the margin — and the portfolio itself is very discounted. And that's not to say the market's going to treat us well immediately or in the next couple of years. But what it *does* say is that we believe the components of our portfolio warrant your commitment of capital as well as ours....

More markets should translate into more opportunities.

Shareholder: You say you're finding the most compelling values in Longleaf International at this point. Would you more fully explain why?

Hawkins: Longleaf International, we think, has the benefit of *many* volatile markets and the prospect for more mispriced businesses, obviously, around the world than

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you might find mispriced in any one country. So to the extent that we're looking for very inefficiently priced and mispriced businesses, we think that it's highly probable that we'll get more of that in a fund that is able to invest in so many markets....

[Editor's note: What living legend John Templeton has said for decades —in our pages and elsewhere.]

Hawkins: If we only need 16-18 companies in order to be highly successful and we have more markets doing crazy things... It's kind of encouraging to be able to buy a De Beers at $14 when there was $35 of cash, securities and diamond inventories — and you got an ongoing business, mines, a brand name and whatnot for free.

So we are very optimistic that Andrew [McDermott] in Tokyo, Jim Thompson in London and our group in Memphis will be able to find the requisite number of qualifiers. It's not much more complicated than that.

Clearly, there are many things we don't understand and won't understand that *might* be attractive that we'll pass on. But with hard work, we're hopeful that consistently over the next decade we can find those things with low risk that will grow and produce good returns for us.

IT *IS* A HAIRY TIME IN JAPAN. THAT'S WHY WE'RE THERE.

But we have been finding more in the large-cap area lately.

Shareholder: As you've been making acquisitions, have you noticed whether they've tended to be in small, mid or large-cap companies?

Hawkins: Well, we're almost agnostic when it comes to capitalizations — as long as they're large enough to accommodate us. But we just recently bought some very large businesses — although I don't want to talk about the names — that we're excited about.

On the other hand, our largest country weighting right now, I think, is Japan. And many of those capitalizations are small by U.S. standards. But just since 9/11, we bought some pretty large companies compared to our three-year history at Longleaf International.

We don't invest in countries....

Shareholder: Are you thinking of adding to [your weighting] in Japan?

Hawkins: To answer you very quickly and simply, we don't invest in countries. We make no call on where we want to be tomorrow versus today. We look at virtually every company over a certain size that's understandable, where there's not two classes of common — one share/one vote —

(continued in next column)

where there's not big minority interest. It's work hard and find the great next business franchise that's very discounted, run by an honorable, capable person.

When the Nikkei doubled, we took advantage of it to sell....

Shareholder: But on a media basis, what we're getting is an onslought of stories about the Japanese not being profit-oriented, about them having a different model, about their economy being a mess and about their banks being downgraded. That doesn't make me nervous, but that's the depiction in the media.

Hawkins: I'm going to let Andrew McDermott answer that question.... He lives in Japan most of the year.

Andrew McDermott: That's exactly the environment that prompted us to start the International Fund in 1998. If you remember the last time the media was this negative, it was after Russia defaulted and the Asian currency crisis and the Nikkei was at a level, I guess, close to 12,000 then — and that's exactly where it is now. And when we started the Fund in 1998, we had 30% of the Fund in Japan.

Well, the Nikkei doubled — and we cut our position in half. It wasn't a macro bet. It was just that half of the companies we owned went to our appraisals, so we sold 'em.

And today, we're loading back up....

McDermott: In the last six months, we again doubled our position in Japan. In one case, we bought one of the same companies that we owned the first time and which was our best performer — Nippon Broadcasting. It owns a TV station there. Every growth guy bought it — and it tripled. Now it's back to where we bought it the first time. And yet the value has grown.

So we have dramatically increased our exposure to Japan. All of the companies we've bought have net cash on their balance sheets. In some cases, we're buying them for *less* than the net cash on the balance sheet. And this media attention is great for us in the same way that it was bad for people who bought all that stuff in 2000 in the U.S. thinking how great it was to invest here. [The media depicted it as if] you couldn't go wrong — and that was *exactly* the wrong time to buy the Nasdaq 100.

So we're confident that the few companies we have in Japan are safe, profitable investments. And we hope that the media contingent stays this negative — because that's always good for us.

You can buy dollar bills for 50¢ — *literally*....

Hawkins: We don't disagree with your observations about the corporate governance and some of the management practices that are carried on daily in Japan. But that's not to say there aren't exceptions to the rule. It's our job to find out if there's a shareholder-oriented CEO that wants to build value.

There are such unbelievable opportunities, in our view, for those with significant capital in a capital short system. We're getting ready to spend 10 days together over there talking to some of these very capital flush partners of ours to encourage them to act more opportunistically and entrepreneurially on our behalf.

It is very encouraging that you can buy dollar bills for 50¢ over there and the dollar is *cash* in certain cases — and you get the businesses for *free*. We like just to own the good business and let 'em spend the cash and make

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another couple of dollars if they do it intelligently. It can be buying in shares, buying out a competitor at a huge discount —there are so many opportunities if they act judiciously and opportunistically.

Two great internal controls: Mason and Andrew's wife's foot.

McDermott: I think it's fair to say it's harder to control Mason in meetings with Japanese managements than it is in other places.

Hawkins: It's a good thing there's a language barrier.

McDermott: That's a great internal control. It means it has to be *really*, really cheap for us to even propose it knowing that we're going to have to sit through a management meeting with Mason at some point.

Hawkins: Andrew's wife is Japanese and acts as our interpreter many times — and she has to step on my foot occasionally.

There's *no* reason to own 100 companies.

Shareholder: Does the current environment and the opportunities you speak of cause you to revisit the relatively fewer issues that are involved in the portfolio — particularly in International?

Hawkins: Well, we've had a 30-year history of trying to keep the number of companies in our portfolio to 20 or so. And the reason's very straightforward: We'd rather own our top 20 choices than our top 50. And maybe it's that we're more limited than some others in terms of our capabilities.

But statistically, you get almost the same amount of diversification with *12* companies — if they're in diverse industry groups — as you do with 50. So there's no compelling reason to own 100 companies. In fact, we can think of *no* reason. Warren Buffett calls it the Noah's Ark approach to investing —just own two of everything.

But first of all, we can't *understand* everything. And secondly, some things are more attractive than others. So we migrate to those that are more qualifying and more compelling. We just want to keep it pretty simple....

WE USE THREE METHODS IN OUR APPRAISALS. BUT OTHER INGREDIENTS ARE REQUIRED, TOO.

Method #1: Discounting future cash flows back to today.

Shareholder: I was interested in the methods that you use to value businesses — the models — and if you could talk about present value and how you come up with discount rates....

Hawkins: We value businesses three ways — and we've done it for 30 years. Discounted free cash flow is the method that we use most often. That's where we figure out the gross cash flows of the business today and take out the required cap-ex and the working capital needs in order to determine what the free cash flow coupon of the business is currently.

Then, for businesses we can understand, we attempt to determine what we think that free cash flow stream is going to be for the next eight years or so. We put a terminal multiple on that based on very little growth subsequent to the eighth year. We get the terminal value and the eight years of free cash flow and we discount that back using a very conservative discount rate....

And we haven't changed our discount rate. It's still 9-1/2% — or more. So we believe that our appraisals are very conservative vis-a-vis the interest rate environment that we're in today. So that's method #1 — valuing the business based on all the future free cash flow it'll produce discounted back to the current period.

Method #2: Liquidation value.

Hawkins: We also have a *long* history of buying balance sheet dollars for discounts. That's where we just tote up the assets, take out the liabilities, divide by shares — and see what it would be worth in liquidation at the courthouse steps. And this method of appraisal is applicable to great pools of assets that don't necessarily produce a lot of free cash flow today, but still have significant current value.

Method #3: Comparable sales.

Hawkins: Our third method is really a check on the first two — and it's comparable sales.... We think at Southeastern we keep as good a comparable sale databank as any in New York — on those industries we're capable of understanding. So if a monopoly newspaper like *The Boston Globe* sells to the New York Times, we record the metrics. And from our comparable sales database of monopoly newspaper sales in the last 40 years, we know that they've typically occurred at between, say, 2 and 3.5 times revenues, between, say, 9 and 16 times operating cash flow and between, say, $1,200 and $1,900 a subscriber — something like that.

And *The Boston Globe* is going to grow lineage and subscriptions much less than *The Talahassee Democrat*. So we would look at *The Boston Globe* when we owned Affiliated Publications and value that paper based on its discounted free cash flow, but also check our appraisal based on arms length trades of monopoly newspapers. And we would take the lower result of those two appraisals.

Then we would see if the stock was available at less than 60% of that conservative appraisal.

But you need intellectual honesty and common sense, too.

Hawkins: So those are the three methods. It's all in the execution, however. If you're not intellectually honest with yourself about your understanding of the business... What is it that drives the revenues, the units and the pricing? What are the obligations to create those revenues in terms of capital? And if you're *not* honest with yourself, you try to apply some of these appraisal methods to things that they shouldn't be applied to. So hopefully, you use a great dose of common sense before you stick something in a computer that comes out with a very finite answer that may be absolutely incorrect.

When do we sell? Only two times....

Shareholder: What kind of sell discipline do you use?

Hawkins: We sell when the stock reflects the value — when there's no longer a margin of safety of value over price.

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LONGLEAF PARTNERS FUNDS'
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We sell things when they get to full value and hold the cash until we can find something that qualifies. It's not much more complicated.

The other time that we might sell a security is if we're fully invested. I have to credit John Templeton for this. Many years ago in Lyford Cay, we asked *him* that question. And he said, "When you can improve your position 100%." So we're quick to sell an 80¢ dollar if we can buy a 40¢ dollar. So those are the two times we normally sell.

WHY GM? WELL, FIRST, THE PRICE IS RIGHT. BUT THE OTHER INGREDIENTS ARE THERE, TOO.

Why General Motors? Well, it starts with our appraisal.

Shareholder: My question is about General Motors. There's something I don't understand — and I'm serious. In *The Wall Street Journal*, they said that its cash position over the last 12 months ending September 30th had gone down by $3.1 billion. So back to revisiting what you said about business appraisals — appraising the free cash flow — how would that affect your appraisal?

Hawkins: Our appraisal is north of $100 a share. And that has come down somewhat. But we've owned GM a little more than a year — and we're still *extremely* excited about it. We believe its opportunities over the next five years are almost unprecedented. It's the most undervalued major holding we have.

As you know, there are three components. It's the truck business, GMAC and GMH — Hughes. We're very excited about the new piece of paper that we'll own — which is the combination of GMH with Echostar — and the position that they'll be in from a competitive standpoint to go up against the cable system. Those satellites do have a very unique advantage. It certainly takes a lot less capital to beam that signal to the roof of your home than it does to drag fiber optics and coaxial cable around neighborhoods.

So our affinity for General Motors is based on our appraisal.

It's really just math —and the right kind of partners... .

Hawkins: Second, it's based on our partners. We are very, very optimistic that Rick Wagoner, John Devine and Bob Lutz are going to be able to do a *lot*. We're thrilled with the leadership there. And we're thrilled with a number of the most recent decisions that have been made. When you ... see what their plans are and you study not only their operating initiatives, but their capital allocation decisions in the last number of years, you get a sense that not only is its value *dramatically* more than the price, but that its value is going to grow.

And as an American, I just want to say that I think the 0% financing has kept this country afloat. Producing an annual run rate of 20 million cars has never been done before. And it's been done in the teeth of this very, very significant recession. So that was, I think, one of the great business decisions we've seen — to clear out your inventories, to turn them into cash and to get your plants running again. There's a lot of operating leverage in having a plant run as opposed to not run.

And we believe, also, that they're doing a *terrific* job on the engineering side — and that you're going to see a very competitive car company three years hence. We are very sanguine about the leadership on the car side. The most recent initiatives they've taken have been nothing short of phenomenal.

So it's pretty simple math — when you add up the three components and take out any potential liability and add in the cash reserves and divide by shares — to arrive at intrinsic value. There's tremendous opportunity. There just aren't many large-cap companies in the U.S. selling below half of what they're worth where value can grow. And GM is one of those. We think they've done a very good job of turning this supertanker in the right direction.

All the important ingredients are in place for high returns.

Shareholder: So that's even despite this loss of cash and the fact that even currently — and probably in the next who knows how many quarters — that cash ... is still going down? That's not too much of a concern?

Hawkins: We did say that we reduced our appraisal. But the margin of safety, as Ben Graham taught us, is still so significant, that as the "market" begins to weigh this business properly, we think we get the return we allude to in some of our presentations.

There's a graph that Lee Harper could show you illustrating that if you buy a business at half of value and that value grows 12% a year and if the price rises to reflect that value five years subsequent, you make 29% per annum.... All three things are important: Buying it at a discount, having the value grow, and then finally getting it recognized. And we believe all three are [or will be] present in GM....

We believe we'll be greatly rewarded for our patience....

Hawkins: When we look through our portfolios today, the companies that are moving towards fair value very quickly are those in the non-cyclical consumer world where people are comfortable — whether it's foods or drugs or beverages or what have you. In our portfolio, a number of our investees of that ilk have gone up dramatically in the last month or so.

Meanwhile, anything with any cyclical exposure has been *punished*. And General Motors would fall into the second category. We believe that view of the world is kind of an evanescent view — that it will change — and we will be greatly rewarded for our patience in certain companies that *do* have some cyclical pressure on them right now.... So we're very happy to take the short-term pain in order to have the opportunity to make very significant long-term capital gains....

But don't expect a great '02. It's going to be pretty terrible.

Staley Cates: We'll most likely be talking about GM for the next few quarters — because '02 earnings in the car and truck business will be terrible. But when we talk about the value of the whole company building, we still think our appraisal can grow even though we're not saying that earnings will grow in '02. It's pretty much doomed to be a tough year.

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But when we put an appraisal on a car and truck company, we're looking at earnings over the cycle — normal earnings power — what the revenues are doing and what the underlying cost structure is doing. And it's on all of those long-term things that we're optimistic. But I don't want to leave you with the impression that we think '02 is going to be some kind of great bounce-back year — because it's not. In fact, it's going to be pretty terrible.

GMH'S PRICE IS WAY BELOW OUR APPRAISAL — AND THAT VALUE SHOULD BUILD VERY NICELY.

We're excited about the value from the combination....

Shareholder: Could you run through some of your value metrics on the satellite company — GMH?

Cates: On satellite, we come at it two ways: One is the Hughes that we own through General Motors — and second, we also own Hughes separately. You get kind of a different result wearing each of those hats.

At GM, they're taking some of the compensation from the deal in cash, which — and there are a lot of different pieces to this — in a vacuum is not that attractive. But the way they've structured the deal *is* attractive because there's a huge tax savings in the way that it's done. And so General Motors comes out OK — not great, but OK.

From the Hughes side, we think it is more exciting because being part of Echostar and being able to capture the value of putting those two together going forward is something we're very excited about.... Now the big drama becomes what's going to happen in D.C. as far as approving the deal.

Our appraisal is *substantially* greater than today's price.

Cates: As far as valuation metrics, the announced price of this deal, depending on how you appraise PanAmSat, puts something around $2,000 per sub on these satellite subs. But if you run the longhand math beginning with $60 a month as kind of a monthly bill and then put EBITDA margins on that and capitalize it, you can get numbers that are *higher* than that — and, frankly, they should realize more value than that.

As you know, that's way below what cable subs go for

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— which can be something like $3,500 a sub ranging up to $4,500 a sub. So we think the deal is a conservative one from the standpoint that there's a lot of value per sub that can be gotten by putting Echostar and Hughes together.

Hawkins: To bottom-line it, our appraisal is *substantially* greater than its current price. And we think that a lot of that discount is due to concerns about the FTC and the antitrust approval. So clearing that hurdle, there's dramatic opportunity to close the gap between price and value. We believe, as Staley said, that value is going to build very, very nicely as satellite competes with cable.

AT LEAST TWO YEARS OF *DRAMATIC* OPPORTUNITY FOR INSURERS TO REPRICE THEIR BUSINESS.

Lots of capital has come in, but lots *more* has gone *out*.

Shareholder: Fairfax is a major holding in two of our funds. Could you discuss its prospects and touch on whether you think all the capital that's being raised in the property/casualty industry will inhibit price increases?

Hawkins: That's a great question. But first of all, you alluded to a lot of capital coming in. There have been announcements of capital coming in. However, the capital coming in compared to the claims going out is still out of balance. The capital going out of the industry is *huge*. Just the New York Twin Towers alone are reported to be taking $80 billion out of reserves.

On top of that, most of the European companies in the property and casualty world are very heavily invested in common stocks. And those common stock portfolios have been just *hammered* in the last 12 months. So between the claims and the declining assets, you have *significant* pressure on capital. And you may have read in *The New York Times* recently all the discussion about Lloyd's and whether they're going to make it or not.

So when you tote it all up, a tiny amount of capital has come in vis-a-vis the capital that's gone out.

The industry's due for some gigantic price increases.

Hawkins: And anecdotally, we're seeing examples of 100% price increases — and many cases where you can't get coverage. It's been a 16-year hiatus of weak pricing. So the industry's due for some gigantic price increases just to earn *respectable* returns on equity shareholders' capital.

Our cut is that you're going to have at least two years of *dramatic* opportunity to reprice your book of business at reasonably good returns. So as that relates to Fairfax, we're optimistic.

[Editor's note: And so, it seems, is Fairfax Chairman Prem Watsa. In his November 3rd letter to shareholders accompanying Fairfax's interim report for the third quarter, Watsa observes:

"When we began in September 1985, industry conditions in Canada and the U.S. were just turning. Our largest competitor went bankrupt in late 1985 and our premiums quadrupled in 1986 as the pricing environment turned dramatically. In the P&C industry, this is called a hard market. Beginning in 1988, pricing began to soften again and only began turning upwards in 2000. In our

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2000 Annual Report, we listed some of the reasons why we felt the cycle had turned.

And now, with the World Trade Centre industry loss ... we're in a hard market again — the best since we began in 1985."

Also, similar sentiments have recently been expressed by long-time *OID* contributors Sam Mitchell and Chris Niemczewski of Marshfield Associates and Bruce Berkowitz of Fairholme Capital (see feature beginning on page 1).]

THE PRICE AND PARTNER ARE RIGHT AT FAIRFAX — AND WE'RE ACTIVELY SEARCHING FOR OTHERS.

Fairfax Financial — a great partner at a great discount.

Hawkins: Fairfax has a hard book of about $240 per share. And when we add in the float value, our appraisal is almost double today's price. We think Prem Watsa's a terrific partner. And so we think that there's an opportunity for this adequately capitalized company going forward.

Fairfax has two hedges — a long bond portfolio and puts.

Shareholder: Why wouldn't you look at other companies in the industry if the prospects are so good?

Cates: Well, one other thing about Fairfax is that the direct reserve hit they're going to take because of the disaster is more than offset by its very long bond portfolio. And they also have puts on the S&P 500 and Nasdaq....

We're looking hard for more P&C insurers and finding some.

Cates: Why aren't we buying other companies in the industry? Well, we appraise them quite a bit. And the math that we do is usually based on book value and how the book can grow and ending up with the right multiple of book. And some of these companies, especially because a lot of them don't pay U.S. taxes, can often look cheap on a P/E basis. But in any given underwriting year, you may have a situation where in a good year it's a low P/E, but it's still maybe not quite as cheap as we'd like on book.

But we are spreading a lot of these out. And we do have a pretty meaningful exposure to insurance....

Hawkins: Longleaf International's biggest asset class is the non-life property and casualty world.

Cates: However, mainly on the basis of valuation, we haven't found a lot of new insurance investments.

We'd usually view so much operating leverage as a *negative*.

Shareholder: Fairfax Financial's stock seems very weak despite the fact that it's got a great management with a superior record. Most of the other strong insurance companies' stocks seem to have recovered since the 9/11 tragedy, whereas Fairfax seems to keep going down. And I just wondered if there was some reason that I'm not catching out of the press?...

Cates: As we poke around to try to hear some of the negatives, the first one is that Fairfax has more operating leverage than most insurance companies out there. And usually, because we're conservative, that's something that we would dislike and be wary of.

But there's lots more upside potential than downside risk.

Cates: In this case, though, the way that Prem Watsa has structured the company does give us lots more *up*side from that leverage than *down*side. The holding company is incredibly well positioned. These different subsidiaries contain the leverage, but they're also walled off from the holding company — for lack of a better word.

So I think part of it is that if people worry about how big these claims from the September attacks can go, the leveraged companies are always going to be viewed a little more skeptically.

Investors may be worrying about Fairfax's recoverables.

Cates: And as we look through sell-side stuff on Fairfax, the other concern would have to do with their large reinsurance recoverable position. That's a *huge* number. And it's terrifying at first blush when you look at how much they do have receivable and recoverable. And then you get into worries about what would happen if some of those European reinsurers run into trouble or whatnot and if X-percentage don't pay Fairfax back — that could be a meaningful dent to their equity.

But I guess where we'd refer you there, on top of the qualitative aspects that the company's always done well — and Prem has done well specifically on the *quantitative* part — is they really lay it out well in the footnotes by credit and by type and by category and capitalization. They do an excellent job of disclosure on this.

Shareholder: Oh, he's been a wonderfully shareholder-oriented manager. I was just confused by the opposite trend [in the share price]. But you've clarified it.

One last worry — two of Fairfax's insurance units....

Hawkins: I think the other unknown and question in everyone's mind is Crum & Forster and TIG — where they *are*. We can go back and look at the last three quarters — and they made great operational progress. But have they finished the task and the job there?

WASTE MANAGEMENT IS STILL ON TRACK — AND STILL TRADES WELL BELOW OUR APPRAISAL.

At Waste Management, there's good news and good news.

Shareholder: You've owned Waste Management for a couple of years — and it's been successful. I remember being in this room a few years ago when you talked about Waste Management and said it would be a *four*-bagger — and I guess it's been a *two*-bagger so far. And you've pared it down, you've said, mostly for strategic reasons — because it became too big an ownership in the fund — and not because you became negative on it.

Meanwhile, they've become a lot more efficient. I think that's driven the price. Where are we in the cycle? Is that still an undervalued stock? How do you look at it?

Hawkins: Where are we with Waste Management? Well, we recently got some very good news. They settled their shareholder suit for $400 and some odd million. And that's been a two year evolutionary event.

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We're *very* grateful for Maury Myers' stewardship. If you'd have listened to many of the skeptics, they had another zero after that potential liability. So it's been a tremendous win there. Second, he's done a terrific job cutting costs and putting in systems and serving clients.

Don't let us cutting back fool you. Waste is still cheap.

Hawkins: Our appraisal is still substantially more than the price. That value is building as they improve their margins and their free cash flow stream.

We did sell some of our stake when the stock was in the $30s — in the mid-$30s — but only because it became a *huge* position percentage-wise and because we found *more* attractive and more discounted investments elsewhere. So we used the more fully valued investment to fund some of our more attractive new ideas....

And more good developments lay ahead....

Hawkins: However, we are very sanguine about Waste Management's future. We think their continuation of improvement is on track. And there's a lot of room left to get to the kind of operating cash flow margins we think are normal. So as they get to those higher cash flow margins with fixed capital spending requirements, a lot of that is going to produce free cash flow for the owners. And that's what we're here for....

ITS SEMICONDUCTOR BUSINESS IS GOOD LONG-TERM,
BUT A NIGHTMARISH YEAR HAS MADE IT REALLY CHEAP.

Philips' management is different, but similarly good.

Shareholder: Have we revisited an old name of ours — Philips Electronics — as a possible acquisition?

Cates: Yeah, we sure have.

Shareholder: Is the same management team in place that we had two-and-a-half or three years ago?

Cates: Well, yes and no. We've got *some* of the team. We have taken a position in it in International.... The team is similar from the standpoint that Jan Hommen, who's the CFO that Cor Boonstra brought in, is still there. And we think a lot of him. Boonstra, who had done the great job the first time around, picked a successor that we're equally excited about — Gerard Kleisterlee. He's been there since May. So although it's not Boonstra, it's a guy of the same ilk. And other parts of the team are similar, as well.

A nightmarish short-term outlook has made it really cheap.

Cates: Their semiconductor business long-term is a good one. But it's having a nightmarish year now. And that's what's made the stock really cheap. When we took our position in International, we were getting those plants — all those semiconductor plants — not only for free, but for a negative number. And we do think they'll be pretty profitable over the long haul. So it is similar logic and it is a similar management team.

Frankly, the company's in a lot better shape than the *first* time we were there because it has been more focused and a lot of the pure junk that they had has been sold or closed over the last few years.

PIONEER'S DONE BETTER THAN WE'D EVEN HOPED,
BUT ITS PRICE REMAINS WAY BELOW OUR APPRAISAL.

PXD's reserves are ramping up, but no one seems to care.

Shareholder: Thank you very much for the wonderful job, again. Could you spend a moment or two on Pioneer Natural [Resources]?

Cates: Sure. In Pioneer, commodity price weakness is masking what's going on there. They've had so much more success on exploration than we would have assumed or hoped for and it's been far better proportionate to their existing reserve base than any other company we know of.

One detail that they're very explicit about and something anybody can look up: They're very clear about how much production's going to ramp up based on all of these new reserves.

But the stock market doesn't seem to care because a lot of that comes on in '03 and some into '04. And even though production in '02 will be up nicely — it'll be up double-digits — you're going to really see all these reserves kick in in '03 and '04.

But we care. Our NAV is *way*, way above today's price.

Cates: To us, as you know, that's very relevant. We're not worried about the next couple of quarters. We're looking at what can happen in three years. So our NAV here is way above the stock price.

And they continue to do a great job. So nothing has changed as far as our affinity for Pioneer....

ALL LEVERAGE IS NOT CREATED EQUAL —
WE DON'T MIND *INTELLIGENT* BORROWING.

Price of money has gone down, but so has its availability.

Shareholder: Have you seen any companies that you think will be able to take advantage of the dramatic decline in interest rates to restructure their debt and thus become more attractive potential candidates for you to buy?

Hawkins: There are a number of balance sheets that need help out there. We were talking about it on the plane coming up. There is an interesting discussion about whether money is *tight* or not. The *price* of money has gone down, but the availability of it is in question. It's pretty difficult to back a truck up to one of these banks right now and load it up.

So the terms of refinancing are better, but not yet *dramatically* improved, in certain cases. It depends on the asset class. We do agree that the cost of money, if you can get it, is much more reasonable. Real rates were at some of the highest levels in our history a year or so ago....

Recent rate cuts are unprecedented....

Hawkins: When you go from a 6% discount rate to a 2% rate, that's a two-thirds cut in the cost of money. I'm not sure we've ever *had* a two-thirds cut in the cost of U.S.

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money... I'm not an economist. But if you look it up, I don't think there's ever *been* a two-thirds cut in the cost of money in, what, a nine month period — *ever*. So that's good. But the reasons for the Fed doing it are challenging.

Capital is cheap *and* available in Japan....

Shareholder: Isn't the same thing happening in Japan in terms of the price of capital versus availability?

Hawkins: Andrew, is capital available at 1% interest rates?

McDermott: If you have something to *do* with it, it is. The problem is that no one wants to borrow because they're so pessimistic about long-term returns in Japan. In fact, most Japanese companies are investing *outside* of Japan — building plants in America or China. But yes, it is available. It's available at *less* than that. I think it's 0%.

Host Marriott will be *benefited* by current interest rates.

Shareholder: Has the reduction in Host Marriott's stock price more than reflected the impact of 9/11?

Hawkins: Yes, very definitely — *much* more. Our price-to-value there is much more attractive than before. And that's probably a company that would be a good example to help answer your question — which was, "Are there opportunities ... on the right hand side of the balance sheet?" And I'd cite Host Marriott as an example of one that will be benefited long term by current interest rates.

Non-recourse borrowing is a pretty interesting dynamic....

Shareholder: In many of your companies — or maybe it's just in the ones that I've looked at — you have a decent degree of leverage, whereas other people get nervous about leverage. Host Marriott is a good example of that. What would happen if we had a recession that extended for a few years? Could you have some of your companies go bankrupt? Or have you included that in your thinking?

Hawkins: That's a great question. We *always* worry about leverage. We don't want the borrowers to usurp the equityholders' position — *ever*. And we look at the terms and conditions of the leverage very carefully. For example, one company we own is Forest City Enterprises. And if you were to look at its nominal leverage on the balance sheet, you'd say that it's significant. But it's all non-recourse — it's all property-specific. It can't come back to the company. We kind of *like* that. That's the kind of intelligent leverage the Ratner family has deployed forever. And so if one property doesn't operate as it should — with people sleeping in the beds or with room rates going up fast enough — then some lender might end up with that asset with no real harm to the company.

In many ways, non-recourse borrowing is good. There's no equity there to begin with. And only if you create the cash flow stream do you create the equity. The equity owner *gets* the equity. And if there's no equity, then that's the lender's problem.

That's a pretty interesting dynamic. Not many people can get *away* with borrowing with no recourse. It takes great operators, usually, to be able to pull that off.

We try not to put ourselves at the feet of the lenders.

Hawkins: But *intelligent* borrowing is not something we shy away from. We don't like big bank syndicates with all the recourse in the world where one particular party can wake up one day and decide they want to get repaid for some other reason. That's not intelligent borrowing in our view. So we as investors in businesses don't want to see a lot of leverage unless it's intelligently deployed — in terms of debt-to-total-capital or debt-to-cash-flow coverages. The terms and conditions need to be correct, as well.

I don't think that there's any simple answer. A debt against one business may be OK, whereas that same percentage of debt against another asset class may be horrible. We have a 30-year history of trying not to put ourselves at the feet of the lenders....

WHAT WAS ENTICING? A 35% YIELD TO MATURITY, AND CONFIDENCE THAT WE WOULD GET PAID.

A 35% yield to maturity was enticing. But there's more....

Shareholder: In the Longleaf Small-Cap Fund you took a position in Level 3 corporate bonds. What prompted you to take that position?

Hawkins: Well, first, I'd say a 35% yield-to-maturity was enticing. Secondly, we believe that its management team is as good as there is. They're cash flow positive — unlike any other communications system that has been laid. And finally, we believe that the cash flows today plus the ones that we expect to receive with new usage of that fiber optic system will pay us 100¢ on the dollar.

Level 3 has since tendered for virtually a third of those bonds. So they're agreeing with their dollars that they will get paid.

We've seen this movie before — in the cable business.

Hawkins: So I think it's pretty straightforward —it's a cash flow stream. In the meantime, the company has a huge cash hoard with which to make interest payments (there are no principal payments yet) as its revenue streams develop.

And we've always liked fixed-cost situations with growing revenue streams. Plus, we've seen this movie before in the cable business. You lay the system and then you sign up subscribers — and eventually the revenues cover the depreciation and the interest cost. And you as a shareholder — or a bondholder — get the benefits.

Whether bond or equity, it's a pretty compelling package.

Shareholder: ...Isn't that income taxable to clients? And as a follow-up question, do you anticipate picking up other corporate type issues?

Hawkins: It's very possible that most of that return will come in the form of long-term capital gains taxed at a low rate — to answer your tax implication question. So if those bonds that we paid in the 30s for — and they're now in the 40s — go quickly to par, that's pretty compelling from where we sit.

[Editor's note: As we head to press, it looks like these bonds — the 9-1/8s of 2008 — are trading at something around 49 with a yield-to-maturity of roughly 26%.]

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Hawkins: We're capitalists and owners of these funds just as you are. So we're looking for high returns and low risk. And if that package happens to come in a bond format, we're just as excited.

WE ACTED IN THE INTEREST OF SHAREHOLDERS — AT THE EXPENSE OF THE MANAGEMENT COMPANY....

We didn't want to be forced to buy unexciting investments.

Shareholder: Why did you liquidate the Realty Fund? Why not just cut it off to new shareholders?

Hawkins: Very simply, we were the largest shareholder of Longleaf Realty — we had about $80 million invested. And we didn't want to be *forced* to invest in real estate. We want to be able to invest in *any* industry across the whole GDP based on its qualifying attractiveness.

So if a Level 3 bond's at a 35% yield-to-maturity and we feel it's going to go to par pretty quickly based on the cash flows of that company, would I prefer to own with my own capital that qualifying investment or would I rather be subject to being forced because of the new rules of the SEC to be an investor in something that was an 80¢ dollar?

And our flexibility was only going to decline....

Hawkins: Come July [of 2002], 80% of a real estate fund's assets will have to be allocated to real estate companies — versus 65% today. In addition, the IRS's definition of diversification prohibited us from being able to buy more Hilton when it got very cheap.

Well, that's not a format that is conducive to long-term capital compounding compared to our other three funds. The other three funds can invest in *any* industry. The diversification rules are *much* more flexible because of that broad mandate. And we're not forced to keep 80% of our assets in one single industry. So it was very, very simple. We wanted to make high returns at lower risk and have more flexibility — which the other three funds provided.

What we did was at the *expense* of the mgm't company.

Hawkins: That's not to say that we don't like owning Hilton and Marriott. We're their biggest shareholders and

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their most supportive advocates. I just want to say very clearly that we acted in the interests of shareholders ... and at the *expense* of the management company. We could have sold this fund. We could have kept it open and collected the fees. We could've merged it into another fund. But we decided not to do any of those things because it wasn't in the shareholders' interest.... Rather, we gave *you* the choice to take your money and put it in the best vehicle for long-term compounding.... So it was very straightforward.

We have no regrets —and we *never* will....

Shareholder: I've read what you've written about closing real estate — and it seems compelling. But today, [I heard] that you made the decision after 9/11. We counsel our clients not to make large decisions in the midst of a crisis. And it seems to me that we as a country are in the midst of a crisis. I wonder if making this decision shortly after 9/11 was a good one — and if you might have regrets about it after we're over the crisis.

Hawkins: We are certain that we *won't* have regrets because of the flexibility we're gaining with our capital and with yours. And the decision was a decision based on a number of factors that evolved. The SEC went from a 65% rule to an 80% rule earlier this year. The number of publicly-traded real estate companies in the NAREIT Index declined by 13% in the last three years. The number of undervalued companies in the real estate sector has gone down as more people have moved to REITs because of those high dividend payouts — and the higher prices are a result of that. So it's been an evolutionary thing.

When you can't buy your best ideas, it's time to take action.

Hawkins: But there eventually comes a point in time when you ask yourself as a board of trustees as we did, what's best for the owners? This was *not* a reactive decision. It was a *pro*active decision.

Shareholder: So 9/11 was kind of the final straw?

Hawkins: When we couldn't buy more Hilton or Marriott at very discounted prices in the Realty Fund but we could in our other funds, it became pretty clear that the rules — the regulatory shackles — governing that fund had become too onerous....

TERRIBLE TIMES IN THE HOTEL INDUSTRY TODAY WILL LEAD TO BETTER FUNDAMENTALS TOMORROW.

Another benefit of closing Longleaf Partners Realty Fund....

Shareholder: How have your valuations changed for Host Marriott, Marriott International and Hilton subsequent to 9/11? Also, what's C.T. going to be doing in the future?

Hawkins: Well, C.T. has the same responsibilities after [the liquidation of Longleaf Partners Realty Fund] as he had before. Many of these real estate investments are his responsibility. And he'll have *more* time to focus on the components of the three other funds. So we're thrilled that our resources per fund have been increased. Hopefully, it'll give C.T. more time for doing additional research and visiting new managements.

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Hilton and Marriott's value declined less than you'd think.

Hawkins: As for Hilton and Marriott International, I'll let *him* comment.

C.T. Fitzpatrick: All of our hotel values took a hit after 9/11. It's just a very sad thing for the whole world that that tragic event happened. We certainly had not factored it into our analysis. But our values did decline as a result. Cash flows are going to be a lot lower for the rest of this year and into next year than we thought they'd be — so we took a hit.

But what's really wonderful about the companies that we own is that the hits we took were less than you'd think. Hilton and Marriott [International] in particular derive so much of their cash flow from franchise fees and from basically renting their hotel brands to others who provide the capital that their values are more stable than the average hotel company.

Less future supply = more rapidly improving fundamentals.

Fitzpatrick: And [their stock] prices declined *more* than their values fell. So we were able to take advantage of that at the margin and add to our positions at more attractive price-to-value levels. The stocks have since rebounded somewhat. And from these lower bases, we think our values are going to compound very rapidly once we get past the next 18 months.

One of the things that we had liked about hotels is that supply growth had been declining for years which was setting the stage for very good fundamentals going forward. Now, supply growth is going to grind to a virtual standstill. And that means that the fundamentals, when they *do* start to improve, are going to improve that much more rapidly.

So whenever we own anything and the value declines, we're not pleased about it. However, behaving rationally, we added to our stakes instead of cutting 'em.

And we think Host Marriott is a wonderful opportunity.

Shareholder: And what about Host Marriott?

Fitzpatrick: It's the same. Its value declined less than other hotel stocks that we follow. It has an amazing set of properties and a very strong management team. Its value declined *more* than Marriott International and Hilton because it's a pure property owner, whereas the other two have franchise fees that absorbed some of the blow. But Host Marriott's value was much more stable than other hotel property owners we follow.

However, we're very pleased to own it at these prices. It's just a wonderful opportunity.

We are very, very excited about the industry statistics.

Shareholder: So even though Host Marriott's an ownership company, you're saying that the price has discounted the discomfort that they'll feel during this period?

Fitzpatrick: We think it's *over*-discounted it.

Hawkins: The cash flows that are lost because of the terrorist attacks are forever gone. And that's one of the main reasons that our appraisals have come down. It's not as though those trips or conventions or whatever are going to be doubled up after a certain period. They were lost. So our appraisals did decline because of lower occupancies and the pressure on room rates.

But longer term, we are very excited about the hotel industry statistics. Supply versus demand looks to be much better — as C.T. alluded to.

We expect Hilton and Marriott to gain significant share.

Hawkins: And clearly, the better hotel companies — especially those like Hilton and Marriott — have a unique opportunity to bring more properties under their flags because they provide more occupancy because of the association with these brands.

So it could be that they gain significant market share — we *expect* them to gain significant market share — in the coming year or two as weaker real estate companies look to align with the stronger brand names.

HOST SELLS FAR BELOW ITS REPLACEMENT COST.
AND ITS ASSETS WOULDN'T BE EASY TO REPLACE.

They'll probably cut the dividend and reinstate it shortly.

Shareholder: I'd appreciate your reaction to the reports about Host Marriott possibly cutting their common dividend payment in the fourth quarter and whether you have any concern that it might be the start of something more sinister down the road?

Hawkins: Well, it's been publicly announced that Host Marriott is expected to *not* pay its fourth quarter dividend. And it only makes sense that Chris Nassetta and his team pay that dividend out of cash flow and not out of principal. So we would think that if they didn't pay that dividend for a 90-day period, it would be the responsible thing to do.

As we've already said, we believe that occupancies and room rates are going to return back to the norm — probably back to the '99 level — within months, not years. And as that takes place, then we would certainly believe that the dividend level would be reinstated. C.T.?

I, for one, hope they cut their dividend to zero.

Fitzpatrick: It's just a foregone conclusion that they're going to lower their dividend.... As I said earlier, our value is lower than it was for all of our hotel investments — and for every hotel company we look at. So that's fully taken into account.

But we think it's very *prudent* for them not to pay a dividend. And I for one hope they cut it to zero — because they have good things to do with the cash flow internally.

[Editor's note: According to an 8-K that Host Marriott filed December 5th, its board of directors did indeed decide to temporarily suspend the dividend.]

We don't value dividends anyway. We value free cash flow.

Shareholder: If for some reason, the projections on Host Marriott are somewhat off and the cash flow, while improved, doesn't get back up to a level where they can completely cover the amount of the common dividend that they've been paying, what do you think would be the likely scenario under that circumstance?

Fitzpatrick: Well, the important thing to us is the

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amount of free cash flow a business generates. It doesn't matter whether it's Host Marriott or Philips Electronics or any other company that we're looking at — we're valuing free cash flow. And whether that free cash flow is used to be paid out in the form of a dividend, to repurchase stock or to pay down debt, that's a capital allocation decision. And Chris Nassetta and his management team at Host Marriott have a very good track record with capital allocation.

They've been great management partners. We have a lot of confidence in their abilities in that area. Really the dividend has nothing to do with the value of the company. We're valuing free cash flow.

Hawkins: But as I said, we expect that dividend to be reinstated at the previous level when the cash flows return. And that's simply a function of their being a *REIT*. They don't have discretion.... They have to pay out 90% of their taxable income.

Dynamics imply a premium, not a discount.

Shareholder: Well, one of the disadvantages that I understand from a REIT structure point of view — and I understand that might have been a reason in the Realty Fund to have looked more at C-corps than REITs — is their need to continually come back to the public market to raise more and more capital if they want to grow.

I understand your point about the dividend — that it's ultimately the free cash flow that counts. But I don't know whether the public markets necessarily share that view.

What, if anything, does it do to their ability to possibly come back to the market and raise additional monies when they need to if in fact there's been this record of them cutting their dividends for a period of time?

Fitzpatrick: I think the likelihood of Host Marriott returning to public markets anytime soon is very low because the stock price is *extremely* discounted compared to the value of its assets. The company is selling for far less than its replacement value. And their assets are located in supply constrained markets where it's very difficult to build new hotels. No new supply coupled with rebounding demand make for a favorable outlook for a very long time for current owners such as Host Marriott. That dynamic implies a *premium* to replacement, not a discount.

And their share price is *far* too discounted for them to return to the public markets — which means that it's a great opportunity for us as shareholders to own it today.

WE EXPECT THE WORLD TO RETURN TO NORMAL — ONLY MORE UNIFIED AND PROSPEROUS THAN EVER.

There's much factoring going on —especially in insurance.

Shareholder: Do you make any attempt to factor into your analysis the possibility of another attack?

Hawkins: Well, we didn't factor in the *last* one. We've spent a lot of time with some insurance companies lately. And I can promise you *they're* factoring it in — writing out terrorism, reducing coverage and raising price. There's a lot of factoring-it-in going on. And I mean that sincerely — from a business standpoint, from an intelligence standpoint and from a defense standpoint.

Long term, we expect the world to return to normal....

Hawkins: But my view is quite different than some of the current thinkers.... One thing we try to teach our partners at Southeastern is to always look forward three to five years and ask yourself, "What do you think the most probable normal case is?" And to us, we think that's that we return to normalcy in a couple of years.

And the nation and world are more unified than *ever*.

Hawkins: And the benefit of this horrendous attack is that we're a more unified nation and world. If someone had told me three months ago we'd be allies with China and Russia and many other former adversaries... It's the most unified the world has been — *ever*. To have China and Jordan within the World Trade Organization and to have the prospect of more open and free trade — and a better existence for 6 billion people...

Plus, longer term, this won't *stand*. I think one of the great things that the Bush administration did was to declare war right then because it crystallized our thinking. There's no room for pacifists on this issue. And I think it's very important to *keep* that clear understanding until the problem's solved — because it's going to be tough to solve.

[Editor's note: Amen on all counts.]

A DECLINING UNIVERSE THAT'S TURNING REIT IS NO HUNTING GROUND FOR HIGH RETURNS.

***OID:* Long time, no speak. Great feature last time. What can you do for an encore? Are you guys finding lots of things to do?**

Staley Cates: Unfortunately not. It's not like 2000 when the internet thing was at its complete manic height. Then, so many real things were just thrown away. We had a buy list of 10 or 12 things — which for us is gigantic. And we bought a lot of those things, although not in the size that we wanted. But there was more there. And we were saying to clients, "Send us money. Give us money — for your own good."

But today, the U.S. market's up a lot since March of 2000. The indexes *aren't* up because all of the tech stuff has completely imploded. But at 25-30 times earnings (depending on how you define earnings) the rest of the market certainly isn't screaming dirt cheap. And outside of Japan, we couldn't just snap our fingers and put a brand new account to work.

***OID:* Not what I was hoping to hear. Oh, well...**

Cates: And you know we closed our Realty Fund.

***OID:* I do.**

Cates: Well, a publication I'd rather not name quoted a guy at a real estate advisory company who's been trying to sell us real estate research for four years now. And we've always said, "No, thank you." But he was one of several people quoted saying that he was shocked and offended that we'd say real estate isn't the best place to invest on

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the planet and that kind of thing.

That's so typical. We do what may very well be the most shareholder-oriented thing that any mutual fund has *ever* done —walk away from millions per year in fees with a record that's not heinous — and this publication goes and gets somebody who's mad at us because we wouldn't buy his product.

OID: No good deed goes unpunished.

Cates: You've got it.

OID: Could you tell me what the primary reason was for closing down the Realty Fund?

Cates: It's the universe. There are plenty of people who won't believe us. They'll just think it was because of the performance. And if they do, that's fine — because if we don't excel at it, we're not going to do it. But that isn't why we liquidated the fund —because as you know, a value manager can look good at times and bad at times.

OID: Of course.

Cates: But that's not what drives us. All that matters is the underlying investments. And for us, we had what literally just ended up being a shrinking universe. Some observers of the real estate scene predicted that all of this real estate was going to get securitized and grow like crazy. Well, that did happen for a while. And that's when we started our fund.

But now, instead of seeing more and more real estate get securitized, we're seeing a lot of it go private. We're seeing real estate C-corps convert into REITs. And for us, that's bad —because you can't buy a 60¢ dollar REIT because of the yield support.

OID: Because companies are required to pay out the bulk of their earnings in order to qualify as a REIT and thereby avoid double taxation, they have a yield — which keeps them from being priced as inefficiently.

Cates: Exactly. And our universe was just not there. The best indicator I can give you of that is that in the wake of September 11th, in our other three funds, we had all of these new names to buy —as you'd expect. And you saw the cash dropping in those portfolios. But in the Realty Fund, we just really had nothing. There was some stuff, but very little. Also, most of the new money buys were

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things like hotels where we were already at company limits.

And part of it was this REIT thing. We've always said that we're not just a REIT fund. We've always preferred non-REITs because you can get 'em cheap.

OID: One of the finer virtues.

Cates: Agreed. So we're sitting there with no names. And we just looked around and said, "You know, this is our only fund that's a sector fund — and we don't like the sector. It's not a growing universe with tons of cheap ideas."

WE STILL LOVE REAL ESTATE STOCKS,
BUT WE DON'T NEED A SEPARATE FUND.

Cates: Then, secondly and kind of related to that, if you were to look at all four of our funds, you'd see that 85% of what we owned in Realty was in either Partners or Small-Cap. So we didn't need a separate vehicle.

We still love real estate. We love TrizecHahn and some other real estate names — and we'll continue to own 'em. And we think we'll be good at analyzing 'em. But that doesn't mean we need a separate fund any more than liking Neiman would require us to have a retail sector fund.

OID: Yeah. I never understood you having that fund in the first place. I remember you guys calling me before you started the Realty Fund to ask me what I thought about the idea. And as I recall, I told you that I didn't much care for it.

Cates: Well, you were right and we weren't.

OID: Well, a broken clock is right twice a day —and a newsletter editor's right twice a decade. So watch out — because I'm overdue.

Cates: But some of the things we did find early in the first years were big. We just had tons of names. We had more names than we could cram into Small-Cap. And if you look at all of the names we've owned — all the different things that have either liquidated or gone private... So it actually made sense at that point.

OID: So you're saying that I'm really overdue — because it was a good idea for awhile.

Cates: I think it was. If we had the same universe, it'd be fine. Stuff like Georgia-Pacific [Timber Group, by combining with Plum Creek Timber,] has now converted into a REIT. TrizecHahn is going to liquidate part and convert part into a REIT. Prime Group's going private. And Host Marriott turned into a REIT — just on and on and on for all these companies. All of these things going REIT or going private —it's amazing as a percentage of what we owned at any given time.

OID: But didn't Host Marriott's stock get eviscerated — despite its being a REIT?

Cates: Oh yeah, it did. And that's one of the ones that we do still like. But we can own that one with a regular diversified fund and buy our best ideas at the margin whether they're real estate ideas or not. But you're right — Host Marriott *is* a great qualifier.

OID: In terms of your investment criteria.

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Cates: That's right. But 99% of the time, if a company converts into a REIT, it ceases to be that cheap. Of course, in Host Marriott's case, this terrorist attack has really laid it out. And it's still cheap.

[Editor's note: Of course, one reason why Host's yield *didn't* keep it from getting cheap is because it had to suspend its dividend subsequent to 9/11.]

OID: And that made Hilton cheap, too?
Cates: Exactly.

IN HOTELS, THE NEW SUPPLY IS *EVERYTHING* — SO PRICING'S GOING TO BE UNBELIEVABLE.

OID: Would you mind me asking you what kind of discount you figure those two are trading at currently based on your appraisals?
Cates: Our value on Hilton is about $18 even now. And that's a huge markdown —it was mid-to-high $20s before. That's the painful thing. Values fundamentally came down. It's always OK if the price goes against you when you know the long-term value's there.

OID: As long as you're confident of the value and you're not in publishing or supporting a large family.
Cates: Exactly. But our hotels were the worst of both worlds —our stocks got killed, but in a way, they deserved it because a lot of those values just got smashed.

OID: What about Host Marriott?
Cates: We had Host Marriott appraised at $18-19. And now we would be at $13. What you have to realize is that if you're looking at an eight-year spreadsheet on these companies, the first year just vanished —zero, zip, nada. And that smokes your appraisal.

That also makes Wall Street just completely throw its hands up. They're not even doing estimates for these companies. They just say forget it. If the "visibility" isn't there for three or four quarters, they take the stock out and shoot it.

But on that eight-year spreadsheet, in years three, four, five, etc., the pricing is going to be just *unbelievable*. And I say that because the demand/supply was already lining up pretty well. However, supply always drives hotels a *lot* more than demand. Demand's just a GDP tracker, but supply's *everything*. And now supply is zero. In some cities, while it's staggering to say, it may even be *negative* — you may even see hotels shut down —which is amazing. So you have zero supply for sure for quite a while.

OID: How convenient —coinciding with zero demand.
Cates: Who knows when demand ever comes back? It's sure never coming back to a 2000 kind of level.

OID: Never say never.
Cates: But even if it comes back eventually to a 1998 or 1999 kind of level and, at the same time, you have a zero supply, going back to that spreadsheet, you're going to have incredible pricing.

Plus, our appraisals are way, way below replacement cost, implying no new rational supply for some time. On average, we probably knocked our values down 30% — which is a *ton*. So it's a meaningful hit. But the stocks got down that much and more.

OID: Would you mind if we asked you what you come up with for a replacement cost for Hilton?
Cates: Oh, gosh. It would be around $30.

OID: And for Host Marriott?
Cates: The low $20s. But we're assuming we don't get anywhere *near* that — at least for the next five years. And that first five years is incredibly important — disproportionately so —on your spreadsheet when it comes to impacting value.

OID: In your discounted cash flow analysis.
Cates: That's right. And that's what we rely on for our price-to-value ratios. However, that replacement cost tells you what your pricing is going to be like going forward — i.e., if there will be new supply or not.

OID: So would you buy either of those today?
Cates: We'd buy Hilton. But we can't buy it — because we're right at its limit.

OID: The limit before you have to report differently?
Cates: To avoid activating its poison pill. We're right at 20% of Hilton —which is at its limit.

HILTON'S MARGIN OF SAFETY IS STILL QUITE INTACT — AND IT'S MOVING IN THE RIGHT DIRECTION, TOO.

OID: On the other hand, given the fact that we were sort of in a recession already...
Cates: Not "sorta". We *were* in recession.

OID: And then we got 9/11 and its aftermath — which, not so surprisingly, includes depressed levels of air travel, etc. Given the high levels of leverage in Hilton and Host and the fact that no one knows just how long travel-related activity will be depressed, does that at some point erode their margin of safety enough to make you question buying or owning them at all?
Cates: They would have to get a lot hairier on the leverage side for that to come into play. C.T. [Fitzpatrick] can speak to Host Marriott better because he covers it. But if you look at Hilton and what its EBITDA coverage should be in 2002 —which is another lousy year... Even with it being depressed for all the reasons you just said, they're still completely fine on covering interest and principal payments coming due, etc. If there was any way that the creditors could either affect our business or stop us out or mess with us, then the answer to your question would be yes. But we're nowhere *near* that on Hilton.

If anything, it's going the *other* way.

OID: So you're very comfortable with it, actually.
Cates: Yes, we are. One of the things that's amazing that they did isthey were able to sell some properties.

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They had a deal that they were working on going into 9/11 to sell some hotels — and it actually closed. That was a $235 million transaction. So that just came in the door.

Getting back to your question though, the bank debt is what always scares you. Right? Long-term funded bonds are a great way to fund a capital structure — because doing so takes away any kind of short-term risk.

OID: Yeah. I think relying on banks is probably more ill-advised than relying on the kindness of strangers — because at least strangers might not pull the rug out from under you when you're facing hard times.

Cates: Exactly. You can see in their 10-Qs that they've taken their bank debt down dramatically. So even after 9/11, they sold some bonds. Therefore, even if the total debt looks like it hasn't down a lot, the structure has changed dramatically for the better.

They've still got half a billion of credit lines. They've still got half a billion of other asset sales to go. They don't have much due in 2002 at all in terms of principal. So the only thing they have coming due that's meaningful is in 2003. They have a $400 million facility against the Hilton Hawaiian Village. But with that kind of asset, I don't think any banker is going to get too worked up about rolling over $400 million against that property.

OID: What's it worth?

Cates: At least a billion.

OID: You certainly wouldn't think so.

Cates: It's worth a ton. And that billion dollar value is justified based on what they paid for it. In 1998, they paid $400 million for a 50% interest. Then they added a new tower for $100 million in 2001. And they've spent about $50 million of cap-ex after they bought the rest of it to spruce it up, etc. So that's an implied purchase price of $950 million. And I don't think they overpaid.

So the value is clearly way more than the $400 million of debt that's on it.

THERE ARE TWO WORRIES ABOUT FAIRFAX — BUT IF YOU JUST READ THE ANNUAL REPORT...

OID: Is Fairfax Financial still a bargain?

Cates: Yes, it is.

OID: Mason mentioned that Fairfax has a hard book of about $240 per share — and that when you add back the value of its insurance float, your appraisal is almost double its current stock price.

Cates: That's right.

OID: And wasn't Fairfax's stock price up around $190 when he said that?

Cates: It was. So we had an appraisal up near $400. But we've obviously taken that down some.

OID: Yeah. Fairfax appears to have done nothing but decline since. Presumably, the latest quarterly contained bad news?

Cates: Yes, it did. There was a reserve addition. And that's always ugly. So there are two things really working against Fairfax right now. And time will tell if we're right or wrong. But Fairfax chairman Prem Watsa has lost his credibility on Wall Street because of this extra reserve hit. And they've never done that before. They've always been like Markel —where they say, "We're way over at this end of the bell curve and the odds of us taking extra reserves are so slim, etc."

OID: And yet you don't sound concerned.

Cates: No, we're not. And the reason why we're not is because the extra reserves weren't primarily the result of Prem having lost his actuarial touch. It's more that he bought TIG and Crum & Forster. And they just keep giving him these surprises. That's where he's been doing most of the adding. But he's really got people upset with him with the latest reserve addition.

OID: Is there anything else?

Cates: There is. Fairfax is a primary insurer. They've paid the claims on a lot of things. And they're waiting for their reinsurers to pay them. Therefore, they have this big recoverable. So the other negative we hear is that if you go through Fairfax's footnotes, they have these huge recoverables for reinsurance. And if you go through them and assume that such and such a percentage don't pay Fairfax what they owe them or whatever and this many reinsurers go under —that kind of stuff — they could get burned on their reinsurance recoverables. So that's another huge concern.

OID: But there again, you don't sound concerned.

Cates: No. In fact, we're real comfortable with it. First of all, Fairfax's disclosure is really good in terms of who owes 'em what. And when you go through those recoverables line by line, it turns out that many of them are companies that you know — and good credits that can pay — where you don't worry. A lot are really big, AAA creditworthy reinsurers.

[Editor's note: Cates referred us to Longleaf analyst Jason Dunn for additional detail. Here's some of what he told us: "As of year end 2000, nearly a third of the company's gross insurance recoverables — $3.8 billion of its $12 billion of total recoverables — were somewhat dicey (rated A.M. Best "B" or lower or not rated). That sounds like a lot relative to its latest hard book of $3.4 billion. However, against that third, the company had collateral, provisions or coverage under its Swiss Re umbrella policy to protect it on 100% of that amount. So its net exposure isn't as bad as it looks."]

Cates: It's just a matter of going through the nuts and bolts. And when we do, we're comfortable with the risk. However, that's the other big negative in the minds of many observers.

OID: I guess it's easier to read a scary article or pass along a false rumor than read disclosure documents —and the latter probably isn't nearly as titillating.

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Cates: That's about the size of it. And the more you see the World Trade Center number go up, the more that negative continues to be out there. For example, now you're hearing whispers that the hit to insurers may even be double what they first thought because the catastrophe may be ruled to be two events instead of one (two planes hitting two towers) —in which case, the coverage could increase from $3.5 billion to $7 billion.

And then you've got the fact that these numbers continue to grow over time —which Buffett was correct about right at the beginning. Berkshire started out with bigger numbers, whereas basically everyone else was using smaller loss assumptions. So my point is that the worse those numbers get, the more fear there's going to be that more reinsurers will go out of business —and if they do, some of those guys may owe Fairfax money.

So those are the two big issues.

OID: But you say you're real comfortable with both?
Cates: Yes, we are. We just kind of go line-by-line. Again, Fairfax outlines all of this in their footnotes.

OID: Maybe the shorts are nearsighted. Does Fairfax use small print?
Cates: Not really. But I think that's about as good an explanation as any.

LOTS OF PEOPLE ARE NERVOUS ABOUT FAIRFAX —
THAT'S THE GREATEST INDICATOR IN THE WORLD.

OID: You said you'd taken Fairfax's value down some from up near $400. Might I ask what kind of value you're coming up with today?
Cates: We still come up with well over $350.

OID: So it's still a 50¢ dollar.
Cates: You bet.

OID: I wouldn't think that it would be advisable to short Prem Watsa at less than 50¢ on the dollar.
Cates: That's where *I'm* coming from.

OID: In fact, I'd think that shorting Fairfax generally might be very hazardous to your wealth.
Cates: Agreed. And it's not that the shorts aren't reading the footnotes. They just don't *believe* 'em —or maybe they expect things to worsen. However, I believe you're right about Prem. There's so much leverage here. And it cuts both ways. So if he just has a decent year... You know how closed-end fund math works.

OID: Yeah. If it were just to go from a 50% discount to a 50% premium — which would not be unusual for this stock — we'd be talking about a triple.
Cates: You've got it.

OID: And that's with the book value staying the same, whereas historically, Prem has managed to grow Fairfax's adjusted book at a very respectable rate.
Cates: Exactly. And unlike Berkshire, which is a very overcapitalized closed-end fund, this one's leveraged — which, of course, can be either good or bad. However, you can definitely get killed if you're a short.

And what some of these guys are doing is buying Fairfax bonds with a yield-to-maturity of 15% or so —and then they'll short the common thinking that that's a good insurance policy if their bonds go bad. But I sure don't think that's such a smart trade — because I think they're going to get carried out on their shorts.

OID: Possibly even without their shorts —absolutely.
Cates: But you can see where they're coming from if they think that this is just an average stock with average return characteristics. They think they can pocket the 15% on the bond and pay for this insurance policy via shorting Fairfax. So some of 'em are doing that. However, again, I think that's a big mistake.

Of course, one of the best indicators, as you know, that we're doing the right thing for our clients is when everyone thinks we're morons. And with Fairfax, even some of our own clients are calling us up and giving us a piece of their mind.

OID: That's great!
Cates: Yeah. We got the same kind of reaction with Waste Management with some of our clients —you know, "How can you buy a company like this?"

OID: Isn't that the greatest indicator in the world?
Cates: Of *course* it is. And *lots* of people are nervous about this one. It's like betting football. If 20 guys are all making the same bet, I'll just take the spread the other way. I don't have to know anything about football, those two teams or anything else. Yet way more often than not, I'll win — because it really is embedded in the spread. It's the discounting mechanism at work.

And it's the same with stocks.

OID: Believe it or not, I do the same thing —although not with money, of course, since I'm in publishing...
Cates: But to be fair, I should mention that those of our clients who *know* Prem aren't worried at all. In fact, they're downright pumped about the opportunity.

THERE COULD BE MORE RESERVE ADDITIONS,
BUT I DON'T THINK FAIRFAX WILL BE A MISTAKE.

OID: What could turn Fairfax into a mistake?
Cates: Well, I don't think it would turn Fairfax into a mistake. But we've been through this kind of thing with Fireman's Fund and Jack Byrne. And Jack's got all of the integrity in the world.

OID: And savvy to burn.
Cates: You bet. Yet he had to fill reserve potholes after saying that he'd never have to do it again. So you never want to say...

OID: Never say never.
Cates: That's right. So I don't want you to think that

(continued on next page)

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from preceding page)

Fairfax is all done having to add to reserves — because 1999 has been a terrible development year for everybody, even the good guys.

OID: Did you say 1999?!

Cates: That's right. The property and casualty insurance industry in general is still closing its underwriting books for 1999. So for whatever the reason (I think it was because the market was so soft 10-12 years into a bad underwriting cycle)business was written way too cheaply. So they still have claims that are coming home to roost from business that they wrote in 1999 — even though here we are two years later.

OID: Very interesting.

Cates: And then there's the 9/11 issue —which has both a positive associated with it as well as a negative. The negative is that some reinsurers could go under and therefore not pay Fairfax back, whereas the positive is that rates are going through the roof.

OID: That's what we keep hearing.

Cates: And it's true. So on the margin, they're writing *incredibly* good business. Therefore, 2002 will be a lot better than 2001. However, historical stuff is still coming in ugly. And in Fairfax's case, that's in TIG.

But the other thing about Fairfax that's peculiar that I should have mentioned before... If you look at Forest City, you'll see that they have gigantic debt. So if you just took a simplistic look at it, you'd probably run the other way.

OID: Nahh. I'm used to debt. In fact, I'd feel naked without it.

Cates: But they are such brilliant people —the Ratner family. Every bit of their debt is non-recourse. So you'd rather have them than another real estate company that has maybe a quarter of Forest City's leverage, but where they've pledged everything under the sun on the same debt. These guys have structured it so well that if you can get leverage on those terms, bring it on all day.

Well, it's kind of the same with Fairfax. If you look at their premium-to-surplus leverage, it's wildly leveraged. But when you look at it more closely, you see that most of its liquidity is at the holding company level. Below that is TIG, Crum & Forster, Odyssey Re and the Canadian guys —and all of that stuff is different and separate and not cross collateralized. So if either bad reserve development, failure to get paid on reinsurance recoverables or some other bad thing happens at TIG, for example —which, frankly, is the bomb of the four right now —it won't bring down Fairfax.

OID: The damage will be contained.

Cates: That's right. So if TIG goes under... Prem is such an upstanding guy and has such good character that he probably won't think about it like this. And perhaps we're even being bad for thinking about alternatives where you'd throw the keys on the table. Prem wants to honor every single commitment. So he doesn't talk like this — even though he's said, "Yeah, that's true."

But if TIG craters, they can walk away from it and take the hit to their book — and Fairfax would still have an adjusted book of $300 or better with Crum & Forster and Odyssey Re and the Canadian companies.

My point is if they don't get into that detail of recourse and how the holding company is set up and just look at it simplistically and say, "If x% of these recoverables go bad, we're in trouble — because that's all your surplus", their analysis is flawed.

OID: They've missed the forest for the trees.

Cates: Exactly. Fairfax may have a multiple of the surplus of TIG, plus lots of float — which TIG doesn't have. So TIG may go to zero while the other guys stay fine. That's the reality. In no way does that mean Fairfax goes from $250 to zero on its surplus. At worst, it means that TIG goes to zero and Prem hands the keys to the creditors.

In that case, Fairfax' hard book goes from $250 to $170 or maybe even $160. But the whole premium over book — i.e., the value of the float —is intact because that's in other places anyway. And Fairfax's value would still be at a number *way* north of today's stock price.

In other words, these worries that are out there in the market are not pro rata to Fairfax. They could sink TIG, but not Fairfax.

OID: Gotcha.

Cates: Even then, there's still a margin of safety here. We still have so much upside. It's still *so* cheap. And if you just assume conservative returns on Prem's investment portfolio and match their contributions to earnings with what they'll probably do on an underwriting basis in 2002, there's *huge* earning power. And that justifies our value again.

Incidentally, that's when we assume *average* returns from those assets. However, as you well know, Prem has earned *better* than average returns.

OID: Haven't they been way better?

Cates: Absolutely. So however you look at it, Fairfax has an ample margin of safety. And after they get through this tough period, they should have the wind to their backs with much more attractive business having been written post 9/11. So I would certainly agree with you that shorting Fairfax might be *very* hazardous to your wealth.

OID: Agreed on all counts.

It's always a pleasure chatting with you, Staley. Thank you for taking the time to share some of your fascinating ideas and insights with our subscribers.

Cates: It's my pleasure. Thanks for having us in *OID*.

—OID

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

we've had a little more luck in that respect lately.

"We also own lots of marketable securities. We bought many of those, for example, in the mid-'70s that did very well for us. But the climate has not been as friendly toward making money out of marketable securities. And frankly, we *prefer* the activities associated with owning and operating businesses over time."

Their preferences aside, (thankfully for us) once a year they provide what is likely the world's best attended and most valued lecture on investing, business, human nature and the current investment, business and political scene to thousands of Berkshire shareholders from around the U.S. and the world. And we're grateful to them for allowing us to share it with you.

In the pages which follow, we're very pleased to present our second and final installment of excerpts from their answers to shareholder questions at this year's annual meeting. As always, we highly recommend that you give them a careful reading, (re-reading, etc.).

THERE'S NO MASTER PLAN HERE AT BERKSHIRE. BUT THERE ARE TWO THINGS YOU CAN COUNT ON.

We knew insurance would be big — just not *this* big.

Shareholder: ...My question relates to the future of Berkshire. Back in 1994, there was a PBS video interview with you at the Kenan-Flagler Business School. And I believe you said Berkshire was not an insurance company. It appears that that's not quite as much the case anymore. And I suppose your insurance operations will provide the financial fuel and the stability that the Johns Manvilles and MidAmerican types of acquisitions will need for their future growth.

But I'm hoping that you and Charlie can describe for us an anticipated future look — about, say, 20 years out — of how Berkshire might be different from how it is today, and perhaps a couple of the not-so-obvious problems that Berkshire will need to contend with....

Buffett: I don't remember whether it was in the 1980 annual report, but we did say at least 20 years ago that we thought insurance would be our most significant business over time. We had no idea that it would get to be as significant as it is. We've always felt that we would be in many businesses, but that insurance was likely to be our *largest* business.

Right now, it's not our largest business in terms of employment. It's our largest business in terms of revenue. And we would hope it gets a lot bigger over time. We don't have anything in the works that would make that happen, although we'll have natural growth in what we already own.

We have no master plan. We just don't *plan* these things.

Buffett: But we will just keep acquiring things. And some years, we'll make a big acquisition. And some years, we'll make a few small acquisitions. We'll do whatever comes down the pike. If there's a phone call waiting when this meeting is over and it's an interesting acquisition, it'll get done.

We don't have a master plan. Charlie and I don't sit around and strategize or talk about the future of various industries or *anything* of that sort. It just doesn't happen. We don't have any reports, we don't have any staff — we don't have any of those things.... We simply try to survey the whole financial field and look for things that we understand, where we think they have a durable competitive advantage, where we like the management and where the price is sensible.

We had no idea two or three years ago that we would be the 87%-owner of the largest broadloom carpet company in the world. We just don't *plan* these things. But I would tell you in a general way that 20-or-so years from now, we will own a lot more businesses.

Insurance will *probably* remain our biggest business....

Buffett: I still think it's likely... I think it's *certain* that insurance will be a bigger business for us in 20 years than it is now — probably *much* bigger. And I think it's also likely it will be our biggest business.

But that could change. We could get a deal offered to us tomorrow that was a $15 or $20 billion deal — and then we've got a lot of money in that industry at that point.

However, we have no more of a master plan now than we had back in 1965 when we bought the textile mill, really. We had a lousy business. And I didn't realize that it was as lousy as it was when we first got into it. So we had to start trying to deploy capital in an intelligent way.

But there are two things you can count on....

Buffett: But we've been deploying capital since I was 11. That's our business — and we enjoy it. And we get opportunities to do it. But the bigger you are, the fewer the opportunities that you're likely to get. Charlie?

Munger: Well, I think it's almost a sure thing that 20 years from now, there'll be way more strength and value behind each Berkshire share. I also think it is an *absolutely* sure thing that the annual percentage rate of progress will go way down from what it's been in the past.

Buffett: No question about it. On that happy note...

BERKSHIRE HAS SIGNIFICANT ADVANTAGES. BUT WE HAVE DISADVANTAGES, TOO.

We're the preferred purchaser for more than a few sellers.

David Winters: Thank you for hosting the Woodstock of Capitalism. Berkshire seems to enjoy an enormous long-term advantage in spite of its large size and high equity prices. The structure of the company's activities, nonpareil capital, substantial free cash flow and improving insurance fundamentals permit it to capitalize on potential asset price declines and dislocations in financial markets where most investors would have neither the money nor the cool minds to buy. Am I on the right track here?

[Editor's note: David Winters, of course, besides being a valued *OID* contributor, is the President/CIO of Franklin Mutual Advisers and the portfolio manager of Mutual Discovery and co-portfolio manager of three other

(continued on next page)

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

Franklin Mutual funds — Mutual Shares, Mutual Beacon and Mutual European.]

Buffett: Well, I think in certain ways you are. We have disadvantages, too. But we do have some significant advantages in buying businesses over time. We would be the preferred purchaser, I think, for a reasonable number of private companies and public companies as well.

And our checks clear. We'll always have the money. People know that when we make a deal, it'll get done — and it'll get done as fast as anybody can do it. It won't be subject to any second thoughts or financing difficulties. As you know, we were able to buy Johns Manville because the *other* group had financing difficulties.

And we're under no pressure to do anything dumb.

Buffett: People know they'll get to run their businesses as they've run them before. And they *care* about that. Anyway, a lot of people do — others don't. We have an ownership structure probably more stable than any company our size or anywhere *near* our size in the country — and *that's* attractive to people.

And we are under *no* pressure to do anything dumb. If we do dumb things, it's because we do dumb things. But it's not because anybody's making us do it. So those are significant advantages.

Our biggest *dis*advantage is our size.

Buffett: The biggest *dis*advantage we have is size. It's harder to double the market value of a $100 billion company than a $1 billion company. I hope that problem won't go away — that we don't become a $1 billion company in order to enjoy all of the benefits of that. In fact, I hope we suffer the agony of becoming a much *larger* company. So you're on the right track.

Whether we can deliver or not is another question. But we go into combat every day armed with those advantages. Charlie?

People will do exceptionally dumb things from time to time.

Munger: This isn't a hog-heaven period for Berkshire. The investment game is getting more and more competitive. And I see no sign that that's going to change.

Buffett: But people will do stupid things in the future. There's no question about it. I will guarantee you that sometime in the next 20 years, people will do some *exceptionally* stupid things in equity markets. And then the question is whether we'll be in a position to do something about that when it happens.

But we continue to prefer to buy businesses. That's what we really enjoy....

(continued in next column)

SOMETIMES WE'VE HAD LOTS OF CASH,
BUT WE ACTUALLY PREFER TO HAVE *NONE*.

We haven't *always* been awash in cash....

Shareholder: ...When you buy a company, you certainly consider not just the future stream of earnings, but also the company's financial condition.... By financial condition, I'm mainly speaking of cash to debt....

And I've always preferred companies with oodles of cash to those burdened with lots of debt. But then I read Phil Fisher's book, *Conservative Investors Sleep Well* — and I haven't slept well since. He confused me when he said hoarding cash was evil — that companies should either put the cash to good use or distribute it to shareholders. Can I get your thoughts on this?

Buffett: Well, there are times when we're *awash* in cash — and there have been plenty of times when we didn't have *enough* cash. I remember in the late '60s when bank credit was very scarce. We were looking for money over in the Middle East. You remember that Charlie?

Munger: Yes, I do. They wanted us to repay it in dinars.

Buffett: Yeah. And the guy who wanted us to repay him in dinars, or whatever the hell they call them, was also the guy that determined the *value* of those things. So we were not terribly excited about meeting up with him on payday and having him decide the exchange rate.

But you'll find us quite unhappy if cash keeps building up.

Buffett: But obviously, we're looking every day for ways to deploy cash. And we would never have cash around just to have the cash. We would never think that we should have a cash position of such and such a percent. Frankly, I think these asset allocation things that tacticians in Wall Street put out — to have 60% stocks and 35% bonds, etc. — are total nonsense. We want to have all our money working in decent businesses.

But sometimes we can't find them, or sometimes cash comes in unexpectedly — or sometimes we sell something and we have more cash around than we would like. And more cash around than we would like means that we have 10¢ or 15¢ around — because we want money *employed*. But we'll never employ it just to employ it.

In recent years, we've tended to be cash heavy. But that's not because we wanted cash per se. In the mid-'70s, we were scraping around for every dime we could find to buy things. We've never liked lots of leverage — and we never will. We'll never borrow lots of money at Berkshire. That's just not our style. But you'll find us quite unhappy over time if cash just keeps building up. And I think that one way or another we'll find ways to use it. Charlie?

Munger: I can't add anything to that....

WE WANT TO UNDERSTAND THE COST STRUCTURE
— AND WHY THE BUSINESS HAS AN EDGE.

The big costs vary enormously from business to business.

Shareholder: ...In past years, you've been very specific about some of the numbers related to Coca-Cola, Wells Fargo, and the like — specifically like Coke's cost of

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

aluminum and sugar and all that goes into the bottom line of Coca-Cola. Can you provide some of the specific numbers that go into some of your more recent purchases the last couple years?

Buffett: Well, they have such different characteristics that that's very difficult. We have service businesses such as FlightSafety and Executive Jet. In many of those companies, the big cost is personnel. At FlightSafety, we have a lot of money invested in simulators. We'll put over $200 million into simulators this year just as we did last year. So we have a big *capital* cost in that business. Then we have a big *people* cost because we're training pilots. And that's very person-on-person intensive. NetJets, which is part of Executive Jet, is *very* people intensive. We're absolutely no better than the people that interact with our clientele.

In the carpet business, maybe only 15% of your costs will be accounted for by employment costs. And you're a very heavy raw material buyer. You're buying lots of fibre. In the insurance business, we're in the business of paying future claims. So that's our big cost. And that obviously involves estimates — because sometimes we're going to pay the claim five, 10 or 20 years later. We're not going to *know* about it sometimes until 20 years later.

If you're in the retail business —which we are in furniture and jewelry in a significant way — then purchased goods are obviously very important because we don't manufacture our own goods to any extent in those businesses. And then the second cost, of course, is labor in a business like that.

So it's very hard to generalize among the businesses — because it varies enormously by business.

What we look for is an enduring competitive advantage.

Buffett: But we don't have any notions as to what we want to buy based on how their costs are segmented. What we look for is an enduring competitive advantage. That's what's going through our mind all the time. And then obviously we want top notch people running the place — because we're not going to run it ourselves. So those are the two factors we look at.

We want to *understand* the cost structure. Charlie and I can understand the cost structure of ... a good many companies. We don't care whether we're buying into a people-intensive business, a raw-material-intensive business or a rent-intensive business.... We do want to understand it and understand why it's got an edge against its competitors. Charlie?

What we're trying to do isn't all that complicated....

Munger: Basically, to some extent we're like the hedgehog that knows one big thing. If you generate float at 3% per annum and buy businesses that earn 13% per annum with the proceeds of the float, we have actually figured out that that's a pretty good position to be in.

Buffett: It took us a long time....

IT'S RELATIVELY EASY TO VALUE OUR HOLDINGS.
LESS CLEAR IS WHAT WE DO WITH *NEW* MONEY.

Biggest issue in our valuation is future capital allocation.

Shareholder: In last year's annual report, you provided some guidance when you said that when the stock price hit $45,000 a share, you considered buying, but thought it would be unfair to do so until the annual report came out so everyone had the same information. And while I realize that you don't feel there is a particular "correct number", would you consider giving any guidance in this direction?

Buffett: ...We don't *know* the exact intrinsic value of Berkshire — obviously. And if you looked at the figures — if we had written down secret figures ever since 1965 — some of them would look *silly* now in terms of what has actually transpired.

But I think Berkshire is *easier* to value than most businesses, actually — because we give you all the information (that is important to us at least) in valuing it. Then the biggest judgement you have to make is how well capital will be deployed in the future.

It's relatively easy to figure out the present value of most of our businesses. But the question becomes what do we do with the money as it comes in? That will have a *huge* impact on the value 10 years from now.

And that will depend a lot on the environment in which we operate over the next 10 years. So there'll be a lot of *luck* in it. And I think there's a reasonable chance of *good* luck. But who knows?

And we could never tell everybody at once....

Buffett: And I think it would be a *big* mistake for us to ever recommend buying or selling the stock. How would you tell everybody to do it at once? You'd negate your own advice. You're certainly not going to tell one person to the disadvantage of somebody else. So there's really no way for us to ever talk about whether we think the stock is a buy or a sale — except to the extent, like I say, on repurchases where there's obviously an implicit judgement being given to the shareholders. Charlie?

Munger: I rather *like* the way it's worked out. If you average out the period that we've been through, we've come within hailing distance of the objective of having our stock track its intrinsic value. It gets a little ahead of itself sometimes and a little behind at other times. However, averaged out, it's worked pretty well....

WE'VE KISSED OUR SHARE OF FROGS,
BUT THEY'VE TENDED TO *STAY* FROGS.

Our track record at enlightening management? Very poor.

Shareholder: ...I'm from Minsk, Belarus. And before I ask my questions, I'd like to thank you for recommending [Ben Graham's] *The Intelligent Investor*. It's a terrific book. And it reshaped me tremendously literally overnight....

If I'm an investor in a superior business that has a durable competitive advantage, a superior business model and is run by able people, but its management starts doing things which are not intelligent, what should I do? Should I write to tell them how they should run the business? Or should I just sit back and do nothing because a superior business model should overcome poor management?

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

Buffett: Did you assume you had *control* of the business or that you just owned the marketable security?

Shareholder: If I owned, say, 20% of the marketable securities.

Buffett: Alright. Well, the situation you describe is not hypothetical. I'd say that the history that Charlie and I have had of persuading decent, intelligent people who we thought were doing unintelligent things to change their course of action has been *poor*. Would you agree with that, Charlie?

Munger: *Worse* than poor.

Buffett: Yeah.

The best thing to do, probably, is to sell.

Buffett: If you really think you're in with people that have got a good business, but that are going to keep doing dumb things with your money, you'll probably do better to get out and get in with people who've got a good business and you think are going to do sensible things with it. You've got that option.

Now, you also have the option of trying to persuade them to change their mind. But it's just very, very difficult.

We have more clout than most. And we *still* don't get far.

Buffett: That's something we've faced for 50 years. And initially, we faced it from a position where nobody even knew who the hell we were or anything of the sort. We've acquired a certain stature over time perhaps in talking on the subject — and we've written on the subject. And we *still* don't get very far.

When people want to do something, they want to do something. And they didn't rise to become the CEO of a company to have some shareholder tell them that their most recent idea is dumb. That is just not the type that gets to the top.

Plus, there's an added bonus besides better returns....

Buffett: So as a matter of investment technique and maybe as a matter of avoiding stress in your life and all of that sort of thing (especially if you're dealing with smaller quantities of stock so it's easier to buy and sell) it's better to be in with a management you're sympatico with than simply to be in a great business where the management is bent on doing things that don't make sense to you. Charlie?

Munger: Well, I certainly agree with that.

WHEN I SEE A BIG IDEA, I KNOW IT — CHARLIE'S A FOOLPROOF INDICATOR.

First of all, we don't have big ideas very often.

Shareholder: Mr. Buffett, you've talked about the importance of an occasional big idea. How are you able to tell when you *have* a big idea?

Buffett: You *know* when you've got a big idea. I can't tell you exactly what happens within your nervous system or brain at that time. But we've had relatively few, good, big ideas over the years. How many do you think we've had in aggregate, Charlie — maybe 25 each or something?

Munger: If you took the top 15 out of Berkshire, most of you people wouldn't be here. So we've had roughly one every two years.

Buffett: Yeah, one every year or two. And sometimes there'll be a *bunch* of 'em like in '73-'74.

And big ideas used to be much easier to come by....

Buffett: But the problem for us is that big now *really* means big. We have to be able to put billions of dollars into an idea to move the needle very much at Berkshire.

When I would turn those pages 50 years ago in the Moody's manuals, I would know when I hit a big idea. I've got half a dozen xeroxes from those reports from 50 years ago that I keep just because it was so *obvious* that they were *incredible*. And that happens every now and then.

When I met Lorimer Davidson in January 1951 and he spent four or five hours with me explaining GEICO, I knew it was a big idea.... Ten months later, I wrote an article for the *Commercial and Financial Chronicle* in "The Security I Like Best". So that was a big idea.

When I found Western Insurance Securities, I knew it was a big idea. I couldn't put millions of dollars into it, but I didn't *have* millions. So it didn't make any difference. And we've seen things subsequently. And if we have a normal life-span, we'll see a few more before we're done.

How do you recognize a big idea? Have a prepared mind.

Buffett: But I can't tell you exactly what transpires in my mind that flashes a neon sign up that says, "This is a big idea." What happens with *you*, Charlie? [Long pause.]

Actually, my idea of a *truly* big idea is one I get where I call Charlie, and he only says, "No," rather than, "That's the worst idea I've ever heard." If he just says, "No," it's a *hell* of an idea.

Munger: The game in our kind of life is being able to recognize a good idea when ... it's rarely presented to you. And I think that's something that you have to prepare for over a long period. What's the old saying — that opportunity comes to the prepared mind? And I don't think that you can teach people in two minutes how to have a prepared mind. But that's the game.

Buffett: Things we learned 40 years ago, though, will help us recognize the next big idea.

EXPERIENCE IS IMPORTANT, BUT SOUND THINKING IS MORE SO.

Experience is useful. But other things are *more* important.

Shareholder: How important is the actual time that an investor has been in the business as opposed to ... the experience acquired from reading the books of Ben Graham or others?

Buffett: In other words, how much does our actual business experience help us versus our book experience?

Shareholder: Well, if you look at a person who has just been investing for two years versus a person who's

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

been investing for 10 years — and the person who's been investing for two years has read a lot about Ben Graham's techniques, your techniques and so forth — would you say that the person with only two years of experience may do much better than the other person?

Buffett: If everything else is equal — *everything* else except for the amount of experience — I think experience is probably useful. But it *isn't* going to be equal. I think what you've thought about for two years is way more important than what you've practiced for 10 years.

If there's a divergence in techniques applied, I'd rather be with the one that I'm philosophically in sync with. If I'm philosophically in sync with both and one's had 10 years of experience, the chances are they'll know a little bit more about more businesses if they've been around for 10 years looking at 'em than if they've been around for two years.

But the *biggest* thing is that basically they've got their head screwed on right in the first place in terms of how they value businesses and how they look at stocks — whether they look at 'em as pieces of businesses or whether they look at 'em as little things that move around and that you can tell a lot about by looking at charts, listening to strategists or anything of that sort.

Warren may be getting older, but he's also getting better....

Buffett: Charlie and I have learned a lot about a lot of businesses over 40 or 50 years. However, in terms of the new things that would come to us, we were probably about as good judges of 'em at the end of the second year as we would be today.

But I think there's a little plus to having [been around a bit] — more in terms of human behavior and that sort of thing than knowing about the specifics of a given business model. Charlie?

Munger: I've watched Warren for a long time now. And I would say he's actually getting *better* as he gets older — not at golf or many other activities...

Buffett: [Laughs] Stay with generalities.

Munger: But as an investor, he's getting better — which I think is remarkable. It shows that the scale of experience matters.

Buffett: Yeah, it helps somewhat to have a seen a lot of business situations. Charlie talks about models. And you construct your models as you go along based on observation. And if you're paying attention, your models will be somewhat better the more years that you've spent *really* observing and not just trying to make everything fit into what you saw the first few years.

BERKSHIRE'S COST OF FLOAT IS HEADED DOWN — WHATEVER GAAP ACCOUNTING MAY SUGGEST.

Last year's cost of float was something of an anomaly....

Shareholder: With regard to Berkshire's reinsurance contracts which were written at what some consider and call "good losses", you discussed those insurance contracts in your annual report and indicated that they've generated $482 million of losses in the year 2000. Do we need an annual schedule disclosing the aggregate amortized charges of all current and past such deals in order to make our adjustments to reflect economic reality?

Buffett: Well, there are two unusual-type deals. And you referred to one type — what I call the "pain today/gain tomorrow" or "good losses" type deals. And under the deals that you are describing, we record what is usually quite significant loss in the current year and then we have the use of float for many years to come. And there are no subsequent charges against that.

So in respect to those contracts, the important thing is that we tell you,and we *should* tell you — really every quarter if they're significant, and certainly yearly — any significant items that fall into that category. As you said, we had over $400 million [of reported losses from those] last year. We had a significant amount the year before. We have not had a significant amount this year. I think in the first quarter, there may have been a $12 million charge for one of those.

If they're significant, we're going to tell you about them. It's a onetime adjustment that, in effect, you should regard as different than any other type of underwriting loss that we experience because we willingly enter into these, we take the hit the first year (the accounting calls for that) and over the life of the contract, we expect to make money. And our experience has been that we *do* make money. But we'll tell you about any significant item of that sort so you'll be able to estimate our adjusted cost of float.

The trend in our cost of float is down.

Buffett: I reported our cost of float last year at 6% — which is high. It's not unbearable. However, it's high — *very* high. And about a quarter of that 6% cost came from these transactions that distorted the current year's figure. Therefore, our cost of float, if we hadn't willingly engaged in those transactions, would have been about 4-1/2%.

As I said in my letter, absent a mega-catastrophe — which I might define as insured losses of something on the order of $20 billion or more — we expected our cost of float to come down this year,perhaps substantially.

In the first quarter, our cost of float will probably run just a touch under 3% on an annualized basis. And I think the trend *is* in that direction....

We don't *mind* looking bad today to do better tomorrow.

Buffett: However, if we were to take on some of these "pain today/gain tomorrow" transactions (and we don't have any of those in the works at the moment) it would be reflected in our cost of float. And we would lay out the impact of that sort of transaction. Charlie?

Munger: Yeah, I think almost *all* good businesses have occasions where they're making today look a little worse to help tomorrow. So I would regard these transactions as very much the *friends* of the shareholders.

Buffett: ...We have a second type of transaction (also described in the annual report) which creates a large amount of float, but where accounting rules spread the cost of that transaction over the life of the float. And those do not distort the current year figures, but they do create

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an annual charge throughout the life of the float. And that charge is running at something over $300 million a year.

There again, it's a transaction that we willingly and enthusiastically engaged in. And that has this annual cost attached to it. So when you see our cost of float at 3% annualized in the first quarter, it includes probably an $80 million charge or so relative to those retroactive insurance contracts....

I recognize that this accounting, and even the transactions, are somewhat Greek to some of you. But they are important with respect to Berkshire. Therefore, we do want to lay 'em out in the annual report for those who want to do their own calculations of intrinsic value.

I'VE NEVER DONE THE CALCULATION, BUT OUR FLOAT IS A HUGE ASSET.

I've never made the calculation, but our float's a huge asset.

Shareholder: If you look at Berkshire as a portfolio of wholly-owned subsidiaries (operating businesses) and marketable securities (common stocks and bonds) ... and strip out the leverage effect of the cost of the float — being nearly zero or negative throughout the years — and look at the portfolio minus that leveraged piece, how fast do you think your book value would've grown over the last 30+ years? Are we talking about 5-6% due to just the leveraged piece on the insurance float?

Buffett: I don't think it would run as much as 5 or 6 percentage points, but the float has been very useful to us. And actually, I've never made the calculation. So you may well be correct. If it was 5 or 6 points, that would be a quarter of our [compounded annual] book value gain over the years being attributable to insurance float — although I think that's probably on the high side....

And we don't look at insurance float 100% the same as we look at equity, but we've looked at it as *largely* tantamount to equity because we've had so much equity that we could afford to do it that way. So you'll have to make that calculation yourself.

But our float has been a *huge* asset to Berkshire. We think it'll continue to be a huge asset. And we look for every way possible to increase the amount of low-cost float.

(continued in next column)

Our float makes us unique.

Buffett: On a small scale, we added U.S. Liability last year — an excess surplus lines carrier based in Philadelphia. And so far, that's working out extremely well. We've got a terrific guy running it. So in a small way, we added float there. I just looked at the first quarter on it. And we had a significant underwriting profit and we had float added —which is the best of all worlds. So we'll keep working on it....

It's a big asset that Berkshire has that virtually no other company has to this degree that also invests in other businesses and uses it as a source of money to invest in other businesses.

Sustaining 10%/yr. float growth may be hard, but we'll try.

Shareholder: Would it be fair to say that our current insurance businesses are likely to grow their float at about 10% annually over time?

Buffett: In our insurance business, we've grown our float — and then we've purchased businesses to add to the float. This year, unless one big transaction falls through or something, I would certainly expect our float to grow at least $2.5 billion. And that is close to 10% of the beginning-of-year float. That's a rational expectation.

But whether it can grow 10% per year and how far you can do that... I would say the total float of the property and casualty industry in the U.S. (and I'm making some calculations in my head as I talk) probably wouldn't be much more than $300 billion. So we're close to 10% of the entire U.S. float now. And I don't think the aggregate U.S. float is going to grow at a 10% rate. So when you're as big a part of the pie as we are, it may be difficult to sustain a 10% rate.

But we're doing everything possible that makes sense to grow float. That is a major, major objective. But the even *bigger* objective is to keep it low cost. So I don't think you could see — unless the world changes in some way — 10% growth over 25 years. But we'll do our darndest to get the rate you suggest at least in the near future. Charlie?

Munger: Well, I certainly agree that long term, it's not going to happen. It's good, but not *that* good.

We'll keep doing things. But it can't go on forever.

Buffett: But we've been surprised at what's happened. There's no question. When we bought Jack Ringwalt's company in 1967, my memory is that Jack had a float of less than $15 million. And would we have ever guessed that we might hit something close to $30 billion this year? No. We never dreamt it.

But we just kept *doing* things —and we'll *keep* doing things. But it can't be at huge rates for a long period of time — because we're too big a part of the pie now. We were nothing initially —and we've just kept grabbing a little more of the pie as we've gone along. And we like that. But it can't go on forever.

Anybody can generate *high*-cost float.

Munger: That's what I call really low-cost float. If it ever should be advantageous for us to go into what I'd call *higher*-cost float, that might change the picture somewhat in terms of growth of float.

Buffett: It could happen that we incrementally take on some higher-cost float under very special circumstances if

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we saw *unusually* good ways to use it. But we don't even like to think about that. We certainly don't want the people running our businesses to think about that...

Munger: No.

Buffett: ...because keeping it low cost — that's the big end of the game. *Anybody* can generate float. If we gave our managers a goal of generating $5 billion of float next year, they could do it in a *minute* — and we would be paying the price for decades to come.

You can always write dumb insurance policies. There's an *unlimited* market for dumb insurance policies. And they're very troubling because the first day the premium comes in, that's the last time you see any new money. From then on, it's all going out. And that's not our aim in life.

THE TRICK IN ALL TYPES OF INSURANCE IS TO FIGURE OUT THE VARIABLES.

The trick is being able to figure out the variables.

Shareholder: You've often talked about your advantages as a direct seller of auto insurance and as an investor of float. How do you control claim costs versus your competitors *other* than through good underwriting? Some of them may enjoy advantages in terms of economies of scale or cutting corners that you won't cut. And that may allow them to eliminate some of the advantages you gain on the other side of the combined ratio.

Buffett: It's a fascinating business because in this audience, there are people with *hugely* different propensities to have an accident. And of course, most people figure they're better than average. Now, *part* of the propensity to have an accident will depend on how many miles you drive. Obviously, somebody who never takes the car out of the garage, no matter what their driving skills might be, is not going to have an accident. If they drive 10 miles a year, you're pretty safe with almost anybody. So there's a relationship to miles driven.

But there's a relationship to all kinds of other things. And the trick in insurance is being able to figure out the variables — and not have *too* many because you still have to get people to fill out a form and you don't want something with practically no significance. The trick is to find out what questions you need to ask to determine in which category to place them as to their propensity to have an accident.

In life insurance, the key issue is mortality....

Buffett: Now in the *life* insurance business, even Charlie and I have figured out that the older you get, the more likely you are to die in a given year. Now that's not the *only* factor, but everybody understands that — that the older you are, the [more your] mortality risks go up.

And they've learned a few other things. They've learned that females live longer than males. Now, that doesn't get into a judgement as to why or anything else — you just *know* it. So you build that in if you're pricing the product. And then you know a whole bunch of other things....

In auto insurance, it's accidents. And experience helps.

Buffett: But in the *auto* insurance business, there are lots of variables that correlate with the frequency with which a person will have an accident per mile driven. And the more experience you have with a large body of people whom you've asked a lot of questions about and can draw conclusions therefrom, the better off you are.

But when we go into a new state, we'll have a very small body of policyholders. And there are certain things that you learn only if you're in a given state for a while. But obviously, some of the factors prevail over *all* states. You're more likely to have an accident, everything else being equal, if you're an urban driver in a big city than if you're driving in a rural area where the density of other cars is very low. If you're the only guy in the county with a car, you aren't going to have a lot of two car accidents.

And State Farm has a *wonderful* body of information. So their actuarial judgments should be better than anybody else's — because they've got more experience with more cars and drivers. However, our experience with close to 5 million policyholders enables us, I believe, to underwrite quite intelligently.

But we keep working on it all the time.

Buffett: But every day, we're looking for some variable that will tell us more. For example, people with a good credit history are better drivers by a significant margin than people with a lousy credit history. Why? We don't *care* too much why — because that wouldn't help us. What we really need to know is that the two factors correlate. So we're looking for correlations all the time.

We're trying to avoid *spurious* correlations — which you can have. It's a moving target. We keep working on it all the time. We're better at it than we were five years ago. And we'll be better at it in five years than we are today. So the underwriting question is all-important.

And there's fast settlement. We think about those things.

Buffett: And fast, fair settlement of claims is very important because people, particularly when injured, start feeling worse and worse as they talk to more and more lawyers. So claims delivery is a vital part of running a good property/casualty operation. And all I can tell you is that at GEICO, we think very hard about those things — and we'll be thinking about them tomorrow as well.

GEICO'S RETENTION RATIO IS MISLEADING. THE DECLINE HAS MOSTLY BEEN A MIX ISSUE.

The change in retention is actually mostly mix-based....

Shareholder: You have a wonderful table in your annual report showing the number of policies issued at GEICO and the policies in force at the end of each year for the last seven or eight years. In general, at the end of one year, the policies in force were equal to 95% of the policies in force at the beginning of the year plus 60% of those that had been issued in the year. And that's been constant up until this last year when the amount in force at the end of 2000 was 24% of the policies issued in 2000 and 95% of

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those that were in force at the end of 1999.

I'm curious if Mr. Nicely has asked why there's such a large difference in lapse between the first-year policies and the renewal policies. And why is there such a discontinuity in the Year 2000?

Buffett: The retention rate is affected overwhelmingly by two factors: One is the mix between the below-standard business, the standard business and the better business in terms of risk. About 75% or so of our business is in the preferred category. But we have grown faster up until the last year or so — in the last three or four years — in the standard and the non-standard business.

Those latter two categories have far greater — *far* greater — non-retention ratios or lapse ratios than the preferred business. They're two different businesses almost. Therefore, any change in the mix between preferred and the other two categories will change the aggregate retention ratio very substantially.

Plus, we've had a greater ratio of *new* business.

Buffett: The second thing is that the first year has a *much* higher lapse ratio than the second year of a policy — and, in turn, than the third and so on. In other words, if you get the preferred business that's been with you five or more years, you have a *very*, very high retention ratio.

In the last few years, we've added more new business than we were adding in the years before that. So we've had a higher percentage of new business and we've had a higher percentage of non-preferred business, both of which would make the aggregate lapse ratio look higher — even though the lapse ratio when categorized by class and age of business really hasn't changed very much. Now it's true, however, that our retention ratio in the preferred business has fallen by a point or so. But that's the big difference.

Today, the mix is moving back toward its traditional level.

Buffett: Now, unfortunately, our new business is not as strong, but our preferred business is running stronger than our standard and non-standard. So you're seeing the mix go back in the other direction right now. Year-to-date, our preferred business is up in aggregate policyholders and our standard and non-standard business is down.

So what you've deduced from those figures reflects changes in mix and age of business far more than it does the retention ratio, although there was a minor change in the retention ratio. And maybe I should explain that better in the annual reports in the future. I touched on it once a year ago, but we can make that clearer in future reports.

GEOGRAPHIC EXPANSION ISN'T EASY, BUT WE WON'T STOP TRYING.

We're always thinking about ways to expand GEICO.

Shareholder: I'm a Norwegian working in Tokyo and a very satisfied shareholder.... In my work, I've seen a lot of insurance companies in Europe and Japan. I think that GEICO's business model is quite superior to most primary insurance companies in Europe and Japan. And I think that GEICO would be very successful in Europe and Asia. So I'd like to hear your views and plans for GEICO doing business in Europe and Asia.

Buffett: Clearly, when you've got a business model that works as well as GEICO's has in this country — and that continues to work well — and has the fundamental advantage of being a low-cost operator, we think about every possible way that we can take that idea and extend it.

But expanding the franchise is more easily said than done.

Buffett: But it's been remarkably hard to do. Ever since Leo Goodwin started the company in 1936, the management's tried various things to take it into other areas. And those efforts have been modestly successful in certain areas — like life insurance (which they subsequently got out of) — and various other things....

We have 4%-or-so of the market in the United States. This market is so huge. And as we look at the drain on human resources required to extend it into other countries — and we've looked at it *a lot* — it may be something we'll do at some time. But we've never felt the possible gain, considering the rigidities — both in Europe and in Asia — of breaking in... Let me just say that it's not easy to get into those markets. Given the cost, the time, etc., we've just felt it would be better to concentrate those same resources in this country.

Geographic expansion with See's Candy *should* work....

Buffett: It's not a question of capital at all. We'd put the money in in a second. And we're doing it in something like NetJets in Europe. There's a human cost to it. And there's a financial cost to it. But the financial cost doesn't bother us at all.

The human cost is a real question — because it gets back to Charlie's notion of opportunity cost. We have talented managers, but we have a finite number of them. And I would rather have Tony Nicely and his crew focusing on how to gain additional market share in this country at the right rates than I would starting in on a project in Europe or Asia now.

But that's a very good question. And it's something that I can guarantee you we think about all the time — and we'll continue to think about.

We've tried to extend geography. Coke has been the most successful company in the world at extending geography. We've tried to do it with See's Candy and it's had very limited success. We've tried 50 different ways — because the trials were relatively cheap to do. And we think it *should* work. We just haven't been able to *make* it work. But it's a very good question.

WE'RE THE BIGGEST AND FASTEST IN REINSURANCE — AND THAT SHOULD ULTIMATELY BE A BIG PLUS.

There truly is synergy between us, Gen Re and Cologne.

Shareholder: You've talked a bit about the super-cat class level of risk that you write. Could you share your thoughts about expanding the competitive advantage and the scale advantages at General Re — referring more to their traditional or historical franchise and the type of contracts they would write?

Buffett: General Re and Cologne are a *very* different

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operation than the historical reinsurance business of National Indemnity. National Indemnity had *nothing* like their distribution system. They have a knowledge base for a whole different form of reinsurance than we could ever accumulate at National Indemnity.

Also, neither General Re nor Cologne retained as much risk as we are quite willing to retain because their financial profile was different before they joined Berkshire. So it's an opportunity for us, for two reasons, to make more money in that respect than General Re might have made on its own:

First, we can retain much bigger portions of what they write in the first place — and which they've been writing over the years, but have laid off with other companies in what has the fancy name of "retrocessionals". And second, they have a distribution capacity that may well have the ability to deliver a lot of big risks to us that we might not otherwise see and which, in the past, they might not have a good outlet for. And I hate the word, but there's really true synergy in General Re/Cologne being married to Berkshire.

Being bigger and faster than anyone else should be a plus.

Buffett: We haven't fully exploited that. And in fact, we probably won't fully exploit it 10 years from now. But it's very much in my mind and the minds of the managers at General Re and Cologne that we have expanded opportunities simply because Berkshire is willing to take on more risk than just about anybody in the world *knowingly* takes on — although we think some other people take on a lot more risk *un*knowingly.

But in terms of writing a specific contract, we're both bigger and faster, I think, than anybody else in the world. In effect, we have some of the abilities that used to be associated with going to a Lloyd's of London.... And we really can give an answer on something in an *hour* that other companies wouldn't know what to do with in a *month*. And that should be a plus for us in the world.

STATE FARM AND USAA HAVE DONE A GREAT JOB, BUT I WOULDN'T TRADE GEICO'S MODEL FOR ANYTHING.

I don't criticize State Farm. I'd probably do the same thing.

Shareholder: Does State Farm's structure as a mutual insurance company help it compensate for having a higher-cost structure — because over the long term, it'll only remain solvent and not provide an adequate return on capital to its investors?

Buffett: State Farm is a competitor —and it is a mutual company. And it has a *huge* amount of net worth. It's certainly true that they don't have the demands for profitability — partly because they've done such a great job in the past and built up so much surplus. Thus, they can subsidize, to some extent, current auto policyholders with the profits derived from auto policyholders of the past.

However, that's always true whenever a stock company competes with a mutual company. And we know that when we go into business. That's true of a lot of other mutual companies out there that operate without the demands of earning a high return on capital.

But I have nothing but basically good things to say about what State Farm has done over the years. If I were them, I'd probably be doing the same thing they're doing. I don't criticize them at all. Charlie?

State Farm is a thoroughly admirable company.

Munger: Well, I don't criticize what State Farm *is*. State Farm is one of the most interesting business stories in the United States. The idea that it could get as big as it is and have as good a distribution system as it does... It's a thoroughly admirable company. In fact, Berkshire has *bought* insurance from State Farm — not auto insurance.

Buffett: But you referred to them as a higher-cost operator. And they're really a relatively low-cost operator. State Farm isn't anywhere near as low cost as GEICO, although it is a low-cost operator compared to many.

GEICO is a *great* business operation. And we have invested significantly to build that because it is so attractive. As I pointed out in the annual report, the incremental investment we made last year in GEICO didn't produce the same results as incremental investments that we'd made in previous years. So we are finding it hard to *grow* the business under current circumstances on a basis that we would like. But it's a *wonderful* business. And it has a business model that I wouldn't trade for anything.

The founders of GEICO actually *came* from USAA.

Shareholder: Last year at this meeting, a gentleman stood up and *implored* you, Mr. Buffett, to invest in some technology stocks in order to "juice our returns". I would like to thank you this year for having *not* done that.

My question is regarding GEICO. I've been a USAA Preferred Risk customer for something like 15 years now.

Buffett: Yeah. You'll do very well with USAA. They're an extremely well-run operation and do a fine job for their policyholders.

Shareholder: I'd prefer to be a customer of the company that I *own* part of. Unfortunately, due to an accident and two speeding tickets in the last five years, they will not accept me as a preferred risk. I wonder if this isn't an untapped group of people who are preferred risks with their own company. Couldn't GEICO possibly take their current preferred risk status into account when determining whether to accept them as a customer?

Buffett: USAA, incidentally, is a *terrific* company. Leo Goodwin, who started GEICO — which was then called Government Employees Insurance Company — in 1936 was actually a key employee of USAA, as was his wife, Lillian. They both came from USAA. And USAA, as you know, limits its clientele. At that time, they limited their clientele to the officers in the armed services. That was a preferred class. And history has *shown* it to be a preferred class.

Leo wanted to extend that to other classes that he felt had similar characteristics that USAA wasn't interested in. That's why he formed Government Employees Insurance. He felt the preferred characteristic that could be determined by employment in that area as to their propensity for accidents would extend beyond the officer

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ranks of the armed services. And he was right.

It's a fascinating story. And there's a good book about USAA that came out about two or three years ago that tells the whole story.

[Editor's note: That book is *USAA: a Tradition of Service, 1922-1997* by Paul T. Ringenbach published by Donning Company.]

USAA's $6 billion surplus is an asset for its policyholders.

Buffett: It's hard for us to take away the preferred customers of USAA. It's hard for them to take away our preferred customers, too. But USAA has some of the same qualities we talked about in terms of State Farm. It has, as I recall, maybe a $6 billion surplus — it may be more now. It's *slightly* different than State Farm. It's not a true mutual — it's a reciprocal, as I remember. But it's tantamount to a mutual. So the $6 billion that's been accumulated over the years is working for present policyholders — which is a terrific asset for them.

In aggregate, predictors are good. But experience is better.

Buffett: And the fact that they keep you as a preferred risk probably means you *are* a preferred risk. Their underwriting judgement is very good. We have various categories that relate to speeding tickets or accidents and all of that sort of thing. And in aggregate, they are a good predictor of future accident potential.

But it's only in aggregate. It's like saying because I'm 70 that I have X% chance of dying. It doesn't say what's going to happen to me *specifically*, but it does mean that if you're insuring 100,000 70-year-olds, then you'd better get this sort of price.

We have predictors, too. Certainly, past driving history is an important predictor. But you've got this long history with USAA. And they, probably for very good reason on their *total* history, keep you in the preferred class.

On the other hand, based on criteria developed from looking at 5 million policyholders, we can't make the determination... We can't come out and actually observe you driving or anything.... We have to look at the information [we have] — which, if it says speeding tickets or accidents, does result in various scores being applied.

So I really can't offer you a better deal. I'd *like* to. I have a feeling you'd be a good client. If USAA ever gets mad at you, come over and see us.

THE AIRLINE BUSINESS IS VERY TOUGH INDEED. FORTUNATELY, OUR BUSINESSES ARE DIFFERENT.

In the airline business, everything's relative.

Shareholder: ...Large airlines have been in the news negotiating labor contracts. They claim they can't pass along their rising labor costs to their customers.

In the annual report, you say Executive Jet is growing fast and doing great. Executive Jet *seems* to be able to pass along *its* rising labor costs to its customers. Is this because Executive Jet has a rational compensation plan that keeps employee salaries in line with billable services? If not, why does Executive Jet do well while the airlines experience troubles?

Buffett: Well, the big problem with the airlines is not so much what their *aggregate* payments will be. The real problem is when you're in the airline business and your wage rates are out of line with your competitors. When you get right down to it, the figure to look at with an airline — among a lot of other things — is to start with the cost per available seat mile and work that through based on the capacity utilization to get to the cost per occupied seat.

And you could have labor costs or any other costs. You certainly have fuel costs up dramatically for the airlines from a couple of years ago. But as long as you're more efficient than your competitor and your costs are not higher than your competitor, people will continue to fly.

Higher costs in a commodity business are eventually fatal.

Buffett: [The problem is] when your costs are out of line with your competitor. That was the situation when Charlie and I were directors of US Air a few years back. Our costs per seat mile were *far* higher than competitors'. That was fine where we didn't *have* competitors on many of the short routes in the east. But as a Southwest Airlines would move into our territory — and they had costs, say, (and this is from memory) below 8¢ a seat mile and our cost might have been 12¢ per seat mile — that kind of thing can kill you eventually. They may not get to a certain route this year, but they'll get there next year or the year after.

So if you're running a big airline, whether it's a Delta or a United or whatever, if your costs are at parity or less (especially labor costs) than your other major competitors, that is much more important than their absolute level. You can't take labor costs that are materially higher than your competitor in a business with commodity-like characteristics such as airline seats — you just can't sustain it over time. You can get away with it for awhile. But sooner or later, in a capitalist society, the guy with the lower costs comes in and kills you. Charlie?

The airline business is *very* tough just by its nature.

Munger: The airline unions are really tough. And it's interesting to see a group of people who are paid as well as airline pilots with such a brutally tough union structure. It really makes it hard in a commodity-style business. And no individual airline can take a long shutdown without having considerable effects on future prospects. It's just a *very* tough business by its nature.

Passenger rail travel, even in the previous era, was a pretty tough way to make a buck. And nothing is all that different with airline travel.

Our businesses have less of a commodity component.

Munger: We hope our services are preferred by customers more than one airline seat is preferred compared to another one.

Buffett: Yeah. And fractional ownership is not a commodity business. The NetJets service isn't really *designed* to be competitive with United Airlines or American or companies of that sort. It has a different group of competitors. I think we have an absolutely terrific pilot

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force there. We want 'em to be happy. You want to pay 'em fairly. But there are a lot of other ways... With our pilots, for example, it's extremely important to them in many cases to be able to live where they want to live — and work the kind of shifts that we can offer. So we attract them in many other ways than bidding against United Airlines or American Airlines.

People care enormously about service and the assurance of safety. And I don't think that if you were buying a parachute, you'd want to necessarily take the low bid. With the big commercial airlines with millions and millions of passengers, people probably correctly assume that there's quite a similarity in both service and safety.

Munger: Along those lines, the shareholders may be interested to know, vis-a-vis competitive advantages in our NetJets program, that the day that another charter plane crashed in Aspen, NetJets had refused to fly into Aspen at all. People remember that kind of thing.

Buffett: Yeah.

In some businesses, financial strength becomes a liability.

Buffett: But if you're in a business that can't take a long strike, you're basically playing a game of chicken with your labor unions because they're going to lose their jobs, too, if you close down. So you're playing a game of chicken periodically. And there's a lot of game theory involved.

To some extent, the weaker you are, the better your bargaining position is — because if you're extremely weak, even a very short strike will put you out of business; and the people on the other side of the negotiating table understand that. On the other hand, if you have a fair amount of strength, they can push you harder. But it is no fun being in a business where you can't take a strike.

We knew the importance of labor relations.

Buffett: We faced that one time back in the early '80s when we were in kind of a death struggle in Buffalo with the *Courier Express*. When I bought the *Buffalo News*... Actually, Charlie did. He was stranded there during a snow storm and got bored. So he called me and said, "What should I do?" I said, "Why don't you buy the paper?"

And when we bought the *Buffalo News*, we had two questions of management. One of them I can't tell you. But the second one was that we wanted to meet with the key union leaders to tell them, "If you ever strike us for any significant length of time, we're out of business. You can make our investment valueless. So we really want to look you in the eye and see what kind of people you are before we write this check."

And we felt quite good about the people — and they *were* good people.

Sometimes it's out of your hands....

Buffett: But we had one situation in 1981 or thereabouts where a very, very small union — I think it was less than 2% of our employees — struck over an issue that the other 10 or 11 unions really didn't agree with them that much on. But they struck and the other unions observed the picket line — which you'd expect them to do in a strongly pro-union town such as Buffalo.

As I recall, they struck on a Monday. And I remember that leaders of some of the other unions actually had tears in their eyes over this — because they could see it was going to put us out of business. And frankly, I said, "Look, if you come back in a day, I know we'll be competitive. If you come back in a year, I know we won't be competitive. And if you're smart enough to figure out where exactly the point is that you can push us to and still come back and we have a business and you have jobs, you're smarter than I am. So go home and figure it out."

And they came back in on Thursday — and we became very competitive again. But it was out of my hands. I couldn't make them work. If they decided they were going to stay out long enough, we weren't going to have a newspaper. And that's the kind of situation occasionally you find yourself in. And I would say the airline industry is a good example where people find themselves in that position periodically.

FRACTIONAL JETS ISN'T AN EASY BUSINESS. AND FRANKLY WE HAVE THE BEST HAND.

We don't worry about dumb competition with NetJets....

Shareholder: You've said it's hard to be smarter than your dumbest competitor. Along that line, what are your thoughts about a recent *Wall Street Journal* article about a major airline getting into the fractional jet business?

Buffett: I don't worry about the dumbest competitor in a business that's service-oriented. The customer will figure that out over time. We have a *huge* advantage in the fractional ownership business. We have 265 planes flying around now. And you can get one on four hours notice at any one of 5,500 airports. We have planes in Europe for our American customers. And we have planes here for our European customers. Nobody's going to catch us, in my view, in fractional ownership.

We've had some dumb competitors in the past in that business — and they *bleed*. And to the extent [they do dumb things], we've got more blood than they have.

If I were an airline, I wouldn't enter fractional jet ownership.

Munger: Vis-a-vis the fractional jet ownership program which has been announced by United Airlines, I find that very interesting. A senior United Airlines pilot now makes about $300,000 a year plus fancy fringes including pension. For that, he works a very limited number of hours a month. And about a third of that, he spends sleeping on a comfortable bunk on long ocean flights. That is not a culture that will work well in fractional jet ownership. Maybe they think they'll get some advantage in the crew and the pilots or something. I don't know *why* they're doing it. I would not have done it.

Buffett: Well, they haven't done it yet. But many of the airlines have organized second companies to take care of commuter flights and all of that. They try to get lower cost structures by doing that. And that produces problems when the pilots of the subsidiaries start comparing their benefits to the pilots of the parent airline.

But I would guess that if you were wanting to set up a

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(cont'd from preceding page)

fractional ownership company, you would probably not think about trying to align yourself with somebody that has extremely high costs....

The advertising campaign would be kind of interesting, too — you know, "Give up first class travel and start traveling right" or something like that. It'll be interesting.

We have competitors in the fractional ownership business — the two largest being companies that are part of plane manufacturers. And you can understand why they went into it. However, it is not an easy business. And we have the best hand, frankly.

Executive Jet should continue to expand for a *long* time.

Shareholder: Once Executive Jet becomes a mature business, would it be fair to say that its net margins should be about 5%?

Buffett: It's really anybody's guess. I don't expect Executive Jet to become a mature business for decades. There's a whole world out there. We have something over 2,000 customers in the United States at the current time— and we have a little over 100 in Europe. But there are tens and tens of thousands — and perhaps *hundreds* of thousands — of people or businesses where it does make sense over time. So it's going to be a *long* time.

There are roughly only 700 jets a year being produced. And of course, up until a few years ago, that was limited to people who wanted to buy single planes. But that output won't change much in the next five years. So you couldn't really take on... We could take on about 600 customers a year just in terms of the delivery schedule that we have built into our business. And we couldn't *change* that — we couldn't double that — because the planes simply aren't available in the next year or two, although we do have orders further out.

But it will be a long time until Executive Jet becomes a mature business — a *long*, long time.... And as we make progress in Europe, then we'll move into Asia. And then we'll move into Latin America.... So I think we're going to be growing that business significantly for a *very* long time.

When it becomes mature — or close to it — I'd say that 5% after-tax margins is probably a reasonable figure. But we're so far away from even thinking about that that it's pure speculation.

(continued in next column)

DERIVATIVES ACCOUNTING IS TOO OPTIMISTIC BECAUSE THAT'S THE WAY ITS DENIZENS WANT IT.

Most CEOs don't understand their derivatives business.

Shareholder: You've made it possible for shareholders to understand Berkshire's financial businesses. But there is one that seems hard to understand — to me, anyway — which is the financial products business, which I guess involves the trading of derivatives. And given the same kinds of concerns that you and Charlie voiced in relation to financial businesses, can you help us out on that and why you're comfortable with it?

Buffett: Well, I think you put your finger on it. It *is* a hard business to understand. And it's a hard business to understand if you *own* it, let alone read about it in somebody else's annual report. I'd guess that most people who run complicated or extensive derivatives businesses — I would say that most of the CEOs — probably *don't* understand it. How many of them stay awake at nights over that, I don't know....

We're not comfortable with the area, but we are with Mark.

Buffett: But it would be a fair criticism to say that neither Charlie nor I know fully, or even in large part, what goes on in the derivatives business. We do have a fellow who is both smart and trustworthy running that in the person of Mark Byrne. So we feel very good about the individual. But we do not feel the instinctive understanding of everything that's going on there that we do probably in most of the businesses that we're in.

I think we've probably got 17,000 outstanding tickets at General Re Securities. And those interplay in all kinds of ways. And I don't think that Charlie or I have our minds around that book of products.

That means we want to be *very* comfortable with the fellow whose job it *is* to have his mind around those products. And I will tell you that there's nobody that I'd feel *more* comfortable with than Mark Byrne. But it's not a natural-type business for us.

It also includes "Oddball Personal Ideas" of Warren & Mark.

Buffett: As to the other things in that area, we made a fair amount of money in some things that *aren't* related to the derivative business last year. And those are under my direct control. So I feel okay about that. The structured settlement businesses is a minor profit area, but it's made us some money. And right now, it's not attractive, but it could be again in the future.

And there could be other financial-type things that we would stick in there. But if we stuck in anything, it would be something that I would be running. Charlie?

Munger: That mix includes what I would call "Oddball Pastimes of Warren Buffett"...

Buffett: The ones that are publishable.

Munger: ...outside the common stock field. Those I'm quite comfortable with — although I'm sure the results will be irregular. And we also have what might be called

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"Oddball Personal Ideas of Mark Byrne" — and I'm quite comfortable with *those*.

Front-ending profits has produced predictable results.

Munger: As you get away from that into what might be called more standardized derivative trading businesses, I think it's fair to say I like them less than most of the people do who are in them.

Buffett: Quite a bit less. Yeah, we regard that area as potentially being dynamite — because if you get a large group of people who, in many cases (although we've tried to go away from it ourselves) are getting paid based on front-ending potential profits, that's a dangerous situation to place 100 people in. You're gonna find people who'll *crack* under that in terms of what they'll do.

They had a case of it actually in the electric utility industry a year or two ago when Edison in California through a subsidiary compensated people based on projecting the profitability of a business that they were putting on the books that day. That's Wall Street practice — and it was brought to the utility industry. It produced, I'd say, predictable results.

So it's dangerous to pay people to make deals where you won't know the outcome for 15 or 20 years and give 'em a lot of money up front for doing it. And that's fairly standard practice in the business. It was standard practice at Salomon when I was there. As I say, people occasionally crack under that.

It isn't exactly analogous, but it's worth reading Roger Lowenstein's book, *When Genius Failed*, because it touches on some of the problems we've described that Charlie and I are apprehensive about.

Derivatives accounting's irrationally optimistic for a reason.

Munger: Yeah. The derivatives business has the very significant problem that the accounting profession sold out. The accounting is improper. It front-ends way too much income. It's irrationally optimistic because that's the way the denizens of the field *want* it because it creates bigger compensation. It's intrinsically an irresponsible system. And it's another case where the accounting profession has failed the wider civilization.

Buffett: Charlie was on the audit committee at Salomon. And we sometimes found single positions mismarked by close to $20 million. Didn't we, Charlie?

Munger: Oh, *yeah*. But deliberate mismarkings were not the main problem. The main problem is that the whole *system* of accounting is wrong. The whole system of accounting is too optimistic. It would be like [allowing] a 30-year depreciation rate in the taxicab business.

We know we're playing with fire. So we're extra careful.

Buffett: Or it'd be like writing very long-tail insurance and paying a big commission up front based on the expected profit of that insurance over a 10-year period — with that calculation prepared by the guy who wrote the policy. There are certain activities that are really just *dangerous* in the financial world. And when you get close to that kind of situation, you just have to be very careful.

Actually, Mark Byrne's been implementing a system that accounts for compensation significantly differently than what occurs in many institutions. So you can try to attack it, but it's hard to get *too* far away from industry norms and still do business.

Munger: Our accounting is *way* more conservative than the standard derivative accounting of the country. Thank *God*!

IT'S CONVENIENT NOT TO REPORT COMPENSATION — AND LUCRATIVE, TOO. BUT IT'S NOT RATIONAL.

The accounting's corrupt. But it's futile for us to fight it.

Shareholder: The area I'd like to inquire about is stock options. As you are aware and have written about in your past reports, companies have been taking advantage of and contributing to FASB's inadequate rules regarding stock options — in particular, the lack of any requirement to expense them on the income statement and report them as a liability on the balance sheet. Are either of you doing anything to change FASB's current stance on the issue? If not, have either one of you ever considered establishing a "real" independent body of accountants that would actually try to make companies produce accounting statements that reflect economic reality?

Buffett: Charlie, I'll let you [answer that one]. You know the history on that....

Munger: Well, we don't like the accounting which we — or at least I — have called corrupt. And I don't think that that's too strong a word. I think it *is* corrupt to have false accounting because you like a certain outcome better than another.

That said, neither of us spends a lot of time fighting with FASB [Financial Accounting Standards Board] or trying to create a better one. It's like shattering your lance against stone or something. You get a lot of back pressure from the butt of the lance. We can't be expected to cure all that ails the world.

If at first you don't succeed, ~~try try again~~ lobby Congress.

Buffett: We've written about it and talked about it. And obviously, you've picked up on it. And when it was an active issue whenever it was — about four years ago or so — Senator Levin of Michigan was one of those who felt as we did. Of course, FASB felt as we did.

American business tried to put pressure on FASB and they weren't getting results. So they just said, "Well, we're not going to let FASB set the accounting rules. We'll let *Congress* set the accounting rules." And I thought that was a bad idea per se. But the pressure American business brought on Congress was incredible. And they got plenty of supporters. In fact, they had a *huge* number of supporters.

And the arguments weren't exactly *rational*....

Buffett: At the time, I compared it to a bill introduced in the Indiana legislature in the 1890s, I believe, that proposed changing the value of the mathematical term *pi* to exactly 3.0 — instead of 3.141 etc. The legislator who introduced it said that it was too difficult for the schoolchildren of Indiana to work with this terribly long,

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unending term —and it would be so much easier if *pi* was just 3.0. And he thought that they ought to enact that.

Well, I thought that was quite *rational* compared to what the Congress of the United States was going to do.... For example, one of the arguments was that it makes it very tough for start-up companies if they have to expense [their stock options]. Well, it makes it tough if they have to pay their electricity bill, too. But that was the kind of argument you got.

Who wants to report expenses —especially compensation?

Buffett: Charlie may remember this better than I do. But I think the accounting firms 40-50 years ago were in accord with our position. Every client would put pressure on 'em. They didn't want to report expenses. They particularly didn't want to report expenses paid to *them* [as managers] that could be huge and prove obnoxious if recorded by conventional accounting. But if they got lost in the table in the proxy statement, people wouldn't pay much attention. So that's how the practice developed.

There's only one way it gets changed. And that's not likely.

Buffett: We wrote about it — and I even talked to a few senators at the time. The only way it'll get changed — and this is the only way corporate governance problems generally will get changed — is if 15 or 20 large institutional investors band together in some way on this. But some of them have the same problem because *they're* getting paid extraordinary sums for doing something that really isn't adding that much value. So they're not really inclined to call attention in many cases to what Charlie would refer to as obscenities in *other* people's compensation. So I think it's going to go on. It's a fascinating subject.

Mgm'ts won't change voluntarily,consultants ever... .

Buffett: Institutional investors seem to focus on matters of form and not substance. They carp a lot about little things that don't have *anything* to do with their economic return over time, whereas on stock options, it's something that's terribly important — they're the ones that are paying the costs and the costs are real whether they get recorded or not.

But American management will not change its position on that voluntarily. Consultants will *never* change their position. They're getting *paid* to encourage people to look at other companies. And it just keeps ratcheting up. So I don't think you're going to see change unless institutional investors do it.

Nominating committees ask the darndest questions....

Buffett: I get these questionnaires about the composition of a board or a nominating committee. And none of that makes any difference in terms of how the business performs. I got one form that said they wanted a list of directors broken down by sex. And I said, "None that I know of." It just isn't germane. Charlie?

Munger: I can't top that one.

PHARMACEUTICALS & TECHS HAVE SIMILARITIES.
BUT THE DIFFERENCES ARE MUCH GREATER.

Charlie answers all of the questions about mistakes.

Shareholder: A few years ago, you said you'd made a mistake by not buying shares of pharmaceutical companies around 1993. You cited their value to society, their terrific growth, their high profit margins and their great potential. And you said that while you didn't know which companies would do best, you could have made some kind of sector play because the entire sector had been decimated.

These exact same words including those about not knowing which businesses will dominate over time could also be used to describe another industry which has recently been decimated. This industry is, of course, technology. How do you see these two investment ideas — pharmaceuticals in '93 and technology today? And what difference in the two situations makes the first a good opportunity for Berkshire and the second not one?

Buffett: Charlie answers all of the questions about mistakes. So I'll turn that part of the question over to him.

Just because an area's down doesn't mean it's a bargain.

Munger: Personally, I think that the future of the pharmaceutical industry was easier to predict than the future of the high technology sector. In the pharmaceutical industry, almost everybody did well — and some companies did *extremely* well. In the high-tech sector, there are many permanent casualties....

Buffett: Yeah. There's certainly nothing obvious to us about the fact that the tech sector as a group, viewed in aggregate, would be a good buy or be undervalued; whereas we should've had enough sense to recognize that the pharmaceutical industry as a group was undervalued. The pharmaceutical industry has a far, far better record of returns on large amounts of equity over time — and with a high percentage of the participants having those returns — than the tech industry. So I wouldn't regard those two as comparable at all.

WHAT REALLY COSTS IN LIFE
ARE THE BLOWN OPPORTUNITIES.

Our biggest mistakes don't show up in our figures....

Shareholder: This question regards mistakes. That being the case, I should probably direct it to Mr. Munger. I know that you're fond of evoking humility to promote rational thought. What's the most recent business mistake that you've made, Mr. Munger, and why did it occur?

Buffett: I'm going to take notes on this one.

Munger: Our most extreme mistakes have been mistakes of omission. They don't show up in our figures. They show up in opportunity costs. In other words, we have opportunities — we *almost* do it. And in retrospect, we can tell that we were very much mistaken not to do it. In terms of shareholders, those are the ones in our history that have really cost the most.

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Very few managements do much thinking or talking about opportunity costs. But Warren, we've blown...

Buffett: Billions and billions and billions — I might as well say that...

Munger: And we *keep* doing it.

Buffett: Some might say we're getting *better* at it. [Buffett chuckles.]

What *really* costs in life are the blown opportunities.

Munger: I don't like mentioning the specific companies because in due course we may want to buy them again and have an opportunity to do so at our price. But practically *everywhere* in life and in corporate life, too, what really costs, in comparison with what easily might have been, are the blown opportunities. It's just an *awesome* amount of money.

When I was somewhat younger, I was offered 300 shares of Bellridge Oil. An idiot could have seen that there was no possibility of losing money and a large possibility of making a lot of money. I bought it. The guy called me back three days later and offered me 1,500 more shares. But this time I passed because I would've had to sell something to buy the damn Bellridge Oil. That mistake, if you trace it through, has cost me $200 million. And it was all because I had to have a slight inconvenience and sell something.

Berkshire does that kind of thing, too. And we never get over it.

It's only an error if it's within our circle of competence.

Buffett: When we speak of errors of omission, of which we've had plenty — including some very big ones — we don't mean not buying some stock where a friend runs it or we know the name and it went from $1 to $100. That doesn't mean anything. We only regard errors as being things that are well *within* our circle of competence — and we still fail.

If someone knows how to make money in cocoa beans or software or something like that and we miss that, that's not an error as far as we're concerned. What's an error is when it's something we understand and we stand there and *stare* at it and we don't *do* anything.

Even worse is when we stand there sucking our thumbs.

Buffett: Or worse yet, what really gets me is when we do something very *small* with it — we do an eyedropper's worth of it — when we could do it very big. When I do that sort of thing, Charlie refers to that elegantly as sucking my thumb. And we've been thumbsuckers at times with businesses we understood well. And it may have been because we started buying and the price moved up a little and we waited around hoping we would get more at the price at which we originally started buying it. There could be a lot of things. But those are *huge* mistakes.

Conventional accounting, of course, does not pick those up at all. But they're in *our* scorebook.

THE INCENTIVES IN HEDGE FUNDS ARE AWESOME,
BUT I DON'T EXPECT RETURNS TO BE TOO SWIFT.

A rose by any other name, etc. — or something like that....

Shareholder: When you started in your business, why did you start with an investment partnership instead of a mutual fund? Also, can you recommend a good book on how to start an investment partnership or fund...?

Buffett: I don't know of any books on starting partnerships or hedge funds. Do you know, Charlie?

Munger: No, but people seem to manage to create them without the books. The incentives are awesome.

Buffett: Yeah. It's always interesting to both of us how you get certain things that are fashionable. And people think that by *naming* something a given name, that somehow makes everybody smarter or able to make money in it. There's no magic to private equity funds, international investing, hedge funds — all of the baloney that gets promoted in Wall Street. What happens is that certain things become very promotable — usually because there's been recent successes by other people — and the new entrants extrapolate the successes of a few people in the past to promote new money from people currently. So they adopt titles that they think will attract money.

But it doesn't make anybody any smarter if they hang out a shingle in front of their house that says "hedge fund" or ... "asset allocation firm" or something of the sort. The form doesn't create talent.

How we got into the business....

Buffett: I backed into the business. I worked for a mutual fund — a closed-end investment company — from 1954 to 1956. In fact, there's a friend of mine here today — and the two of us worked there. And we were 40% of the whole company. There were three other people — all of whom outranked us considerably. And that firm was Graham-Newman Corp. It was a regulated investment company. It had about $6 million in assets — which seemed like a big deal at the time. Ben Graham was one of the best known investors in the world — and he only had $6 million in his fund.

There was a sister partnership — Newman & Graham — which operated in what is today called the "hedge-fund style" where the partnerships split the profits and so on. But when I left there in '56 and I came back here, we had seven people — a couple of whom are here in the room — who said, "Do you want to manage money?" And I said, "Well, here's what I learned at Graham-Newman — that Newman & Graham is a better way to do it than Graham-Newman."

So I formed a little partnership. And I met Charlie a few years later — and he figured that if *I* was making money doing it, he'd make a lot *more*. So he formed one. And that was the carefully calculated strategy of how we both became involved in the partnership business. Charlie?

I'd bet a lot of money that most hedge funds don't excel.

Munger: It's amazing how big the hedge fund industry has become. They have *conventions* on the subject now. These things come in great waves.

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BERKSHIRE HATHAWAY'S
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In the late '20s, you could take a course on how to run a crooked security pool. I'm not suggesting that hedge funds are crooked. But I *am* suggesting that you get these *waves* of fashion that go to great extremes. The amount of money — what is it now, Warren? — that hedge funds have under management...

Buffett: It's very big, although it's a little less in the last few quarters than it used to be. [He chuckles.] But I'd be willing to bet a *lot* of money that if you were to take the aggregate experience of all the hedge funds starting today and going for the next 15 years, it would not hit 10% in terms of the return to partners. And if you were to push me, I'd bet at a lower figure than that.

And then there's the fund of funds idea....

Munger: Then you have Bernie Cornfeld's idea — the fund of funds. There are people who want to get paid for selecting hedge funds for other people. And that didn't work very well for Bernie Cornfeld.

Buffett: Well, it worked pretty well for Bernie for a while, but it didn't work so well for his investors. [Chuckling] But that result was probably something Bernie had in mind at the start.

FOR GREAT RETURNS, THINK SMALL. FOR GREAT PROFITS, THINK BIG.

When I was working with small sums, I did *much* better....

Shareholder: Mr. Buffett, from my reading, you achieved the best results of your career quantitatively in the years from 1956-'69: 29% annually against only 7% for the Dow. Your approach then was different than it is now. You looked for lots of undervalued stocks with less attention to competitive advantage or favorable economics and sold them rather quickly.

As your capital base grew, you switched your approach to buying undervalued excellent companies with favorable long-term economics. If you were investing a small sum today, which approach would you use?

Buffett: Well, I would use the approach that I think I'm using now of trying to search out businesses where I think they're selling at the lowest price relative to the discounted cash they would produce in the future. But if I were working with a small amount of money, the universe would be *huge* compared to the universe of possible ideas that I work with now.

You mentioned that '56-'69 was my best period. Actually, my best period was before that — right after I met Ben Graham in early 1951. From the end of 1950 for the next 10 years, my returns averaged about 50% per year — 37 points better than the Dow 30 or something like that.

But I was working with a tiny, tiny, tiny amount of money. So I would pore through volumes of businesses and I'd find one or two that I could put $10,000 or $15,000 into that were just *ridiculously* cheap. And obviously, as the money increased, the universe of possible ideas started shrinking dramatically. The times were also better for doing it at that time.

As the money rises, the expectable results fall dramatically.

Buffett: But I think that if you're working with a small amount of money with exactly the same background that Charlie and I have — the same ideas, the same ability, etc. — I think you can make *very* significant sums. But as soon as the money gets up into the millions — into the many millions — the curve on expectable results falls off dramatically. That's just the nature of this business.

When you get up to things that you can put millions of dollars into, you've got a lot of competition looking at them — and they're not looking as I did when I started. When I started, I went through the manuals page by page. I went through 20,000 pages in the *Moody's* industrial, transportation, banks and finance manuals — *twice*. I actually looked at every business — although I didn't look very hard at some.

For great returns, think small. For great profits, think big.

Buffett: Well, that's not a practical way to invest tens or hundreds of millions of dollars. So if you're working with a small sum of money and you're really interested in the business and you're willing to do the work, you'll *find* some things — there's no question about it in my mind — that promise *very* large returns compared to what we'll be able to deliver on large sums of money. Charlie?

Munger: I think that's right. A brilliant man who can't get any money from other people who's working with a very small sum probably should work in very obscure stocks searching out unusual mispriced opportunities.

But it's such a small world. It may be a way for one person to come up, but it's a long slog.

Buffett: Yeah. Unfortunately, most smart people on Wall Street figure that they can make a lot more money a lot easier just by one way or another getting an override on other people's money or delivering services in some way.... And the monetization of hope and greed is a way to make a *huge* amount of money.

Big money on Wall Street hasn't been from performance.

Buffett: Take hedge funds. I've had calls from a couple of friends in the last month who don't know *anything* about investing. They've been unsuccessful and everything else. One of them called me today and said, "Well, I'm running a small hedge fund — $125 million — and since it's only $125 million, maybe you ought to put in $10 million or something of the sort." [Buffett chuckles.] But if you look at this fellow's Schedule D on his 1040 for the last 20 years, you'd think he should be mowing lawns. But he may *get* his $125 million.

It's just *astounding* to me how willing people are during a bull market just to toss money around. They think it's easy. Of course, that's what they felt about internet stocks a few years ago. And they'll think that about something else next year, too.

The biggest money made in Wall Street in recent years has not been made by great performance; it's been made basically by great promotion. Charlie?

The current investment scene is obscene.

Munger: I'd state it even more strongly. I think the

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current scene is obscene. There's too much mania. There's too much chasing after easy money. There's too much misleading sales material about investments. There's too much on television emphasizing speculation in stocks....

PEOPLE WHO TEACH INVESTING RIGHT ARE LONELY — BRUCE GREENWALD, JACK MCDONALD ET AL.

There are a few places that teach investing right....

Shareholder: Years ago, you wrote to a friend ... that you were applying to Columbia's business school because they had a pretty good finance department and a couple of hotshots in Graham and Dodd. If you were considering a business school today, with which individuals or professors would you want to study?

Buffett: I think Bruce Greenwald's class at Columbia is very good. He gets in a lot of people that are practitioners. So there's a lot of practicality to the course. And I think Bruce is good. He's got a new book coming out ... that will deal with that. [Ed. note: *Value Investing: From Graham to Buffett and Beyond* published by John Wiley & Sons, Inc.]

And there's also been certain courses endowed at the University of Florida relating to value investing. [Ed. note: Endowed by Longleaf Funds' Mason Hawkins.] And I think there's been one at the University of Missouri. So I'd suggest that you at least check out the curriculum at the University of Missouri and Columbia and Florida, do a little comparison and maybe check with a few recent graduates as to what kind of experience they had. If you can find them, I think that's the best system for evaluating a place. But those three at least have courses that, based on the catalogues, sound like they may be of interest to you. Charlie?

And don't forget Jack McDonald at Stanford....

Munger: The huge majority of the business school teaching on the field of investment of passive portfolios of securities is not what we believe and not what Warren was taught years ago by Ben Graham. There are just little pockets of our attitude left. For example, there's another one at Stanford — taught by Jack McDonald.

Buffett: Yeah, sure —at Stanford Business School.

Munger: And what's interesting about that is I think it's the most popular course at Stanford Business School. They've got some kind of a bidding system. Yet I asked Jack how he felt — and he said he felt lonely. He's got the most popular course. But in the whole professoriate dealing with investment matters, the Jack McDonalds are a little clan of their own in a side pocket, so to speak.

Now they're *right*. And I think they're going to have to take whatever consolation they get from that. But mostly, if you go to business school, you will learn a lot of things we don't believe.

Buffett: Bob Kirby [portfolio manager and Chairman Emeritus of Capital Guardian Trust Company] comes in and works with Jack sometimes, too. And Bob has a terrific mind in terms of investments.... It's not the easiest school in the world to get into.... But there are these occasional little anomalies, as they'd say, in the teaching world.

Investing is all about business valuation.

Buffett: What you really want a course on investing to be is how to value a business. That's what the game is about. If you don't know how to value a business, you don't know how to value a stock. And if you look at what is being taught, I think you see very little of how to value a business.

And the rest of it is playing around with numbers or Greek symbols or something of the sort. But that doesn't do you any good. In the end, what you have to decide is whether you're going to value a business at $400 million, $600 million or $800 million — and then compare that with the price. That's what investing is. And I don't know any other kind of investing to do.

But valuation isn't taught for a reason....

Buffett: And that just isn't taught. And the reason why it isn't taught is because there aren't teachers around who know how to teach it. They don't know themselves. And since they don't, they teach that nobody knows *anything* — which is the efficient market theory.

If I didn't know how to do it... If I ever teach physics, I'm going to come up with a theory that says nobody knows anything about physics, because that's the only way that I could get through the day.

Generally, the teaching of investing is kind of pathetic.

Buffett: It's fascinating to me how the really great universities operate in this respect.... You get in the finance department because you sign on to whatever the present group *thinks*. And if they think the world is flat, you better think the world is flat, too. And your students better answer that the world's flat when they get the question on their exams.

I would say that, generally speaking, finance teaching in this country is kind of pathetic.

They're missing an enormous opportunity....

Munger: Well, I think the business schools do a pretty good job when it comes to accounting...

Buffett: Accounting — sure.

Munger: ...or personnel management. There are a whole lot of subjects I think they do quite well with. But they miss one enormous opportunity. If you learn to think intelligently about how to invest successfully in businesses, you'll become a much better business manager than you will if you aren't good at understanding what's required for successful investment. So they're missing a huge opportunity to improve the *management* profession by doing such a lousy job in teaching investment.

Mgm't ignorance isn't *all* bad — for investment bankers....

Buffett: Charlie and I see CEOs all the time who, in a sense, don't know how to *think* about the value of the businesses they're acquiring. Therefore, they go out and hire investment bankers. And the investment banker gets 20X if they do it and only X if they don't. So guess how the

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advice comes out.

When a manager of a business feels helpless in asset allocation — which he won't say out loud, but he feels that way inwardly — you've got a real problem. And they haven't gone to business schools that have given them any real help in terms of learning how to think about the valuation of businesses. That's one of the reasons that we write and talk about it — because there's a gap there.

IF SOMEBODY STARTS TALKING ABOUT BETA, I'D RECOMMEND ZIPPING UP YOUR POCKETBOOK.

Risk with us doesn't relate to volatility at all.

Shareholder: Wall Street often evaluates the riskiness of a particular security by the volatility of its quarterly or annual results — and, likewise, measures money managers' riskiness by *their* volatility. I know you guys don't agree with that approach. Could you give us some detail about how you measure risk?

Buffett: We regard volatility as a measure of risk to be nuts. And the reason it's used is because the people that are teaching want to talk about risk — and the truth is that they *don't* know how to measure it in business. Part of our course on how to value a business would also be on how risky the business is. And we think about that in terms of every business we buy.

Risk with us relates to several possibilities. One is the risk of permanent capital loss. And the other risk is that there's just an inadequate return on the kind of capital we put in.

It just doesn't make sense to equate volatility with risk.

Buffett: However, it doesn't relate to volatility at all. For example, our See's Candy business will lose money — and it depends on when Easter falls — in two quarters each year. So it has this *huge* volatility of earnings within the year. Yet it's one of the least risky businesses I know. You can find all kinds of wonderful businesses that have great volatility in results. But that doesn't make them bad businesses.

Similarly, you can find some *terrible* businesses with very *low* volatility. For example, take a business that did nothing. It's results wouldn't vary from quarter to quarter. So it just doesn't make any sense to equate volatility with risk. Charlie, do you want to add anything on that?

A more important question —explaining mass craziness .

Munger: Well, it raises an interesting question which is, "How can a professoriate that is so smart come up with such silly ideas and spread them all over the country?" That's a *very* interesting question.... But I've been waiting for this craziness to pass for several decades now. I do think it's getting dented some, but it's not passing....

Buffett: If somebody starts talking to you about beta, [the Greek letter used in Efficient Market Theory to connote volatility], zip up your pocketbook.

PEOPLE TEACH WHAT'S *EASY* TO TEACH INSTEAD OF WHAT'S CORRECT....

We've always believed that opportunity cost is important.

Shareholder: Mr. Munger, at last year's meeting, you said that you didn't feel that the concept of cost of capital made economic sense. Would you explain why you feel this way and what you would replace it with, if anything?

Munger: First, obviously, considerations of cost are important in business. And obviously, *opportunity* costs — which is a doctrine of economics, but really a doctrine of lifesmanship — are also very important. We've *always* had that kind of basic thinking. Of course, capital isn't free. And of course, you can figure cost of capital when you're borrowing money — or at least you can figure cost of loans.

But we don't agree with cost of capital theory or practice.

Munger: But the theorists had to develop a theory for what *equity* cost. And there they went absolutely bonkers. They said if you earned 100% on capital because you had some marvelous business, your cost of capital was 100% — and, therefore, you shouldn't look at any opportunity that delivered a lousy 80%. That is the kind of thinking which came out of the capital asset pricing models and so forth that I've always considered inanity.

We calculate our cost of capital differently than most....

Munger: What is Berkshire's cost of capital? We *have* this damn capital. It just keeps multiplying and multiplying. What is its cost? You have perfectly good, old-fashioned doctrines like opportunity cost. And at any given time when we consider an investment, we have to compare it to the best alternative investment we have at that time.

So we have perfectly good old-fashioned ideas that are very basic to use, but they weren't good enough for these modern theorists. So they invented all this ridiculous mathematics which concluded that the companies that made the most money had the highest costs of capital. Well, all I can say is that's not for us....

Buffett: What you find in practice, of course —the test used by most CEOs — is that the cost of capital is about 1/4 of 1% below the return promised by any deal that the CEO wants to do. It's very simple.

When we have capital around, we have three questions — leaving aside whether we want to borrow money, which we generally don't want to do. First, "Does it make more sense to pay it out to the shareholders than to keep it within the company?" The sub-question on that is, "If we pay it out, is it better off to do it via repurchases or via dividend?" The test for whether we pay it out in dividends is, "Can we create more than a dollar of value within the company with that dollar by retaining it rather than paying it out?"

And you never *know* the answer to that. But so far, the answer, as judged by our results, is, "Yes, we can". And we think that prospectively we can. But that's a hope on our part. It's justified to some extent by past history, but it's not a certainty.

Once we've crossed *that* threshold, then we ask ourselves, "Should we repurchase stock?" Well, obviously, if you can buy your stock at a significant discount from conservatively calculated intrinsic value and you can buy a

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reasonable quantity, *that's* a sensible use for capital.

To us, risk is about business risk —competitive risk, etc.

Buffett: Beyond that, the question becomes, "If you have the capital and you think that you can create more than a dollar, how do you create the most value with the least risk?" And that gets to *business* risk. It doesn't get to any calculation of the volatility. I don't *know* the risk in See's Candy as measured by its stock volatility — because the stock hasn't been outstanding since 1972.

Does that mean that I can't determine how risky a business See's is because we don't have a daily quote on it? No. I can determine it by looking at the business, the competitive environment in which it operates and so on.

We just do what makes sense, not what we we're taught.

Buffett: So once we cross the threshold of deciding that we can deploy capital so as to create more than a dollar of present value for every dollar retained, then it's just a question of doing the most intelligent thing you can find. And the cost of every deal that we do is measured by the *second* best deal that's around at a given time — including doing more of some of the things we're already in.

And I've listened to cost of capital discussions at all kinds of corporate board meetings and everything else. And I've never found anything that made very much sense in it — except for the fact that it's what they learned in business school and what the consultants talked about. And most of the board members would nod their heads without knowing what the hell was going on. So that's been my history with the cost of capital.

People teach what's *easy* to teach instead of what's *correct*.

Munger: The current freshman economics text which, incidentally, is sweeping the country, has it right in practically the first page. And it says, "All intelligent people should think primarily in terms of opportunity cost." And that's obviously correct.

But it's very hard to *teach* business based on opportunity cost. It's much *easier* to teach the capital assets pricing model where you can just punch in numbers and out come numbers. And therefore, people teach what is easy to teach instead of what is *correct* to teach.

It reminds me of Einstein's famous saying. He said, "Everything should be made as simple as possible, but no more simple."

Buffett: Write that down.

SUB-WORKING-CAPITAL STOCKS WOULD STILL WORK. BUT GOOD LUCK PUTTING TOGETHER A PORTFOLIO.

Sub-working-capital stocks are almost impossible to find....

Shareholder: In your letter to shareholders this year, you indicated that it was 50 years ago that you met Benjamin Graham and that he had a major impact on your life — especially in your investment success. Moreover, you've stated in the past that *The Intelligent Investor* is by far the greatest book ever written on investing.

One of the central tenets in the book was that if you bought a group of stocks — say 10 or 20 — that traded at two thirds or less of net current assets, you would be assured of a margin of safety coupled with a satisfactory rate of return. If you were to find 10 or 20 stocks today trading at two thirds of net current assets, would you be inclined to purchase them for your personal portfolio — and not for Berkshire Hathaway?

Buffett: If you found a group like that (and you won't, I don't think), you'd probably do all right buying the group. But you wouldn't do well because the businesses themselves worked out that well over time, but because there would probably be a reasonable amount of corporate activity in a group like that — either in terms of the managements taking 'em private or takeovers or that sort of thing.

But sub-working-capital stocks are almost impossible to find now. And if you were to get into a market where a lot of 'em existed, you could probably also find wonderful businesses selling a lot cheaper, too. And our inclination would be to go with the cheap, wonderful businesses.

In a high market — or something close to it —I don't think you'll get a lot of sub-working-capital stocks anymore. There's just too much money around to promote deals before they really get to that point.

Walter Schloss has a sensational record investing that way.

Buffett: But that was a technique 50 years ago. Is Walter Schloss here still? Stand up if you're here. I met Walter 50 years ago when I met Ben Graham. I know Walter came out this year — but he already knows everything I've been talking about, so he may have left. But Walter actually has practiced in securities much closer to the original [Ben Graham style]. He's run a partnership now for 46 years, I guess it is. And he's done it much more with the type of stocks Ben was talking about in those days.

And he has a record that is absolutely sensational — far better than people who get promoted, go on TV shows and all that sort of thing. And he's done it in what I tend to call "cigar butt" companies: You get one free puff and that's about it — but they don't cost anything. And that was in the sub-working-capital type situations.

Walter's had to extend that somewhat. But it's been a *great*, great record over a very considerable period of time — and 46 years is *very* considerable.

Plus, the culture has changed. It's no longer your capital.

Buffett: So I think if you found that kind of a group and did it as a group operation... And Ben always emphasized a group operation — because when you're dealing with lousy companies, but you expect a certain number to be taken over and all that, you *better* have a group of them — whereas if you deal with wonderful companies, you only need a couple.

So I think if you see that period again, we'll be very active, but it won't be in that kind of securities. Charlie?

Munger: And there's *another* change. In the old days, if the business stopped working, you could take the working capital and stick it in the shareholders' pockets. Nowadays, as you can tell from all the restructuring charges, when things really go to hell, somebody else owns a lot of the

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working capital. The whole *culture* has changed.

If you have a little business in France and you get tired of it, as Marks & Spencer has, the French say, "What the hell do you *mean* trying to take your capital back in France? There are French *workers* in this business." They don't say, "It's your working capital. Take it back when the business no longer works for you." The French say, "It's *our* working capital."

The whole culture has changed on that one — not completely, but a lot from Ben Graham's day. There are a lot of reasons why the investment idiosyncracies of one era don't translate that perfectly into another.

It was a different breed of animal in Ben Graham's list.

Buffett: I've forgotten whether it was published in the 1951 edition of *Security Analysis* or the '49 edition of *The Intelligent Investor*, but there was a list of companies that included Marshall Wells and Foster Wheeler. All those companies were sub-working-capital companies selling at three or four times earnings. And if you bought a group of stocks like that, you were going to do well.

But you certainly don't see that in companies of any size today. I've seen a few lists of tech companies selling below cash, but they're determined to *use* that cash. And it may not be there in a year or two. It was a different breed of animal, to some extent, in Ben's list at that time....

WE'VE NEVER LIKED THE MATH OF SHORTING. IT'S EASIER TO MAKE MONEY ELSEWHERE.

There is much more mispricing in *over*valued stocks.

Shareholder: I'd like to hear your thoughts on selling securities short and what your experience has been recently and over the course of your career.

Buffett: Short selling is an interesting item to study because it's ruined a lot of people. It is the sort of thing that you can go broke doing. There are famous stories about Bob Wilson and Resorts International. He didn't go *broke* doing it. In fact, he's done very well subsequently. But being short something where your loss is unlimited is quite different than being long something that you've already paid for.

And it's tempting. You see *way* more stocks that are dramatically *over*valued in your career than you will see stocks that are dramatically *under*valued. It's the nature of securities markets to occasionally promote various things to the sky. So securities will *frequently* sell for 5-10 times what they're worth. And they'll very, very *seldom* sell for 20% or 10% of what they're worth. So you see much greater discrepancies between price and value on the overvaluation side.

But making money on the short side isn't as easy as it looks.

Buffett: You might think, therefore, that it's easier to make money on short-selling. All I can say is that it hasn't been for me. And I don't think it's been easier for Charlie. It is a *very*, very tough business because of the fact that you face unlimited losses and because of the fact that people that have *very* overvalued stocks are frequently on some scale between promoter and crook. And that's why they *get* there.

They also know how to use that very valuation to bootstrap value into the business — because if you have a stock that's selling at $100 that's worth $10, obviously it's in your interest to go out and issue a whole lot of shares. And if you do that, when you get all through, the value could be *$50*.

In fact, there are a lot of chain-letter-type stock promotions that are based on the implicit assumption that the management will keep doing that. And if they do it once and build it to $50 by issuing a lot of shares at $100 when it's worth $10, people say, "Well, these guys are so *good* at that, let's pay $200 or $300 for it" —and then they can do it again and so on.

It's not usually quite that clear a connection in their minds, but that's the basic principle underlying a lot of stock promotions. And if you get caught up [shorting] one of those that *is* successful, you can run out of money before the promoter runs out of ideas.

It's just not worth the irritation....

Buffett: In the end, they almost always work. Of the things that we've *felt* like shorting over the years, our batting average would have been very high in terms of eventually working out very well if we'd held them through. But it's very painful. And it's been my experience that it's a *whole* lot easier to make money on the long side.

I had one situation ... when I moved to New York in June or July of 1954 that involved a surefire-type arbitrage transaction that *had* to work. But there was a technical wrinkle in it —and I was short something. And for a short period of time, I felt like Finova was feeling last fall. It was *very* unpleasant.

In my view, you can't make really big money doing it, because you can't expose yourself to the loss that would be there if you did do it on a big scale.

And it would never work on a Berkshire scale anyway. You could never do it for the kind of money that would be necessary to do it with in order to have a real effect on our overall value. So it's not something we think about. Charlie, how about you?

Munger: Well, Ben Franklin said, "If you want to be miserable during Easter, borrow a lot of money to be repaid at Lent" — or something to that effect. Similarly, being short something which keeps going up because somebody is promoting it in a half crooked way and you keep losing and they call on you for more margin — it just isn't *worth* it to have that much irritation in your life. It isn't *that* hard to make money somewhere else with less irritation.

And strange things happen to drive stocks much higher....

Buffett: It's interesting though. I've got a copy of the *New York Times* from the day of the Northern Pacific corner. And that was a case where two opposing business titans each owned over 50% of the Northern Pacific Railroad. And when two people each own over 50% of something, it's going to be interesting. And Northern Pacific on that day, went from $170 to $1,000 — and it was selling for cash because you had to actually have the certificates that day rather than the normal settlement date.

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And on the front page of the *New York Times* — which, incidentally, sold for a *penny* in those day (it's had a little more inflation than Coca-Cola) — right next to the story about Northern Pacific, it told about a Newark brewer who had gotten a margin call that day because of this. And he jumped into a vat of hot beer and died. And that's really never appealed to me as the ending of a financial career....

Who *knows*?! They had a corner on Piggly Wiggly. They had a corner on Auburn Motors in the 1920s.... Corners were part of the game back when it was played in kind of a footloose manner. And it didn't pay to be short.

If Hetty Green didn't need to short, neither do we.

Buffett: [There's something else from] that period you might find interesting. In [the recent] issue of the *New Yorker* that has the interesting story about Ted Turner, there's also a story about Hetty Green who was one of the original incorporators of Hathaway Manufacturing (half of our Berkshire Hathaway operation) back in the 1880s. And Hetty Green was just piling up money. She was the richest woman ... maybe in the *world* — certainly in the U.S. Maybe some queen was richer abroad, but Hetty Green just made it the slow, old-fashioned way. And I doubt that Hetty was ever short anything. So as a spiritual descendant of Hetty Green, we're going to stay away from shorts at Berkshire....

LOU'S RECORD IS JUST AS GOOD AS MINE.
BUT I'M IN NO HURRY TO TURN IT OVER.

Lou is smart and careful and high grade....

Shareholder: Gentlemen, you've stated many times that Lou Simpson manages the GEICO investment portfolio on an independent and autonomous basis. What unique or superior qualities does he possess as an investor that have earned him this tremendous vote of confidence?

Secondly, Berkshire invests in privately-owned businesses as well as publicly-traded securities. While the skill set required to value public and private businesses may be the same, does Mr. Simpson also have the additional experience and skills necessary to negotiate a private transaction if called upon to do so?

Buffett: Yeah, I think he could. But I hope he doesn't get called on to very soon. [Buffett and Munger laugh]. Lou is smart and careful and high-grade — and *experienced*. So he does manage a couple billion dollars autonomously.

And he'll buy things that I won't know about until I either look at a monthly sheet or sometimes read about it in the paper. That's fine. He doesn't know what *I'm* doing. I don't know what *he's* doing. And every now and then, we'll be in the same security. So we try and coordinate if we're buying or selling under those circumstances.

And you can't be sure whether a single idea is his or mine.

Buffett: You will occasionally read a headline — not a very big headline — in the financial press that says, "Buffett buying XYZ." Well, sometimes it should say, "Simpson buying XYZ." The reports we file wouldn't tell the reader necessarily which one of us made the decision, because even if the reports show that something was bought in GEICO, that could be bought by me and placed in GEICO for various reasons — or conceivably Lou can buy something and place it in National Indemnity or some other Berkshire company, also for perfectly good reasons.

So some of what gets reported as done by Berkshire is done by Lou entirely independent of me. But most of it, in terms of dollars, is done by me.

But Lou's record is just as good as mine.

Buffett: But Lou knows how to evaluate businesses — whether they're private businesses or public securities. And Lou's track record is just as good as mine. So... But I'm in no hurry to turn it over. [Buffett chortles.]

The world assumes I bought the Gap. It was actually Lou.

Shareholder: I have two questions. First, as a big fan of the Gap, why at this time, do you feel it's undervalued?

And second, if you could direct your answer to my husband, as a shareholder, would you agree that buying a large present at Borsheim's this afternoon is like taking money out of one pocket and putting it back in another?

Buffett: I'll let Charlie handle the second one. He's our expert on consumption at Berkshire.

The Gap is a good illustration of what I was talking about because I think the world assumes that I made the decision to buy Gap at Berkshire — and actually, that's *totally*, 100% a Lou Simpson portfolio investment....

I haven't ever read the annual report of the Gap — and I don't know anything about it. You probably know a lot more about it than I do — and I *hope* Lou knows a lot more about it than I do. [Buffett laughs.] It's not a company that I've ever looked at.

Lou has a different universe. That may be a good thing....

Buffett: And Lou — and the people who help him — can look at smaller securities in terms of aggregate market caps than I can. Because he's investing $2 billion, he can work with $200 million positions — or even $100 million positions sometimes. And I'll *do* that occasionally just because I happen to bump into them in effect. However, I'm really looking for things where we can put $1 billion or $2 billion or more in.

So Lou's universe of possible candidates for purchase is a bigger universe than mine. That may be a good thing — having two of us in there — because he's going to see things that I'm not going to see.

In any case, you'll have to ask Lou about the Gap.

The rationale for some purchases transcends finance.

Buffett: But Charlie, give her a little advice on Borsheim's.

Munger: Well, I think when you're buying jewelry for the lady you love, it probably shouldn't get too much financial calculation into it.

Buffett: I will say this — and it's true. And you're

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talking to a guy who does not normally go down this path, but I'd say this: I've never bought a piece of jewelry that I've regretted in terms of what's happened subsequently....

If that isn't a sales pitch, I don't know what is.

WE HOPE THE FINOVA MODEL CATCHES ON — BECAUSE IT WOULD BE GOOD FOR SOCIETY AND US.

Confidence is a coward. It runs at the first hint of trouble.

Shareholder: Mr. Buffett, could you please describe the extent, if any, of Berkshire Hathaway's investment in Finova Group earlier this year? Finova's back appears to be against the wall.

Buffett: Yeah. It's *worse* than against the wall — they're in Chapter 11. But that was all contemplated, obviously. Finova was the old Greyhound Leasing Company that grew to about $13-14 billion in assets. And then, just about a year ago, it ran into funding difficulties. And when you run a highly-leveraged finance business and you run into funding difficulties, they compound on you very quickly. Confidence is a real coward — it runs when it sees trouble.

And in a finance business, you're constantly faced with refinancing old obligations —you have commercial paper out and all of that. So there's no honeymoon period when you get into trouble in the finance business. And we've even seen big ones in the past like Chrysler Financial. It can strike *anywhere* when confidence disappears. So that hit Finova about a year ago.

Finova debt looked attractive. So we loaded up.

Buffett: It became clear, not that many months later, that Finova would have to either be sold or reorganized. And I think there were attempts made to sell the company to other finance companies. And a couple of little portions of the portfolio *were* sold. But they didn't make a sale.

And when the bonds started selling down to prices that I thought were very attractive in the Fall of last year or whenever it was — and by attractive, I mean I thought that if they went into bankruptcy, that the assets were considerably greater in relationship to the liabilities than indicated by the market — we started buying the bonds. And we publicly announced that we'd bought $1.428 billion face amount of bonds — or bank debt. So out of $11 billion of aggregate debt at Finova, we own $1.428 billion of it at face value. And we bought those at prices that looked attractive then — and look attractive now.

We're waiting to see what plan will be approved.

Buffett: And it was clear all along that they were either going to sell or go into bankruptcy. And it became clearer that they weren't finding a buyer as time went by. So it became very likely that they'd declare bankruptcy sometime earlier this year — one of the reasons being that they didn't want to use the available cash to pay out the creditors whose money was coming due tomorrow and, thereby, shortchange creditors whose claims were due at *later* dates.

We thought perhaps somebody would come in with a plan of reorganization. And it got very close to where, in our view, they were going to default. So we jointly, with Leucadia in a joint venture called Berkadia, put forth our own plan and arranged a transaction.

But they are now in Chapter 11. And there will be a plan or plans presented to the court in short order. And then the court will determine — Charlie may know a bit more about exactly how bankruptcy works than I do, although I don't think he's had any personal experience with it [chuckles] — a plan that gets submitted to creditors for approval. And we will have a plan which has been outlined in the press and will be submitted to the court almost certainly within a week....

Then we'll see whether anything else happens. It may be that somebody else comes in with a plan. It may be that our plan is approved. And if our plan is approved, it involves a significant additional investment so that an initial payment can be made to the present debtholders. And then we'll see what happens.

We think Leucadia brings a lot to the party.

Buffett: We feel very good about Berkadia. We think the Leucadia part of Berkadia brings a lot to the party in term of efficiently managing the assets that are there. When an entity gets in bankruptcy, it makes a lot of difference how it's handled. There could be a lot of wastage of assets in bankruptcy or there could be a reasonably efficient way of handling it. We think that the Berkadia arrangement will maximize the value of the assets — and we think that's important.

But we'll see what happens. I think our position is going to work out fine. Charlie?

We hope Finova becomes a model for cleaning up messes.

Munger: Yeah. I think it's a very interesting transaction. And you'd hope there would be *more* of it.

Buffett: There *will* be. [Buffett laughs.]

Munger: I mean more *cures* where bankruptcy follows this model — not more bankruptcy. I think it's a *very* intelligent model and a very clean, simple, prompt way of cleaning up a corporate mess. I hope the rest of the world feels about it the way I do and that the judge and other people concerned will say, "Thank God. We want this one to go through. And we want more like it to happen."

Buffett: That's what we *tried* to do in Salomon, incidentally. We tried to behave in a somewhat different way in terms of a corporate crisis than is typical. And we hoped that if it got a good result, it might become a model that people might gravitate toward in future problems — because there *will* be future problems.

We are the largest creditor of Finova now. So we have more money on the line than anybody else. Our interest is not primarily in getting fees or extending the bankruptcy or any of that sort of thing. We just want to get the greatest realization of assets as possible. And the swing in that between doing it right and doing it wrong could be measured in the billions.

[Editor's note: Finova emerged from bankruptcy on August 21st.]

(continued on next page)

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

IT'S ABSOLUTELY *CRAZY* TO GET IN DEBT — BECAUSE IT'S SO HARD TO GET *OUT*.

Early to bed, early to rise — and rarely or never borrow.

Shareholder: We know that individual debt can be devastating. Are you concerned that the American consumer is so far in debt as a whole as to be a problem?

Buffett: Well, I think it's very hard to answer about the consumer as a whole. I get letters every day from people with problems in life. They revolve around health or debt. And frequently, the debt is connected with health problems. It's been very easy for them to borrow money; they've gotten in over their heads —and it's all over then.

[Editor's note: Sequoia Fund's Bill Ruane also suggests that leverage is hazardous not only to your wealth, but also to your health and has some interesting anecdotes along those lines.]

Buffett: There's no question that American consumers are *somewhat* more indebted in *aggregate*. However, I think it's a very hard thing to come to any conclusions about whether this poses a serious problem.

Most people have had assets, directly or indirectly, which have gained in value enormously — particularly in real estate and some in securities. And therefore, there's a greater *capacity* to carry debt as earning power increases and the value of other assets held increases.

It's crazy to get *in* debt because it's so hard to get *out*.

Buffett: I can't give you a useful answer in terms of the world as a whole. However, I *constantly* give advice to young people (and those are the only people I talk to aside from our shareholder group) —and I tell them, "Just don't start out behind the eight ball. It's crazy to get *in* debt because it's so hard to get *out* of debt."

And we issue credit cards in all of our businesses, as does every other retailer. But the idea of trying to borrow money at 18% and thinking that you're going to get ahead in life — that just isn't going to *work*. I urge people to use credit cards, but I urge them to pay it off before it starts revolving — because it's just too expensive. Charlie and I can't make money with 18% money. We're looking around for float because we don't want to pay 5% for money.

So I'm very sympathetic to people who get in debt. But once you get in it, it is hell to get out. Charlie will have a few Ben Franklinisms to quote on that subject. In fact, do you want to give a few from Ben now? [He chuckles. After a pause] He'd *love* to, but I led him into it the wrong way.

THE BEST INVESTMENT YOU CAN MAKE EARLY IS TO INVEST IN *YOURSELF*.

Unfortunately, I got off to a *very* slow start in investing....

Shareholder: I'm 10 years old and this is my fourth consecutive year here.

Buffett: Terrific. We're glad to have you here.

Shareholder: Thanks. How I got to own your stock is that my dad taught me to start my own business and buy a lot of Berkshire Hathaway stock with my profits. And in school, they don't teach you how to make and save money — not in high school or college. So my question is, how would you propose to educate kids in this area?

Buffett: That's a good question. It sounds to me like you could do a good job yourself, too. At 10, you're way ahead of me. Unfortunately, I didn't buy my first stock until I was 11. So I got off to a *very* slow start.

What it takes really — and you find it in some schools and you don't in others — are teachers who can explain the subject. Charlie will say that Ben Franklin was the best teacher of all in that respect. But it looks like you got your education on that from your parents. And parents can do more education really in that respect even than teachers.

The best investment you can make early on is in *yourself*.

Buffett: I get a chance to talk to students from time to time. And one of the things I tell them is what a valuable asset they have in *themselves*. I would pay any bright student probably $50,000 for 10% of his future earnings the rest of his life. So he's a $500,000 asset just standing there.

And what you *do* with that $500,000 asset in terms of developing your mind and your talents is hugely important. The best investment you can make at an early age is in *yourself*. It sounds to me like you're doing very well in that respect. I congratulate you on that.

But life is more than being shrewd at wealth accumulation.

Buffett: But I don't have any great sweeping program for doing it throughout the schools. Here in Nebraska, we have an annual get-together of students from all the high schools throughout the state. And it's a day or two of economic education. I think it's a very good program. But I think if you just keep doing what you're doing, you may be an example to other students. Charlie?

Munger: I'd like to interject a word of caution. You sound like somebody who's likely to succeed at what you're trying to do. And that's not always a good idea. If all you succeed in doing in your life is to get rich early from passive holding of little bits of paper and you get better and better at only that for all your life, it's a failed life. Life is more than being shrewd at passive wealth accumulation.

Buffett: I think he's going to do well at both.

Save early —and choose your parents with care... .

Shareholder: Hi Mr. Buffett. My name is Melanie. I'm 11 years old and I'm from Kearney, Nebraska. I have two questions. First, my dad would like to know if you have any grandsons my age?

Buffett: Tell me how many shares of stock you have and I'll tell you the answer.

Shareholder: Also, what investment advice do you have for young people of my generation?

Buffett: I've got a grandson fairly close to your age — and he probably would go for a younger woman anyway.

(continued on next page)

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

[Chuckling] So I'll mention you to him.

If you're interested in financial matters, you've got to have something to work with. I was fortunate in that respect because my dad paid for my education. If he hadn't, I probably wouldn't have become educated if I'd had to pay for it myself. So I was able to *save* $10,000 by the time I was 21. And that was a huge, huge head start. If I hadn't been able to do that and my first child had come along when I was 22... It's much easier to save money in those teenage years if you're lucky enough to be in a family where your parents take care of your financial obligations. Every dollar then is worth $10 or $20 you make later on.

Build a database in your mind. It'll pay off over time.

Buffett: So if you're interested in financial matters, getting a stake early is very useful and getting knowledge early is very useful. So I would say you're well on the way if at 11 you're interested in coming to a meeting like this. And if that interest is maintained, I would read financial publications. I would read whatever was of interest to me.

I'd be curious about how the businesses around you operate. To the extent you can get people to talk to you — and people usually *like* to talk — try to learn about who's got good businesses and why they're good businesses. And learn about the businesses that went *out* of business and why they went out of business.

Just try to keep accumulating knowledge. That's one of the beauties of the business that Charlie and I are in — everything is cumulative. The stuff I learned at 20 is useful today — not in necessarily the same way and not necessarily every day, but it's useful. So you're building a database in your mind that's going to pay off over time.

Your dad may have the best idea, but do your due diligence.

Buffett: But you have to have a little money to work with. So there's nothing like getting a few dollars ahead. Stay away from credit cards — and you can have a lot of fun if your mind goes along that track as you get older. Charlie?

Munger: Well, I'm glad to see somebody that has so early shown an interest in getting ahead. There's nothing wrong with getting ahead.

Buffett: Actually, your dad may have the *best* idea about getting ahead by learning the name of my grandson.

Munger: Well, there I can give the young lady some advice. Before your feelings totally take over, you should look carefully at both parents and all four grandparents.

Buffett: Write Charlie and tell us how it works out.

THE CAMPAIGN FINANCE SYSTEM IS A PERVERSION — BUT THERE'S SOMETHING TO BE SAID FOR IT, TOO.

Present campaign finance situation is totally out of control.

Shareholder: You talked earlier about companies that monetize greed. It's great to be with leaders who monetize values. A couple of years ago, you spoke very passionately about campaign finance reform. Could you comment on your views of this given recent developments?

Buffett: You've read about campaign finance reform as much as I have. I happen to admire enormously what McCain and Feingold have done. I don't think it's a panacea — I think money is going to find its way into trying to buy political influence one way or another.

But the present situation, in my view, has gotten totally out of control — and incidentally, totally out of sync with what the American Congress, as well as the public, intended because in 1907, Congress said (and it's never been changed) that corporations shall not contribute money to federal elections. And in 1947 they said the same thing about labor unions. Then they enacted legislation in the early '70s which, when later interpreted by the Federal Election Commissions, enabled corporations and unions to do on an unlimited scale what Congress has said that they shouldn't do at all. And politicians didn't really understand the potential in that initially.

It's become a perversion of the system....

Buffett: I remember the first guy, a senate candidate, that called me for a soft money contribution — probably in 1985 or so. And he was kind of embarrassed about it and sort of danced around the subject about how this money was going to find its way into his campaign and everything. And he was asking me for an amount of money that was illegal under the law except if I did it via soft money.

And that has now developed to the point where I've literally had people (where I have firsthand knowledge) requesting million dollar contributions or larger which would never be required to be reported. And I regard that as a perversion of the system.

And I'm not expecting perfection, just improvement.

Buffett: But I think we're going to get some significant improvement. I think it was only possible because of the credibility McCain built up with the public and the fact that he just wouldn't let go of this issue.

I'm not hopeful about it changing the whole course of American democracy or anything of the sort. But I *am* hopeful that the system of government where access is sold to the highest bidder and where the bidding starts at a higher level by a material amount in every election cycle will at least be checked for awhile. Charlie?

I think I prefer the evil I know to the evil I don't know.

Munger: Well, my trouble with campaign finance reform is that I fear career politicians just staying on and on just about as much as I fear special interests protecting themselves with money. And I never *know* exactly how the reform is going to work.

When I came to California, we had a semi-corrupt, part-time legislature dominated by racetracks, saloons, liquor distributors and so on. And people entertained the legislators with prostitutes and what have you. I sort of *prefer* that government in retrospect over the full-time legislators we have now. So, I'm more skeptical about my ability to predict which reform I'm going to like the results of and which I would like to trade back for former evils.

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

BERKSHIRE'S RESIDENT ZEN MASTER IS CHARLIE. BUT SUSIE'S FATHER WAS *TRULY* ENLIGHTENED.

The source of true enlightenment: low expectations.

Shareholder: As a Coke addict myself, I'm excited to report to you, our worldwide Promoter-in-Chief, that the Cokes in Beijing taste just as wonderful as in Omaha. As an ex-Zen monk, today I feel like visiting the Buddha of the financial world. We have an investment club with a name that ends in dot-com, believe it or not, which tells you that the dot-com frenzy even seduced Zen monks when we tried to follow you.

Mrs. Susan Buffett used to send Zen Buddhism books to her sorority sisters. That's probably why she always has a peaceful smile — due to her low expectation of life which, according to Buddha, is full of sufferings. But Mr. Munger tells me that her smile is really because as her husband, you exceeded her low expectations?

Munger: That's right.

Buffett: And her *father's* even *lower* expectations.

Some things are more important than true enlightenment....

Shareholder: Did Susan also share those Zen books with you? And if you've read those books, what are the key ideas that contributed to your investment talent which even made sense to secluded, narrow-minded Zen monks like me? Thanks for the financial enlightenments that you've given us today.

Buffett: I actually sent those books on to Charlie. So I'll let him answer.

Munger: Actually, I tend to be a follower of Confucius. And I think this group is full of Confucian values. The first law of Confucianism is filial piety, particularly toward elderly males. So you can see why I would like that system.

BUFFETT AND MUNGER'S RECOMMENDED READING: BIOLOGY, MODELS AND BIOGRAPHIES....

Genome is a perfectly *amazing* book.

Shareholder: What books have you and Mr. Munger been reading lately that you would recommend?

Buffett: Tell 'em what books you've read, Charlie.

Munger: I have a book recommendation ... that's called *Genome* by Matt Ridley who was for years the science editor of the *Economist* magazine. *Genome*, which is the history of a species in 23 chapters, is a perfectly *amazing* book — and *very* interesting.

And some shareholder sent me a book that not many of you will like by Herb Simon: *Models of My Life*. It's a very interesting book for a certain academic type.

Katharine Graham was compulsively honest in her book.

Buffett: I may have recommended it before, but if you haven't read *Personal History* by Katharine Graham ... I think you'll find it's a fascinating story. More amazing yet, it's an *honest* story. If I ever write my autobiography, I'm going to make myself look like Arnold Schwarzenegger. But she is compulsively honest about what's happened. And it's really quite a saga.

Munger: It *is* a good book.

[Editor's note: Sadly, Katharine Graham passed away in July at the age of 84.]

And the book about Charlie Munger has struck a chord.

Munger: That Janet Lowe book about me [*Damn Right!: Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger* published by John Wiley] I find has had a very interesting subchapter, so to speak, in its distribution. I notice a considerable number of people buying that book and sending a copy to each descendant. They believe that if they just do that, the descendants will behave more like the parents.

It'll be interesting to see if that works. If it does, it's going to outsell the Bible.

Buffett: Don't hold your breath, though.

[Editor's note: It's must reading for Munger groupies like me — and Buffett groupies, too. I highly recommend it.]

WE HAVE A TERRIFIC SUCCESSION PLAN. BUT STEP #1 IS MY PERSONAL FAVORITE.

Succession is an important question in business generally.

Shareholder: Being somewhat pessimistic by nature, I have a recurrent nightmare of a *Wall Street Journal* headline proclaiming "Buffett Kicks the Bucket".

Buffett: They may phrase it a little more elegantly. But some day, the headline will be there.

Shareholder: And Charlie's no spring chicken either. In light of these concerns, could you please go into a little more detail than that presented in your annual report regarding the succession issue? And my apologies for the morbid nature of the question.

Buffett: There's no reason to apologize. It's a question I ask *our* managers, incidentally, every couple of years. About every two years, I send them a letter and I say, "If you die tonight, what will I wish you'd have told me tomorrow morning?" — because I have to make that same decision. And I'm not conversing with them every night. So I want them to put in writing to me once every couple of years what they think about the subject — who they think should succeed them, whether there are several candidates, the strengths and weaknesses of each, etc. That way, I have that information available.

And you're entitled to the same sort of answer about succession. It's part of buying into this business.

No one is more interested in the issue than Charlie and I.

Buffett: And I can tell you that no one has more of an interest in it than I do —and Charlie has a similar interest — because we have a very high percentage of our net worth in the business. Plus, we've got a lifetime of effort in it. And we want it to succeed for both (probably, at least, in my case) the ultimate reward to the foundation that I have, but also because we like what's happened so far and we

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

want to prove that it's not dependent upon a couple of guys like us — in effect, that it can be institutionalized.

And Charlie and I know who will succeed me in what are likely to be two jobs: one being marketable securities and the other being business operations.

Now, in terms of who succeeds me, that depends on *when* I die. So there's no sense telling you who it would be today because it might not be the same person 20 years from now. For example, 20 years ago, it would have been Charlie, obviously. But it won't be Charlie now because of *his* age. It'll be somebody else. But 15 or 20 years from now, it might be some third party.

Step #1 of our succession plan is my personal favorite....

Buffett: In any case, we feel very good about the succession situation. We couldn't feel *better* about the managers and the culture we have in place. And we want to be *very* sure that culture is maintained, although I think it's so strong that it would be very hard to change it.

Also, we feel very good about the stability of the organization in terms of the stock ownership situation — because that is insured for a very, very long time to come. So the stock ownership situation is such that if there *were* any inclination to change [Berkshire's culture], it could be prevented from happening —although I don't think it'd happen anyway.

So the individual will be named. I think I mentioned though that when they open that envelope, although the contents of that envelope are already known to the key people, the first instruction is, "Take my pulse again." But if I flunk that test, there'll be somebody very good in place. Charlie?

Asset allocation aside, we'll be just as strong.

Munger: The main defense, of course, is to have assets that will do well more or less automatically. And we've got a *lot* of those. And to the extent you improve that further by having very good managers in place, and very good individualized systems for bringing new managers into the place, there's a lot of momentum here that would go on very nicely with the present management gone — although I don't think our successors are going to be as good as Warren at actually allocating the money.

Buffett: We even ran a little test case 10 years ago because for nine months and four days, I took another job — at Salomon. And things went fine at Berkshire.

The managers don't *need* me. We have to allocate capital. We have to make sure they're treated fairly. But we're not making decisions around the place — except in the allocation of capital. And that will be important. But even some of that is semi-automatic. Some of it does require some imagination sometimes or something of the sort. However, for nine months and four days in 1991, Salomon was primarily on my mind and Berkshire wasn't. And everything went on just as before.

And we're far, far, far stronger now than we were then. So I'm very comfortable with 99% of my estate being in Berkshire shares. And I think it's an intelligent holding eventually for the foundation....

YOU DON'T NEED TO WORRY ABOUT BUFFETT'S HEALTH.
JUST ASK HIS DOCTOR OR CHARLIE OR MATT RIDLEY....

Why Buffett sees his doctor so infrequently....

Shareholder: ...Every time I hear what you like to eat, Warren, it makes me wonder what your cholesterol level is — or if you even worry about it. Everyone here wants you to be with us for a long time. So, have you considered taking medication to reduce your cholesterol?

Buffett: [Laughs.] My doctor tells me it's a *little* high. But if he says it's a little high, then it means it isn't *that* high because he's always trying to push me into making a few changes in my life.

But I've got a wonderful doctor. I was lucky last year — because I hadn't been in to see him for about five years. [Audience starts laughing — to which Buffett wisecracks:] Those guys cost a lot of *money*. [Buffett cracks up.]

My life expectancy's probably a lot better than average....

Buffett: And purely due to an accident (to a reaction I had to some other medicine I was given while I was out of the city), he got a hold of me and shamed me into having a physical. That was extremely lucky because I had a polyp in the colon that would have probably caused me trouble within a couple of years.

So if you were to ask my doctor, he'd tell you that he wants me to make a few changes. But he would also say that my life expectancy is probably a lot better than the average person of 70.

The Buffett Plan: How to live forever without really trying.

Buffett: I have no stress whatsoever — zero. I get to do what I love to do every day. I'm surrounded by people that are terrific. So that problem in life just doesn't exist for me. I don't smoke or drink or — [chuckles] well, we'll leave it right there. So if you were an underwriter for a life insurance company, you would rate me considerably better than average. You'd rate Charlie better than average, too.

And I'm sure that if I'd change [my life-style] slightly, perhaps then the probabilities [might improve a little] — if I changed my diet dramatically or something. But that's *very* unlikely to happen....

You know, the most important thing in life in terms of how long you live is how long your parents lived. So I got my mother an exercise bike when she got to be 80. And she put 40,000 miles on it! I told her to watch her diet and do all these things. And she lived to be 92. So she did her share. But I helped her do it by giving her the exercise bike. So I think that improved my odds.... Charlie?

If you're worried about Warren, just read *Genome*.

Munger: If Matt Ridley [who wrote the book I recommended earlier, *Genome*] is right, Warren has a *very* long life expectancy. There are *very* interesting correlations between people who cause stress to others instead of suffering it themselves. And Warren has been in that position ever since I've known him.

The figures Ridley quotes are awesomely interesting. It is a *fabulous* book.... And you'll feel very good about Warren's future if you agree with the science of that book.

—OID

WEITZ FUNDS'
WALLY WEITZ
(cont'd from page 1)

return of all funds covered by *Morningstar*. And as if that weren't enough, Weitz has managed that feat while keeping both ranked #1 and #2 among all funds in their category for lowest risk. (All figures provided by *Morningstar.*)

Last edition, we told you that we were pleased to have finally found Weitz in a rare down period, that such periods had been few and far between in the past and that Weitz and associate Rick Lawson were finding some very intriguing ideas.

But because they had more ideas than we had pages available to showcase them, we couldn't fit them all into one edition. Therefore, we're pleased to bring you two of the ideas that we didn't have room for in our last edition. The material that follows was excerpted from a series of conversations which took place between October 18th and shortly before we went to press. As we said last time, we find Weitz's ideas intriguing and hope you do, too.

HERE'S THE POOP ON RURAL TELEPHONE SYSTEMS.
THEY'RE NOT NEARLY AS BORING AS YOU MAY THINK.

OID: You've mentioned being pretty excited about buying Citizens Communications. Is that still the case?

Wally Weitz: Yep. Actually, we've had to stop because we've gotten to where we own close to 10% of the company. And because of the Public Utility Holding Company Act, we can't go any further for now. But I'd *like* to.

OID: I'll take that as a yes.
Tell us what you like about it.

Weitz: First of all, the rural telephone business — wireline out in the country for the most part — is inherently a good, growing business. Part of it's the simple and stable nature of the business. It's the kind of business where you can use some leverage with maybe a little more safety because the revenues and cash flows are stable.

OID: I have a confession to make. In all the years that Mario Gabelli has been talking about POTS [Plain Old Telephone Systems], I have never understood his investment rationale.

Weitz: You know, for the longest time, I didn't either. I'd read the same thing and thought, "How in the world could he be interested in that?"

OID: Exactly.

Weitz: But I sat down one day with Sal Muoio. He used to work with Gabelli, but he's off on his own now. (His company is called S. Muoio & Co. LLC.)

At any rate, I sat down with him. He was an analyst at the time with another firm. And I said, "I don't get it. You guys get so excited about these small town phone companies. What's the deal?"

And he said, "Look, if you can buy some little system in a town of 30,000 people in Michigan that has 20,000 phone lines that generates so much revenue per subscriber and so much in free cash flow and you can buy it for 6 or 7 times pre-tax cash flow, you'll do it over and over again — and you'll *love* it." And he ran me through the numbers.

OID: Could you share the secret with us?

Weitz: Let me give you a back-of-the-envelope for a typical rural telephone system before I give you the particulars for Citizens:

Suppose a rural phone line costs $3,000 and generates $67 a month, or $800 per year, of revenue for its new, rural carrier owner. With a 62% operating margin, there would be about $500 per year of operating income. Subtracting maintenance cap-ex [capital expenditures] of $150 and cash taxes of $75, the line would generate about $275 of after-tax cash flow. That represents an unleveraged return of 9% on the $3,000 investment. However, if the buyer of the line were to then borrow $2,000 at an after-tax interest cost of 5%, the return would be $175 on $1,000 of equity — or 17.5%.

OID: Hooray for plain old telephone systems.

Weitz: Plus, you're out in the country. Therefore, us city folks who pay access charges pay money into a kitty where the proceeds go to rural telephone companies as an incentive to provide telephone service for people located out in the country.

Incidentally, if the line was bought from an RBOC [Regional Bell Operating Company] that was not eligible for these universal service subsidies, the seller was not receiving as much revenue per line — which helps explain its willingness to sell at a price that is attractive to the buyer.

OID: Interesting.

Weitz: And it gets better. Since the new owner can earn more on his investment, he has more incentive to invest in upgrading the line and will be able to offer new services (like Call Forwarding, Call Waiting and Caller ID), second lines, high-speed DSL lines for internet access, long distance, etc. So on a given group of lines, Citizens should be able to generate revenue growth of 5% or so per year and increase profit margins. So double-digit increases in gross cash flow seem very doable.

And after initial expenditures to upgrade lines, cap-ex should decline — and if free cash flow (after-tax earnings plus depreciation minus maintenance cap-ex) is applied to retiring debt, interest charges should also decline. All told, the result should be very strong increases in free cash flow over the next several years.

OID: But what kind of capital requirements are associated with generating that incremental revenue?

Weitz: There's some controversy about that. In various cases, these rural telephone systems have had to spend $150-200 per line for a year or two to upgrade the line to be able to offer the extra services. But one of the questions is whether that upgrade cap-ex will taper off over time. Citizens thinks it will. And we're willing to believe 'em on that.

OID: But that's obviously anybody's guess.

Weitz: It's not a certainty. However, I've talked to some people who are in the telephone business and others

(continued on next page)

WEITZ FUNDS'
WALLY WEITZ
(cont'd from preceding page)

who came out of the telephone business. And they say that it's perfectly reasonable. It's like a cable upgrade — you need to move your 450 megahertz systems up to 750 or 850.

OID: This year. But what do you need to do next year?
Weitz: There have been extra upgrade cycles that nobody planned on in cable. So maybe there's another one coming. I don't know.

OID: Why would they ever end?
Weitz: The cable guys would tell you that they don't need to upgrade any further —that 750 megahertz will do everything they can imagine selling you for many years.

OID: Famous last words.
Weitz: [Laughs.] That's another argument for another day. But the idea with these telephone lines is that the capital expense trend line has one slope. The revenue trend line has a more steep slope. And the cash flow trend line has a steeper slope still, which allows them to deleverage. So the returns five and ten years out are big relative to the price they paid —and the company grows the value. At least, that's the theory.

OID: Quite a theory. I think I now understand why Gabelli loves plain old telephone systems.
Weitz: There's a lot to like.

WE'VE MADE MONEY WITH TOW BEFORE
— ACTUALLY, WE'VE DONE IT TWICE....

Weitz: So that's a good start. But the next ingredient is that you have to be able to realize that value somehow. And I think there are some companies that are content to just keep collecting that coupon forever. They'll go out and buy some lines from time to time. And maybe they'll overpay a little. So it starts off as good raw material, but it never turns into a great investment as a public company.

But then there are *other* managements that recognize it as raw material to use towards a specific end —meaning building their assets in order to sell them. And at Citizens, there's a CEO named Leonard Tow in his early 70s who's put together a collection of water, gas, electric, and telephone companies all over the country over a period of decades.

As part of that, he also got cellular licensesand built a cellular company. And he got cable licenses and built a cable company. Well, he sold the cellular company at a great price. And he sold the cable company at a great price.

OID: Interesting.

(continued in next column)

Weitz: And we owned Century Communications — where Tow was CEO and a Director from its founding in 1973 through 1999. It was one of our great holdings from the '90s. Actually, we also owned Centennial Cellular — which was a joint venture between Citizens Utilities and Century Communications. So we've actually owned companies that he's built up and sold twice.

OID: It's sounding better and better.
Weitz: And now, in the last three or four years, he's concluded that the price he can get for water, electric and gas companies is huge relative to the price of plain old telephone systems.

OID: So?
Weitz: He's found he can sell his water and gas companies and his electric generating and distribution companies for *big* multiples of cash flow. So he's doing an arbitrage, basically. He's selling those other kinds of utilities at high multiples and turning around and buying phone lines at reasonable multiples.

OID: Fascinating.
Weitz: Equally important, the phone lines are *available* at reasonable multiples.

OID: An important point.
Weitz: On the other hand, the cynic would say that the lines are available because they're not worth much. But basically, Citizens is trying to buy these things at 7 or 8times EBITDA and put together a company that does a better job, raises margins, clusters, sells new services and, hopefully, is worth, say 8 or more times a bigger EBITDA figure to somebody else later.

OID: Not that we're cynics or anything — because it's not in our nature — but isn't it true that if you assume anything is worth more than an acquirer is paying, you're almost reaching a foregone conclusion? What makes you think the cynics are wrong?
Weitz: The bull case is that they're available because after the merger of two RBOCs, the lines need to be sold for anti-trust reasons or because they're parts of small systems that are not economic for a very large company.

OID: And presumably you're in the bull camp.
Weitz: I am. As I mentioned before, a rural carrier like Citizens has access to subsidies and can charge fees that are not available to the large carriers like RBOCs with both rural and metropolitan lines. So the economics can be very different for buyer and seller. There really *will* be more cash flow after the deal for the new pure rural carrier than there was for the old owner. And so those systems really *could* be worth more to Citizens than to the RBOC the day the transaction happens.

OID: Very interesting.

AND ANALYSTS VALUE CITIZENS
IN THE MID-TEENS TO LOW $20S.

Weitz: So basically, Citizens is a collection of rural

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plain old telephone systems collected in acquisitions over time. And there are several ways to value them. I believe in a number in the high teens. Mind you, we've tried all kinds of different models. And there's a lot of guesswork. But depending on how you value its assets, you can get to a private market value anywhere from $16-$20 per share.

OID: If it's all the same to you, please take us to $20.

Weitz: Incidentally, that assumes that all of the deals that they have in the works wind up closing.

OID: And if they don't?

Weitz: I think the odds of those deals not closing are very low. The sales should eventually happen — and if they don't close, others will be in line to buy.

But they also have a CLEC called Electric Lightwave that they set up to join in the fray a few years ago.

OID: A CLEC?

Weitz: A competitive local exchange carrier. The incumbent phone company started out as a monopoly. However, in the course of unfolding deregulation, new phone companies were allowed to come in and try to take business from the incumbent, former monopoly. The latest, big change in that was the 1996 Telecom Act where the government was real interested in having a second or third competitor in various markets to get rates down and be good for consumers and so on.

Therefore, a whole bunch of companies — everybody from Time Warner Telecom to McCleodUSA to Adelphia Business Solutions, dozens of 'em, many of which are now bankrupt and many others that are on their way to being bankrupt — went into these markets and, for the most part, cherry-picked business customers by offering lower rates. And the local incumbent phone company was required to let the competitor plug his line into the local Bell switch. Therefore, when the customer that the new competitor had just stolen from the RBOC wanted to call somebody who was a Bell customer, the RBOC had to take the call and complete it. So it was quite a nasty thing.

OID: Nasty from the RBOC's perspective, you mean.

Weitz: Yeah. However, each of these little CLECs thought, "If we can just get 2% of the market, we'll have a huge, wonderful business." And that would've been fine if there had only been one in each market. Unfortunately, there were dozens. Some of them were stand-alone start-ups. And a lot of 'em have gone broke.

Others were companies already in a related business who thought of their competitive company as sort of a complimentary thing. So, for example, if Citizens has the incumbent phone system of a little town of 40,000 and the system in the next town over is owned by somebody else (whether it's the Bell company or another little one), Citizens might go next door and as a competitive company (a CLEC) sign up those customers and plug 'em into its own network and thereby gain incremental business for its network.

OID: Gotcha.

Weitz: So different CLECs had different strategies. But a lot of it had to do with laying long-haul fiber to connect their little clusters of customers. And sometimes they laid their own, whereas other times they bought fiber from companies like Level 3, Qwest or Williams.

So the Level 3s of the world, in order to finance their own expansion, sold parts of their network or the use of their network to what turned out to be their competitors. And that's been part of *their* problem.

Anyway, Citizens started one of these CLECs —just like a lot of other companies did. And they've gotten it to a cash break-even level, but they can't make any money on it. And they've got about $1 billion of debt at the CLEC level that's guaranteed by Citizens — which is about $3 per share pre tax.

OID: Ouch.

Weitz: After I got involved in Citizens, they spun off a little piece of their CLEC —which is Electric Lightwave — to the public. And back when those things were hot and popular, it sold at a big price — over $25 per share. So the imputed value of Lightwave amounted to something like $3 to $4 per share for Citizens. But I never gave it *any* credit — I never counted any positive number for it. Unfortunately, I didn't count a *negative* number for it — and at the moment, its value is negative.

OID: With assets like that, who needs liabilities?

Weitz: Citizens sells for $9-1/2. So my nutshell is that Citizens is an $18 plain old telephone company that's growing modestly and getting more profitable and a CLEC that is, at worse, worth zero minus the guaranteed debt — which is a negative $3 per share. So there's at *least* $15 per share. And I think you could make a case that it's worth a lot more than that.

OID: Actually, if I knew more about it, I might try. But it's customary for the interviewee to do that.

Weitz: Buckingham Research said at one time that it was worth something like $30, although *I* can't get there.

OID: You're no fun. Could you at least tell us how much of Buckingham's $30 is from Citizens' CLEC and how much is from a different valuation of its phone lines?

Weitz: I'm afraid I can't. I haven't seen a recent report from them. They might even be a little lower than that now. But I think they may still be close to $30.

OID: What's your best guess for the CLEC?

Weitz: Citizens sold 8 million shares at $16 in '97 and still owns about 30 million shares. But the public market price is now only 34¢ per share. And it used to be $25. So it's not down quite 99% yet, but it's getting there.

OID: Who's closer to the median valuation —you or Buckingham?

Weitz: Almost all of the other telecom analysts that follow the rural companies have it in the mid-teens to low-$20s, I guess. But that value is growing. When I say it's worth $15, if I'm right about that (because we use a 15% discount rate) remember that that means you can buy it at $15 and get a 15% return forever.

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OID: And 15% is far above the discount rate used by most people in their valuations.

Weitz: Correct. The discount rates I've seen others use have much more often been in the 8% to 12% area.

OID: So that you should arrive at a lower valuation than they do — other things being equal.

Weitz: That's right.

OID: So if they're coming up with a similar valuation, does that imply that you're more optimistic about Citizens' future cash flows than most observers?

Weitz: I could well be.

OID: I actually caught you being optimistic!?

Weitz: I am a lot less skeptical than most about their plan over the next several years to buy more lines, to get more profit out of each line and to control their costs and the amount of their investment. They're estimating free cash flow of 70¢ for 2002. Then, I make what I think are relatively modest assumptions about what they can do — and I think you can make a case for that 70¢ tripling — over the next several years.

That's what I come up with when I assume that they use their free cash flow to make some acquisitions or to pay down debt, lower their cap-ex per line to reflect that they're not upgrading new acquisitions — and I make some assumptions about margins that apparently Wall Street is not willing to make.

OID: I'm glad I finally caught you drinking.

Weitz: We got on a conference call with an analyst the other day. And we were talking about different telephone companies. Well, when we got to Citizens, she said, "They won't tell me anything. They won't tell me what the numbers are going to be in the future."

She had various reasons —none of them grounded in fact or logic —to triple discount everything about Citizens. And it really didn't have much to do with their business versus other peoples' businesses. It just had to do with how hard she was going to have to work to understand it, that they wouldn't help her and they wouldn't borrow from her firm and so forth and so on. So it's not necessarily the case that if she were to seriously look at it that she would disagree. She might — but she just hasn't tried.

OID: Why do I suspect that's not that unusual.

Weitz: No, I don't think it is.

OID: What do you think a fair free cash flow multiple would be for Citizens?

Weitz: Well, I think the texbook theory is that if the cash flow is growing 8-10% per year and you require a 15% return, you can pay 15-20 times cash flow.

[Editor's note: Weitz's figures are correct. Of course, the multiple of free cash flow that one can theoretically afford to pay and earn one's required return is as follows:

1/(Required Return - Growth Rate).

So if one's required return were 15% per year compounded and cash flow were growing 8-10% per year, one could afford to pay 14.3 to 20 times free cash flow.

Of course, if a company's free cash flow were likely to grow at a low-double-digits rate — at say 12% — based on the preceding formula, all other things being equal, it would deserve a multiple of *33-1/3* times free cash flow.]

OID: So if Citizens were to have $2.00 of free cash flow five years from now, we'd be talking about a value north of $30?

Weitz: That's right. However, even if it were to trade at *10* times free cash flow five years from now, we'd be talking about a double. And that would be fine with me.

There are all sorts of reasons why they'll come up short of that. They'll probably keep making acquisitions. So their free cash flow will be masked for a few more years. And Wall Street won't be able to figure it out.

But if they were to do what I described and got to $2.00 of free cash, the stock would probably sell for a *lot* more than $20. At any rate, if the company develops the way they (and I) hope they will, I think that they'd be worth paying $15 for today.

OID: Master of understatement that you are...

AND CITIZENS CASH FLOW IS COMPOUNDING
FASTER THAN YOUR AVERAGE RURAL SYSTEM.

OID: Roughly what kind of valuation per line does your $15 per share valuation imply?

Weitz: Something in the low $3,000 range —which is a little over 7 times EBITDA.

OID: And how does that compare to transactions occurring in the industry?

Weitz: Well, CenturyTel just bought 675,000 lines from Verizon for $3,200 per line. The low $3,000 per line price tag gets confirmed over and over and over again. And incidentally, that equated to between 7 and 8 times EBITDA for those Verizon lines.

OID: This business doesn't look very easy to evaluate. It seems to be about cash flow, not earnings. In fact, it's not clear from Value Line that Citizens has any earnings at all.

Weitz: Right. [Laughs.] Part of the explanation is that depreciation charges can exceed required maintenance expense. In the generic example of the $3,000 rural line, we used an assumption of $150 for maintenance cap-ex. But the depreciation charge, based on the historical cost of the line which is marked up to $3,000 with the puchase, might be something like $275. If the depreciation charge had matched maintenance of $150, then pretax earnings would have been $125 higher.

The difference between GAAP accounting for asset values, depreciation charges, etc, and the economic reality of the assets and their useful life makes evaluating "earnings" an art, not a science. Since real, live, free — or discretionary — cash flow is what counts to a business owner, the earnings statement is only the starting point for valuing a business.

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Of course, on the other hand, if we underestimate the costs of upgrading and maintaining these lines, then we'll be *over*stating the value of the company.

OID: Which do you think it is here?

Weitz: What you've got to believe is that the average revenue per unit grows, and that the maintenance declines — or at least grows more slowly. But in this case, we're definitely thinking of it declining — because there are front-end upgrades going on here.

So the EBITDA grows a bit. The cap-ex goes down. Therefore, you have free cash and deleveraging over time. So you have less interest. And you ultimately wind up with a more mature company like a Century Communications. There's a lot of noise. Every quarter's different. What they have to spend on each new property varies. However, if the trend lines continue to go in the right direction, the margins continue to widen.

It's like cable and the cable model. The cable guys have never had a dollar of reported earnings —and they may never.

OID: Sounds a lot like investment publishing.

Weitz: I think there's *hope* for these guys.

OID: That sounds different, all right.

But what's your sense of how fast Citizens can increase its EBITDA?

Weitz: Well, first of all, they can get 2-3% per year revenue growth just from growing their number of lines and from little price increases. But Citizens' plan —and, as I mentioned earlier, the plan of all these little companies like it — is to sell other services (Call Waiting, Caller ID, etc.) and high-speed internet access through DSL lines as well as long distance. And Citizens isn't doing wireless, but some of these companies are trying to resell wireless as a bundled product.

In any case, I think the actual revenue growth that they're hoping for and expecting from all different sources will be more like a high single-digit number.

OID: And what would that imply for EBITDA growth?

Weitz: The more you know, the more you realize you don't know. Sometimes I'm still finding out about wrinkles in these things in the third or fourth year I own 'em. But when Citizens buys a group of telephone lines, the EBITDA margin might be in the 40s. And they've usually been able to move 'em up into the high 50s — and they think they can get into the 60s. So they do manage to get some margin improvement.

And when they buy these lines, depending on exactly what kind of shape they're in, they may have to do some onetime upgrades—which might be $150 per line for a year or two. And Citizens' been doing that with some of the lines it's bought. Then, what they're expecting is that it *is* a onetime thing — that they do it for a year or two and then the line is upgraded and ready to deliver DSL or whatever.

OID: Sure. Technology may stop advancing...

Weitz: In the rural areas, things to do change more slowly. And they also hope that, like cable, the maintenance cap-ex shrinks as a percentage of revenues. And *that* helps them with their margin.

OID: According to Value Line, over the past 10 years, Citizens' revenues and book value have grown 12% and 11-1/2%, respectively.

Weitz: Yeah. But the company's changed so much. Five years ago, they were so much more involved with gas, water and electricity.

OID: Maybe so. But presumably Tow was doing smart things back then, too.

Weitz: That's true. And that's the idea. It's an arbitrage between the high prices at which he can sell the other types of utilities relative to what they're worth and the low prices at which he can buy more telephone lines — as well as an operating story.

THEN WHY IS CITIZENS CHEAP?
VERY SIMPLE. IT'S CONFUSING.

OID: So why is Citizens so cheap?

Weitz: Citizens is confusing to people for a lot of reasons. First of all, as I mentioned earlier, rural telephone lines are eligible to get subsidy payments. There's money collected from the urban systems and redistributed to rural phone companies because there's so much lower density in the rural areas and, therefore, a higher cost to deliver the service. And the American government views telephone service as a right of citizenship. So the rural companies can get subsidies meant to guarantee them a certain rate of return.

OID: Interesting.

Weitz: Or they can opt to forego the subsidies, get a set rate/price cap, and try to lower their costs enough to earn an even higher return. Just in case that's not confusing enough, any given rural company may have some systems on one regulatory scheme and others on another. And from year to year, one might have changed from one to another. So it's an interesting industry —all the more reason why we want a big margin of safety.

Again, the more I learn, the more I know I don't know.

OID: Feel free to call anytime.

Weitz: Also, there's a metamorphosis in process. As I mentioned earlier, they used to have investments in four different kinds of utilities. However, they've sold off three kinds and added to the fourth — which is telephone. So it's messy and in transition.

People are also confused about it because the sales that have been announced but haven't closed take quarters and quarters and quarters to close —because each one involves regulators in many states. In addition, all sorts of odd things have gone on and strung out the process —like the utility fiascos in California that created a distraction. So I think it's cheaper than the others for *that* reason.

OID: Maybe so. But who would ever be distracted by odd things happening in California? That's like being

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distracted by rain in Seattle.

Weitz: Good point. Let's say more odd than usual. Plus, Citizens is undertaking a *very* ambitious objective — trying to go from 1 million lines to 5 million in only a few years and taking on debt to do it. So there's skepticism that they'll be able to do it. And they've announced the purchase of millions of telephone lines from Qwest and others which will take several quarters to close.

Meanwhile, they're raising money periodically to pay for the acquisitions. And again, because the dispositions haven't all closed, they don't have the cash. So figuring out where the balance sheet is at any given moment is a bit of a challenge — because it's a moving target. And that puts people off. So it's cheap for *all* of those reasons.

OID: And here again, it sounds like you're buying assets, in effect, at a discount to adjusted book — similar to Berkshire or Liberty Media — where, through some combination of underlying economics and the efforts of a capable manager, those assets are compounding at an above average rate.

Weitz: That's the hope. If you have good assets that have good economics in their own right and you have smart management working for you — and you don't pay extra for those factors — I *like* that kind of situation.

The idea of a margin of safety is *very* important. But the amount of margin that you need depends on the uncertainty or the riskiness of what you're doing.

OID: And the expected return. If you expect the manager to increase the value of the assets faster than your discount rate, you don't need any discount.

Weitz: That's right. And I think that is the idea with Liberty and Berkshire and Citizens, to some degree —that you're sort of delegating the investment process to them.

CITIZENS HAS WHAT IT TAKES —
AND A MARGIN OF SAFETY, TOO.

OID: What could turn Citizens into a mistake —aside from technology, regulation or a more rapid than expected transfer of phone usage from wirelines to wireless or cable?

Weitz: I don't think of cable as too much of a threat. Wireless substitution could be a bigger threat.

OID: Why don't you worry about cable?

Weitz: I *love* cable. And I think of telephone as being a very nice add-on at *some* point for cable. But cable's had such trouble getting going in the phone business — partly because they've had more interesting things to work on, like cable modems and digital cable. So I think it's going to take a long time before they get around to really competing hard in the phone business, especially in rural areas. And I think there's a perceptual difference in the quality of the service offered by the phone companies versus that of the cable companies.

OID: At least for now.

Weitz: That's right. That might change in 10 years. And it might *be* a big problem in 10 years. But I don't expect it to be a problem in two years. I'm a long-term investor, but I don't worry a lot about potential competition 10 years down the road. Plus, it's going to be an evolutionary thing, not an overnight thing.

OID: And you'll have cashed out one way or another by then.

Weitz: That's right. But wireless substitution is a more imminent threat. One of the threats and one of the things that Western Wireless has been trying to do for a long time is to get its fingers on that subsidy pie.

OID: And that's another risk, isn't it — that the government subsidies get cut?

Weitz: Yep. And I do worry slightly about that. But I've talked to some telephone analysts who came from the regulatory world. And they tell me that there's an awful lot of inertia to overcome before that would happen.

OID: Kind of like the tobacco subsidies. Why our society should want to encourage tobacco production is over my head, but there we are.

Weitz: Exactly. I love that one. Let's subsidize the same thing we're trying to discourage. But keeping the cost of phone service down for rural constituents is less controversial.

OID: What else could turn it into a mistake?

Weitz: Gabelli talks about the future of these rural telephone systems as being an ironclad cinch. I wouldn't begin to be so certain — about anything. But I think there's enough margin of safety in terms of valuation in something like this that there's room to be wrong there — especially if it's growing.

For Citizens to work out as an investment, the two or three key trend lines just have to behave the right way. And what could happen is that revenue could grow more slowly or shrink because of competition and whatever. We could find out that the maintenance doesn't go down or that it goes up faster than we thought. The regulatory picture could change so that a wireless company could get some of the subsidy instead of the wireline. There are all kinds of things that could happen.

But plain old telephone systems out in the country are a very slow moving and slow changing segment of the telecom spectrum.

OID: Until they aren't.

Weitz: Maybe I'm being naive. But I think we're talking about little changes every five or 10 years as opposed to the cataclysmic things that have happened elsewhere in telecom.

OID: And for a small fee, you could even insure that we don't buy any.

Weitz: The other extreme is Level 3 where the prices are coming down 80% per year or thereabouts. Citizens and our other telecom companies are at different places in their life cycle. But I'm willing to believe that the ones we own are all close enough to the point where they can generate

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sufficient amounts of free cash flow to have some choices.

But Citizens has to work pretty hard while they're in this buy-a-million-lines-at-a-time mode. They've got to really execute as a phone company.

OID: And how would you assess the odds there? What can you tell us about management — as operators?

Weitz: Citizens' margins are probably average to above average — and as I said, I believe that they can improve their margins going forward. But the knock on that... When you talk to a CenturyTel person, they'll tell you that Citizens cuts corners on quality, amount of upgrades and so on. It's the same as if you were to talk to Cox Cable. They'd be a little disdainful of the other cable companies. But if you talked to Comcast, Insight or somebody like that about Cox, they might suggest that Cox has a gold-plating mentality.

OID: Do you think they're up to the task?

Weitz: Citizens has proven industry operators who have done a very good job with wireless and with wireline over decades. It's *not* a matter of some sleepy water and electric utility management trying something new. Tow's building Citizens' telephone business with experienced telephone people.

So if you have good, experienced people, the business itself is consolidating and has good economics, and management is motivated to build something of value presumably to sell, I think the odds are very good.

OID: I'm going to take that as a "yes".

Weitz: And I think some of their competitors are missing some of those ingredients.

OID: Even better.

Weitz: And again, there's enough margin of safety in the valuation that I have room to be wrong and still be OK.

THE US WEST PORTION OF QWEST ALONE IS WORTH MORE THAN THE CURRENT PRICE.

OID: Your biggest purchase in Weitz Partners Value and Weitz Value Fund in the third quarter — and again in the fourth quarter — according to Portfolio Reports was Qwest Communications.

Weitz: You noticed. But it's a smaller position now.

OID: It hasn't done so well?

Weitz: It's been like catching a falling knife. I started buying it in the high teens (up around $19 or thereabouts) and I've bought more at different prices — including under $12 today. So I think it's *more* of a bargain today.

[Editor's note: Apparently, Legg Mason Value Trust's Bill Miller agrees. In mid-December, here's what he had to say about the company: "One of the names we bought in the previous quarter — and that we've added to *substantially* — is Qwest where there is some controversy. We've added to some of the other [telecom] ones as well. But that one is exceptionally cheap."

He seems to be putting his money where his mouth is. *Portfolio Reports By Money Manager* shows Qwest as having been Legg Mason Value Trust's largest purchase by far during the third quarter (based on end of quarter prices) — nearly double the size of any other position purchased.

And the latest edition of *Portfolio Reports By Security* also shows Qwest as having been the largest purchase of Franklin Mutual Advisers (better known by the former name of its flagship fund, Mutual Shares).]

OID: Then we're all ears.

Weitz: The part of the business that's referred to as "Qwest Classic" is a broadband long-haul fiber optic network that carries long distance, voice and data throughout the United States and has connections in Europe and Asia.

Let me give you a thumbnail history. About five or six years ago, Qwest Communications International started to build a long-haul fiber network on the roadbed of the Southern Pacific Railway that oil multi-billionaire Phil Anschutz had bought. It was the first of the new wave of fiber networks that got to be very hot the next few years after that.

And Anschutz brought in Joe Nacchio to run it. And I think Nacchio gets bad marks for being an abrasive fellow and, possibly, for overstating how well things have been going at times.

OID: That's hard to imagine.

Weitz: Indeed. But he gets good marks from people around the industry — both for financing the buildout with sales of capacity to other carriers and the building up of the client base as he went along. So in the years after that, as Williams and Level 3 and others started building competing networks, I think Qwest had a *little* leg up on building a customer base.

But somewhere along the way, with the stock market going absolutely crazy over broadband, the growth of the internet and the need for new capacity and so on, Qwest and others got astronomical stock market valuations. And by some combination of good luck and foresight —I can't tell you exactly how much of each —Qwest decided to use their very expensive currency to buy US WEST (which is also known in some quarters as US Worst). Of course, US WEST is the RBOC [Regional Bell Operating Company] that covers most of the western part of the country.

And in buying US WEST, they got 18 million access lines which got them into 18 million homes and offices with that last mile connection —which has turned out to be the really valuable part of the telecom network.

OID: How so?

Weitz: It's turned out to be the most valuable part because it's much harder for a competitor to dislodge a customer who has your physical wire into their house. That customer can switch from MCI to AT&T to Sprint with the flip of a switch or a small bit of reprogramming somewhere far away. But if you have a US WEST phone line into your home, there's no competitor that would even *try* to have you pull that wire out and send a new wire into

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your home. It's the same way with cable, incidentally.

Plus, with US WEST, Qwest bought the huge cash flow that comes with an old, sleepy Bell company. And it's that huge cash flow and those local access lines that have made Qwest able to spend billions on building out its long-haul business without jeopardizing its balance sheet.

OID: Interesting.

Weitz: And I've never had any great use for RBOCs — because it seemed to me that a lot of other players do parts of their business better than they do and they have huge inertia and cultural problems. But when I saw Qwest fall from the $60s to the $30s and below as people seemed to be looking at the financial distress of some other long-haul carriers and apparently fearing Qwest might have the same fate, I started getting interested. I probably started looking at it in the $30s. And I finally bought it when it dropped into the high teens.

And I don't pretend to be an expert on the details of the long-haul businessor even the RBOC business. On some of these things that take four or five years to work out, it can take that long to begin to understand them.

OID: You learn why you shouldn't have bought 'em.

Weitz: [Laughs.] Yeah. I've often been a little early. And I certainly have been in this case. But my thought with Qwest was that with the RBOC there, you can value it in a number of different ways. However, I think you can get to a number in the upper teens, at *least*, just for US WEST.

OID: And that high teens value for US WEST alone is net of all of Qwest's debt?

Weitz: That's right.

OID: Wow.

Weitz: As I mentioned, US WEST's RBOC business consists of 18 million access lines. Plus, US WEST has a directory business that, as sleepy as it is, generates *huge* cash flows. Plus, it has a little wireless operation. And you can argue about what the right multiple is. But before debt, if you use 7 times gross cash flow for the access lines — and some people would say that you ought to use 6 or 6-1/2 —you get $24 per share for the access lines.

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Then, if you put a multiple of 5 times gross cash flow on the directory, you get about $3 a share. And if you use $3,500 per subscriber for US WEST's wireless, you get another $3-1/2 per share. So that adds up to $30+. And then there's $13 per share of debt. So that gets you to $17+ for US WEST alone.

WHEN WE ADD UP THE VALUE OF ALL THE PIECES, WE FIGURE QWEST TRADES AT A SERIOUS DISCOUNT.

OID: So as long as the rest of the company isn't worth a negative $5...

Weitz: That's exactly right. And the market is acting as if the rest of Qwest *is* worth a negative number.

PORTFOLIO REPORTS estimates the following were Weitz Value Fund's largest equity purchases during the 3 months ended 12/31/01:

1. QWEST COMMUNICATIONS INTL
2. COMCAST CORP CL A SPL
3. WASHINGTON MUTUAL INC
4. US BANCORP
5. VORNADO REALTY TRUST
6. LIBERTY MEDIA CORP CL A
7. PRUDENTIAL FINANCIAL INC
8. ADELPHIA COMMUNICATIONS CL A
9. HOST MARRIOTT CORP
10. CITIZENS COMMUNICATIONS CO

OID: And it's not?

Weitz: It's not. There's no question about it. With Citizens' CLEC — its competitive local exchange carrier — Electric Lightwave, I don't know if they *could* give it away. As I said, there's some question about whether Electric Lightwave has any value at all. And Citizens has guaranteed about $3 per share of debt. So it's possible that Electric Lightwave is worth a minus $3.00.

But the difference here is that we've already assigned all of Qwest's debt in our valuation to the plain old telephone company. What's left iswhat's referred to as Qwest Classic —Qwest before it bought US WEST. And that includes a long distance voice business which is shrinking like everybody else's. So if you put 2 times EBITDA on that, you get $1.20 per share.

OID: I was sorta hoping for a bigger positive number...

Weitz: Then, Qwest also has a data business. It's been building a top notch data transport network. It has real customers —like Microsoft among others. And it's been growing its revenues at a high teens/low 20s rate annually. It's one of those things where up until recently they had been spending a *lot* of money to build out their network.

And this is a questionable number, but I've seen industry analysts put a number like 3 times revenues on that data business. And that results in a value for that segment of $5.30 per share.

OID: Presumably, that seems reasonable to you?

Weitz: It does. What you're guessing is that it

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continues to grow —that they continue to get new business customers and continue to carry a lot of traffic. And I don't think anybody really questions the fact that that market is growing a lot. What they question *severely* is whether or not it's growing enough to accommodate all the players and all the capacity. But I don't think anybody questions whether it's really growing.

And that means real customers in hand and continued revenue growth of 15-20% per year. I think that's plausible. I'm not going to bet my life on it, but it's certainly plausible.

OID: And because of the other assets, you're not betting your life on it. In fact, if your other valuations are even close, you're not paying anything for it.

Weitz: You've got it. So that's Qwest Classic. And that gives us a value of $6-1/2 for it —$1.20 for the voice and $5.30 for the data.

OID: Or $24 in all — including US WEST.

Weitz: That's right. And again, you can quibble with each of those, but it's certainly a positive number.

And there's another piece: Qwest had long distance customers all over the country when it first started up. But when it bought US WEST, because of regulation on the Regional Bells, it wasn't allowed to provide long distance service to people in those 14 states. And therefore, Qwest was required to sell off its long distance business in those 14 states. Incidentally, it's basically the western U.S. minus Washington, Oregon and California, I believe.

OID: No People's Republic jokes. Darn.

Weitz: But they can *terminate* long distance calls that come from somewhere else. And they have deals with companies like BellSouth to take a BellSouth customer that's calling into Qwest's area. But they can't originate long distance calls on their own network —until they get government permission to do so under Rule 271. And the RBOCs have gradually, state by state, been getting permission to offer long distance in competition with the AT&Ts and MCIs of the world.

What they have to do is prove to the FCC's satisfaction that there's enough competition in the local phone business before they can go into competition with the long distance people there. And what's happened when Verizon and others have gotten so-called 271 approval is that they've taken a quick 20% or so share of the long distance business in their own territories.

OID: Interesting.

Weitz: Again, the long distance voice is no great, exciting business for the future. Data is more important. But it does represent incremental business to a network that's already there at Qwest. And I've seen research that says, "Let's suppose US WEST gets 271 permission in its 14 states." And it might still take another year or two, but I don't think anybody would question that they'll get it eventually. "And assume they get the kind of penetration that Verizon and others have gotten. That represents so many billion dollars of revenues out three or four years." Then they discount that back to the present.

And I've seen different numbers. But the one that looks the most sensible to me arrives at a $7 per share number as the present value. I think that's using 15 times 2004 EBITDA and then discounting that figure back to the present. Again, I absolutely won't hang my hat on $7.00. But it's definitely some positive number.

OID: So it sounds like one can reasonably add that up and wind up with...

Weitz: If you add that all up and believe it, it's $31. I say that because I'm willing to believe hardly *anything*.

OID: Oh?

Weitz: But I *can* believe we get $17+ worth of RBOC and something on top of that. So I was comfortable tiptoeing into Qwest at $18 — and I'm *very* comfortable at $12.

QWEST HAS HUGE POTENTIAL CAPACITY.
BUT WHETHER IT EVER GETS USED...

OID: In your analysis, how much of Qwest's value is in its fiber optic network?

Weitz: In the breakdown that I just gave you, in gross numbers, $30 was the RBOC and $6-1/2 was the existing long distance business over the fiber network. And that extra $7 represented incremental value that they could put through the existing network, the existing billing system, etc. once they get 271 approval.

OID: And presumably, their fiber optic network is barely being used.

Weitz: You can get a lot of discussion about what capacity really is on a fiber network. But I think the only thing that everybody seems to agree on is that there's *plenty* of capacity today. [He laughs.]

OID: What do they disagree on?

Weitz: Well, if — and here's where I start to get lost in the physics...

OID: Don't worry. I'll help you through it.

Weitz: If you have a strand of fiber going from here to there, the way it's made useful is using lasers and amplifiers and all sorts of electronics to "light it", as they say. And you can light a little bit at a time. There's a certain amount of cost of equipment to light each increment of capacity. And in one fiber optic cable that goes over some long distance, there can be hundreds or thousands of increments of capacity that you can light one at a time. At least, that's my layman's understanding.

So when Level 3 or somebody says they're running 50-80% full, that's just the part that's lit. They may only be dealing with 10% or 5% or even 1% of the total theoretical capacity.

OID: Gotcha.

Weitz: The bull case on data and the Level 3s of the world is that the elasticity of demand is very high. So that for each unit of decrease in price, you get much more than one unit of increase in demand. In other words, as these

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companies cut price, their units sold increase much more —which results in revenue growth.

But I think even [Level 3's CEO] Jim Crowe and others who are bullish on the industry have said that some of the fiber that's in the ground now probably will *never* be lit — because there'll *never* be enough demand for it. However, if you want to hear more about that subject, you should speak with Rick [Lawson, the portfolio manager of Weitz Hickory Fund] — because Level 3 is really his idea.

[Editor's note: We took Weitz's suggestion and spoke with Lawson. Here's some of what he had to say:

Rick Lawson: I agree that fibers that are in the ground will not be lit. But it's not because there won't be demand. It's because there will be, in my opinion, sufficient improvement in technology that those optic fibers will prove to be uneconomic —and it will make more sense to put in *better* fiber.

The key to understanding why is to understand that the cost of fiber is a small fraction of the total capital cost to provide the service. The fiber itself —the fiberglass — represents only about 5% of the all-in cost of a lit network.

OID: Wow.

Lawson: So if you're going to the trouble of constructing a fiber optic network in the first place, it doesn't cost that much more to put extra fiber in the ground at the beginning —which is why so much extra fiber capacity has been available. But you don't actually have service until you put all of the electronics around it. And again, that's what costs the bulk of the money.]

OID: Very interesting. So there's a huge amount of potential capacity. But whether it's ever used or not...

Weitz: Exactly.

OID: And I gather that the capacity of optical fiber is enormously greater than cable?

Weitz: Well, that's true. But a cable system — and, again, I get lost in the engineering — uses fiber from its own head end (which is its own source of information) to deliver its signalout into the neighborhoods.

OID: So cable systems actually use fiber optic cable?

Weitz: That's right. But it doesn't reach the home. It's routed into coaxial at some point in the neighborhood. And it's that coaxial wire that actually goes into the home. There are technological barriers that make it impractical to use fiber optic cable for that purpose. I think it's *technically* possible, but it's still too expensive — although someday they may find a way to take it all the way there.

Still, if you have a cable modem that goes through the coaxial cable to the fiber to the head end of the cable system here in Omaha, it has to be connected to the internet — which is a data network that spans the world. That's what @Home and Road Runner were meant to do for the cable companies. So it's not an either/or proposition...

OID: Gotcha.

Weitz: ...unless Qwest comes into a business or a home and sells them a DSL line —which basically connects the home's *copper* wire that they're using for their regular telephone to the internet with modems on each end, etc. But either way, the long-haul information going from your home to someone's website in Michigan to someone else's website in California to someone else's website in Stockholm goes over phone lines and somebody's network —whether it's Qwest's network or the Level 3 network or the AT&T network.

OID: But the enormous value on the come with Qwest is the potential value of its huge capacity...

Weitz: That's right. However, I can't imagine it ever justifying the prices of these stocks two or three years ago. But of course, I'm not counting on *any* of that.

OID: But that was the reason for the excitement when Qwest was trading up in the $60s...

Weitz: Yeah. And demand for broadband was doubling every so many hours, it seemed. But who knows? The kind of scenario the optimists were expecting may still come to pass. But I think they got carried away.

PORTFOLIO REPORTS estimates the following were Weitz Partners Value Fund's largest equity purchases during the 3 months ended 12/31/01:

1. QWEST COMMUNICATIONS INTL
2. COMCAST CORP CL A SPL
3. WASHINGTON MUTUAL INC
4. US BANCORP
5. PRUDENTIAL FINANCIAL INC
6. ADELPHIA COMMUNICATIONS CL A
7. HOST MARRIOTT CORP
8. LIBERTY MEDIA CORP CL A
9. PARK PLACE ENTERTAINMENT
10. IMPERIAL CREDIT INDS INC

A PRIMER ON FIBER OPTIC CABLE NETWORKS —
OR MORE THAN I KNOW, BUT SINCE YOU ASKED...

Weitz: To me, it's still most important to have actual customers, serve them well, figure out what they need and have the technicians on hand to build systems that work for each customer.

OID: I thought that was just in the old economy.

Weitz: I'm afraid not. I talked to somebody who'd been in the business in the phone industry. And he basically said if you think about the old legacy companies like AT&T and MCI and Sprint and the new companies like Level 3 and Qwest and Williams [see Editor's Note below] and you put 'em all on a continuum of when they built their systems, the last system built is the most modern. And there are differences in efficiency and cost structure and so on that make a modern network more desirable than an old network — all other things being equal.

[Editor's note: Weitz informs us that he's referring to Williams Communications — which came from the

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Williams Pipeline. And he tells us that there are a whole bunch of others —including one from Montana Power.]

Weitz: But all other things *aren't* equal. There's also sort of a *reverse* continuum in effect, too. Companies like AT&T that have been at it forever, for all their faults, do have zillions of technicians with lots of expertise and an enormous experience base of working with customers, whereas the very newest companies are scrambling to *build* that kind of capacity. So you need both.

And in a period where there *is* excess capacity, from what people tell me, although a brand new network has lots of technological advantages over an old one, from the customer's point of view, if you just want X units of data transported from one place to another, it really isn't that important whose network you're on.

OID: Or how old it is.
Weitz: Exactly.

OID: And what does that have to do with Qwest?
Weitz: Well, this fellow was sort of bullish on Qwest. And as he described it, they're sort of the oldest of the modern networks (meaning that they started six years ago, whereas Level 3 started maybe three or four years ago). So being the oldest of the new, if you will, Qwest has had six years to develop its staff and its expertise and its relationships with its clients and so on. And I don't mean to pick on Level 3...

OID: Especially with Rick out of the room...
Weitz: That's right. Level 3 is one of his stocks. So I don't mean to pick on it, but it's the one that I've heard more information about. And I think that in the earlier stages, they were thinking they'd be more of a carrier's carrier and not have to deal much directly with individual customers.

OID: Because there would be capacity constraints and they'd help to fill the gap.
Weitz: Exactly. They were going to be the giant, backbone, wholesale provider. And they're finding out that they need to learn to deal with individual enterprise customers. I'm sure that they're doing a good job of dealing with 'em. But people like Qwest have a few years head start.

OID: Why wouldn't it be worse to be the oldest of the modern —on the premise that you can catch up on things like knowledge and customer service, but whatever technology was built into the network ain't changin' without very significant financial outlays?
Weitz: That's the bull case for the new guy. I'm sure that there's something about what was laid last year — even by Qwest — that's better than what was laid five or six years ago. I don't know whether there's a practical difference between a long-haul broadband network that's six years old and one that's four years old or two years old or one year old — but I doubt it.

At the margin, if and when they reach full capacity, being new and modern and lower cost is going to make a big difference. But I don't think it's all that relevant unless they're capacity constrained and the low-cost provider really does have a big advantage and so on. The new guys will probably be glad five or ten years from now that they built their system in the late '90s as opposed to the early '90s or whenever. But I don't know that it's going to make a difference whether it was the '98 model or the 2000 model.

OID: Gotcha.
Weitz: And I'd think that if you had a beauty contest for all the networks, Level 3 would win it.

OID: Maybe so. But I wouldn't count on high ratings.

DON'T EVEN ASK ME WHAT CAPACITY *MEANS* —
BUT I'M NOT PAYING FOR IT. AND THAT'S THE TRICK.

OID: How far along is Qwest in building out its network?
Weitz: [Laughs.] That's a good question. Qwest just announced very recently that they were telling their suppliers to stop building for now —that they're going to go with what they've got so far. But they haven't finished all the things they have in their mind.

OID: Who has?
Weitz: You've got it. They cover the United States. They have a joint venture that covers Europe. They have connections to Canada and Mexico. They have connections to Asia. And I can't tell you frankly... But I think that they could probably all build forever —by making more connections and more rings and more redundancy and reaching the last remote corners of the U.S. and the Earth.

OID: Wall Street willing.
Weitz: Exactly. But I think they have *enough* built. And Level 3 says they're finished with their network. But of course, they're still spending billions a year. So it's not quite clear to me what the difference is between being finished with the basic network and still spending billions and *not* being finished.

OID: Probably investment relations strategy more than anything.
Weitz: Probably.

OID: For whatever it's worth, Value Line says Qwest's fiber optic network now reaches 113,000 route miles. And the company also operates local broadband networks in 25 major markets outside of its 14-state local service territory.
Weitz: Right. The route miles and the strand miles — again, it's sort of an overwhelming chore to figure out what that capacity really means.

OID: It certainly sounds impressive.
Weitz: It does. I think what it means is that they can find a way to serve any major customer they can sign up — even if it means renting capacity on somebody else's network for some key segment.

A lot of companies have built networks of their own.

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And a lot of 'em have spliced together networks. They'll go from Point A to Point B on Qwest's network and Point C to Point D on Williams' network and Point F to Point G on Level 3's network, etc.

OID: I assume that you're trying to make a point?

Weitz: So if you saw a map of each of the companies that say they have a fiber network and laid 'em all on top of each other, you'd see lots of double counting —because Level 3 and Qwest and the other big wholesale guys have sold or leased capacity on their networks to a lot of these other people who boast that they have a network.

Incidentally, that's gotten people upset with Qwest. They built this fiber network. And they said out loud and were proud of it as they were building it that they were selling off parts of it to whoever wanted to have their own network —whether it was the upstart CLECs or whoever. And they used the proceeds from selling those pieces to finance building out the network. It's kind of like you were building a 12-lane highway and you could get somebody to pay half the price of your construction by giving them one of the lanes. That's been an explicit part of their strategy to finance their network from the beginning.

So it's very difficult to measure actual *total* capacity, much less *excess* capacity.

OID: Interesting.

Weitz: And if there *is* overcapacity, it won't just be because of the number of miles of fiber in the ground — whether it's the gross miles, the net miles, the double-counted miles or what have you. Again, there's much more to calculating capacity than estimating the raw fiber — because there are also electronics involved.

OID: How much of the fiber is lit and so forth.

Weitz: That's right.

OID: And even if there is massive overcapacity today, as I recall, technology guru George Gilder suggests that basically whatever bandwidth is available will get used —and generally sooner rather than later — because technology and commerce will evolve to take advantage of it.

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Weitz: Exactly. And the cost is coming down nearly 50% per year or whatever it is. That's the argument that the capacity will be filled up at some point.

OID: In fact, as I recall, he suggests that bandwidth is likely to be the constraint more often than not.

Weitz: It's certainly not today. We seem to be moving towards the point where bandwidth is virtually free.

OID: But I believe that Gilder might suggest that today's oversupply is an aberration.

Weitz: The constraint recently has been the last mile. The bottleneck's getting into town and into people's offices.

OID: Why has that been so difficult?

Weitz: I think it's partly just getting one more wire from one block to another. And even one apartment to another is hard in New York City. It's harder in New York City than it is out in a cornfield in Nebraska. And part of it is signing up the customers and getting 'em hooked up.

Again, Qwest's network covers the country, but they can't use it for long distance inside their territory until they get Rule 271 approval. They're transporting things on it inside their territory. They can do what is called intra-LATA: Inside the 14 states, when you call from Nebraska to Iowa, it's a toll call. You pay extra for it. However, it's not long distance because it's inside US WEST's territory. They can do that business now. But they can't handle a call from Nebraska to New York before they get Rule 271 approval.

OID: But when they do, that should also help them start to get their long-haul network utilization up.

Weitz: Exactly. However, I'm not your guy on what the competitive landscape's going to look like in 10 years in this whole broadband telecom world.

OID: But you're not paying for it.

Weitz: I'm not paying for it. And that's the trick.

OID: Since you're not paying anything for it, this question may be irrelevant. But when it comes to selling bandwidth on their fiber optic network, would the fact that some of the logical buyers would be competitors with US WEST be a potential problem?

Weitz: I can see some situations where that would be the case — for instance, when they get 271 approval and are able to challenge long-distance providers in-territory where they've only been challenging them out-of-territory before. That could be a problem that a "neutral" player wouldn't face.

Frankly, it doesn't strike me as a major factor. However, I don't really know.

WHAT COULD TURN QWEST INTO A MISTAKE? OVERZEALOUS EXPANSION AND NOT MUCH ELSE.

OID: What could turn Qwest into a mistake? I don't see a whole lot of insider buying going on...

Weitz: There are lots of little negatives that one can quibble on here. And one of 'em is that the company just

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repriced a bunch of options for top management and for a broad spectrum of management.

OID: Thus has it been and thus shall it always be.

Weitz: So they don't need to be out buying in the open market when they can do that. I find that annoying. It's all the more reason to treat options as compensation — because there's no risk associated with 'em really if they're going to be repriced. Either your first option works and you make money on 'em or you keep getting new ones until they do.

OID: Heads they win. Tails they win. Either way, the shareholder loses.

Weitz: Yeah. But again, that level of detail pales... That only gets to be important —or even *may* get to be important — after the stock doubles.

OID: What's the order of magnitude of dilution from outstanding options? Value Line shows fully diluted shares outstanding of about 1.7 billion.

Weitz: That sounds about right to me. Reported numbers show something in excess of 1.6 billion shares outstanding. So I think we're only talking about dilution of tens of millions of shares, not hundreds of millions.

OID: What else could turn it into a mistake?

Weitz: If they got too aggressive about trying to crush the competition by going out and spending billions to build faster — or if they cut prices to put the competition out of business or something — I guess they could get into a jam. But they don't show any signs of doing that.

Furthermore, they've said that they're cutting back on their capital expenditures at least $2 billion from their previous plan. So they should be generating net free cash in 2002 after cap-ex — not a *lot*, mind you. However, as long as they're not spending more than their cash flow, they can afford to have it take a few extra years and not have a serious problem.

OID: Plus, I imagine not too many of their competitors own an RBOC.

Weitz: Exactly. They have those 18 million US WEST phone customers paying their phone bills. There are other sum-of-the-parts stories where the parts are deteriorating and if you don't get to realize the value fast enough, you're in trouble. If you're talking units times price, your units have to at least grow faster than your price shrinks — or you go backwards. And I think that is what's going on with all segments of the phone business —some faster than others. Voice long distance is the most visible and ugliest.

But the nice thing about Qwest is that for all the faults of an RBOC (like US WEST), I don't think their situation is deteriorating. It may be growing too slowly to be of interest to most people, but I think it's still a positive number.

So what could turn it into a mistake? I don't know.

OID: How strong is Qwest's management in your view — overselling shareholders aside.

Weitz: Nacchio is sort of a flamboyant, confrontational kind of guy. He'll snap back at the analysts on the conference calls and sound defensive. So there's a personality issue there. And there have been questions about there being lots of management turnover and layoffs. But I think at least *part* of that is the young, aggressive, entrepreneurial culture of Qwest butting heads with the old, bureaucratic, slow-moving RBOC culture and the RBOC culture losing. So I don't know whether the turnover is *just* because of that. But I read somewhere that most top US WEST people have left Qwest.

Nacchio was passed over for the top job at AT&T. And that's one reason why he chose to leave there after 20 years. He's gotten very good marks for having learned his lesson with 20 years or so at AT&T.

OID: By having learned his lesson,you mean not to buy telecom stocks...

Weitz: No. I've heard him praised for understanding what big business customers want, what kind of support they need, how to sell to them, how to make 'em happy with your engineers and technicians and so on. But are there other weaknesses in the management? I don't know.

You can bet that in the US WEST part that constitutes 75%+ of Qwest's revenue and all of their profits that there's still lots of fat and lots of old telephone culture and other such things that led 'em to be called US Worst.

I think maybe your local phone company may be like the airline that you fly the most. The one you know the best is the one you hate the most — because most people's expectations tend to run ahead of reality. So I don't know if US WEST was really worse than any of the other RBOCs. But management quotes FCC stats showing that Qwest is better than average in most service categories.

OID: Everything's relative.

Weitz: It is. When you're looking at broadbrush, big chunks of value, what you count on management for... You want great execution, visionary stuff and all of that, but first and foremost, you want to make sure that they do the capital allocation right and don't get you in trouble. And I think management has gotten the message that they need to prove to everybody that the Qwest Classic segment is not going to sink the entire company.

I've never talked to 'em about this, but if I were in top management's shoes at Qwest, I would say, "First, let's get the perceived value of Qwest Classic up to zero. And then we can take it from there."

OID: Baby steps.

Weitz: Exactly. And getting it up to zero means getting the cash flow positive so that you're not spending the plain old telephone earnings forever —and you can start to have the debt going down instead of up.

OID: So what would turn it into a mistake?

Weitz: If they *don't* pay attention to that — if they don't pay attention to getting cash flow positive and to filling up the network that they have instead of continuing to enrich it or expand it or whatever else they might do.

OID: But you don't sound like you worry about that.

Weitz: I think they've gotten the message.

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THERE ARE ACCUSATIONS ABOUT Q'S ACCOUNTING,
BUT I DON'T THINK IT'S DELIBERATELY MISLEADING.

OID: In your view, is Qwest's accounting appropriate?

Weitz: I'm not sure that I can speak well to that. The most controversial subject that *I* know about with Qwest was their treatment of sales of what people call IRUs [Indefeasible Right of Use] — which are sales of capacity on their network to other telephone companies. The controversy has basically been about whether Qwest implied that the onetime sale of dark fiber, for example, represented recurring revenue.

And the company's response is basically, "We accounted for 'em in a proper way. And we never implied that they were anything other than what they were."

OID: And your take?

Weitz: I don't know enough about the history of it to know whether they were really as clear as they claim in retrospect to have been.

The other controversy, I think, is in an area where either Qwest bought equipment from a vendor and resold it to a customer or did what's called "swapping of capacity". That's where two different network companies have gaps in the network. So Qwest might say, "I'll sell you the use of so many fibers on my network and you sell me the use of so many fibers on yours." And even though, in effect, that was just a swap in kind, critics suggest that they put a high value on each side of that transaction so that both of them can inflate their sales.

OID: I'll create some revenues for you if you create some revenues for me.

Weitz: Exactly. It's like the old joke, "I'll give you a million dollars for your dog. But I'm going to pay you with two half million dollar cats."

There's the accusation that Qwest and a lot of the other new network builders have done that.

OID: And your view?

Weitz: I honestly don't know if the disclosure was adequate and the readers weren't careful to understand what was going on or whether it was purposely obscured. But it was probably some of both in the industry.

OID: For purposes of your analysis, how much does that stuff matter?

Weitz: Well, if it were big relative to the total, it would make a difference. But the success or failure of what we're doing depends on being roughly right about the big things.

OID: And that's on the margins.

Weitz: That's right. So what an RBOC is worth over the years and what you're paying or not paying for a new business that may have value in the future... Presumably, the issues and the amounts involved in these swap questions are dwarfed by the bigger picture.

On the other hand, if we were to detect a pattern of deliberately misleading —even if it weren't about amounts that are material —I think that would be a symptom of the character of management that we wouldn't want to be involved with.

OID: Similar to "bimonthly, more or less".

Weitz: It certainly wouldn't have to be *that* egregious. In that sense, it's probably worth knowing more about how it unfolded. But I don't know enough to comment.

OID: Obviously, it's not enough to concern you —or you would've dug further or you wouldn't own it.

Weitz: That's right.

QWEST ISN'T ONLY UNDERVALUED,
IT'S ALSO PRETTY MUCH HEDGED.

OID: Anything else?

Weitz: The other thing that could turn it into a mistake, although I don't think it would be a killer, would be if the phone business generally were to get so competitive that you actually started having shrinkage in the number of regular access lines. There have been some quarters when some RBOCs have had declines in their actual number of lines. If people start taking out their second line to put in their cable modem... Some of the young people around our office tell us that when their friends move into a new apartment, they don't even *get* a land line phone. They just use their cell phone.

OID: Wow.

[Editor's note: His observation was subsequently confirmed by a customer service representative of one of the leading cellular phone service providers.]

Weitz: Maybe, instead of the RBOC world *growing* a few percent a year and generating big cash flow, they start *shrinking* a few percent a year. Then, instead of being worth 7 times gross pretax cash flow, maybe it's worth 6 times or 5 times. And maybe their debt goes down slower. That wouldn't be a disaster, mind you. But it could turn it into a value trap —where the value doesn't do much of anything for an extended period.

OID: Presumably, something else that could turn any company in this business into a mistake is regulation.

Weitz: Yeah. Regulation. [Laughs.] As I said before, after I own it for five years, I may begin to understand *some* of the complexities. For example, I'm still learning about the rural subsidy world.

OID: So are the people in that business, I suspect.

Weitz: Yeah. The reason Qwest was going to sell some lines to Citizens was because Qwest wasn't eligible for some of the subsidies because they also owned city lines of their own, whereas Citizens (because they didn't) *would* be eligible. So there was sort of an arbitrage there.

OID: Very interesting.

Weitz: If Qwest doesn't get 271 permission and can't do long distance, that takes away a big chunk of its upside.

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WALLY WEITZ
(cont'd from preceding page)

OID: And the odds of that?

Weitz: I can't *imagine* that they won't get it. It's more competition — and that's what the government wants.

OID: And I guess the other thing that could always turn this kind of business into a mistake is technology — if it were to make its current network obsolete or noncompetitive cost-wise.

Weitz: Yeah. When I started out, I said that I'd never been a fan of the RBOCs because there are always other little companies that can do parts of their business better. In other words, wireless can eat into the wireline business, the cable modems do a better job than DSL, and the CLECs can go cherry-pick the business customers.

OID: Agreed on all counts.

Weitz: But all during the '90s, when all those threats were financed by seemingly infinite amounts of money, the RBOCs just seemed to keep on plodding on through. And US WEST is doing its *own* cellular. They have PCS service. And they're trying to be able to offer people bundles — wireline/wireless and high-speed data.

So it's kind of hard for me to picture anybody leapfrogging the RBOCs technologically. Even though the Qwest network has new multicolored fiber and the old AT&T network uses old fiber — I hesitate to say any more because I'm already saying more than I know —a customer can still get the job done through an old AT&T line.

OID: Yeah. I'm with you. But my inability to imagine it has never seemed to keep it from biting me in the...

Weitz: That's right. But there's also inertia. When you think about who the telephone customers are and how small a part of your overall expense your telephone is... For example, I can save $10 or $20 a month by dropping my US WEST or my Qwest phone lines to my house and getting it on my Cox Cable. But I'm not *quite* sure —you know, Cox might only be up 98% of the time instead of 99.9%.

OID: Yeah. We learned the hard way not to go with the cheapest long distance service.

Weitz: Exactly. And for our business here, if we spend $1,000 or $2,000 per month on phones, we're not

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going to jeopardize our link with the outside world just to save $500 per month.

I don't mean to say there are no threats. But inertia is a powerful thing. That's what's been a problem for the fixed wireless guys and a lot of the new competitors. Just look at the new generation of fiber optic networks — like Williams, Level 3 and Global Crossing. They're technologically superior to the old legacy networks of AT&T, MCI and so on. They have *huge* margins of advantage in cost and electronic capacity and so on. There's no question that if you had a choice of taking one or the other (if it were going to be given to you) that you'd take the new fiber optic. Yet they're still having trouble actually getting enough customers to pay the bill.

OID: So in a way, with Qwest, you not only have an undervalued stock and a warrant, but also a hedge — because not only do they have the RBOC to fund their network, but if their existing businesses do wind up fading away quicker than they expect, far and away the most likely reason will be that their customers are switching over to providers like Qwest Classic.

Weitz: I think that's right. You've sort of straddled worlds in a way.

OID: And frankly, that would probably be good news — because the revenue is probably more valuable to Qwest Classic than it is to their RBOC US WEST segment.

Weitz: What I like about the business is that the RBOC side is apparently fairly predictable. And I like it at this price. It's not like it's the greatest company or the greatest business that ever was.

OID: Remind us to edit that part out...

Weitz: But from $12, I think it'll be good.

A QUICK UPDATE ON CITIZENS AND QWEST:
FIRST, NO MATERIAL CHANGE AT CITIZENS.

OID: Since we last spoke, I learned that Citizens has terminated its acquisition agreements with...

Weitz: Qwest?

OID: ...and Verizon. Those deals not happening doesn't materially change anything?

Weitz: I don't think so. I know that they had deals in process with Verizon and Qwest. I was with the Citizens people a couple of weeks ago. In fact, I heard some of the story of what happened with the Qwest deal.

OID: I heard Qwest's chairman say, in effect, that Citizens never stopped negotiating on the price.

Weitz: Right. Citizens has a different take — that the cash flows weren't as advertised. And they had a colorful description of how it all unfolded. But Citizens does have a reputation for continuing to negotiate along the way. So one of us asked him, "People say you do that all the time. And here you're saying that you backed out of it because the cash flows weren't as advertised."

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He said, "Well, *yeah*. Other times, we *do* go back and beat the sellers up for a better deal. But we don't pretend that we aren't doing that." [Weitz laughs.] "However, in the case of the Qwest acquisition, that *wasn't* what happened."

OID: That is funny.
Also, Citizens' recently released "2002 guidance" didn't lead you to modify your view either?

Weitz: No, I continue to feel very good about it. One thing that *has* changed is that they had a pending sale of their water business for about $850 million — which was really a big deal for a balance sheet the size of Citizens' — that had been postponed. And I think that some people were worried about that one. However, it finally did close in January.

[Editor's note: The aggregate purchase price was $979 million which consisted of $859 million in cash and $120 million in assumed debt and other liabilities.]

OID: But it doesn't materially change anything either.

Weitz: No. It's just a confirmation thing. Citizens did invest some more money in its CLEC. And that's not a great positive in my view. But it doesn't worry me enough to change my view.

WALL STREET IS AWAITING PROOF OF BETTER TIMES,
BUT I BELIEVE THAT WAIT WILL PROVE EXPENSIVE.

OID: Switching companies, based on the headlines, there seems to have been a fair amount of bad news about Qwest recently.

Weitz: I don't know. At their Investor Day in Denver, I heard a lot about Qwest. And it didn't sound so bad to me. What I basically got was confirmation of my valuation. I got confirmation that the plain old telephone part — the old US WEST — is intact and solid as a Regional Bell Company. And I got confirmation that its long distance fiber network does have some positive value. I know that doesn't sound so exciting. However, the market is giving it a big *negative* value.

I also got confirmation that the upside that they'll get when they have in-territory long distance is really an important addition for 'em. I told you that there was one valuation that I thought was plausible that put about a $7 per share valuation on the future income from their getting 271 approval to be able to offer long distance in territory — to be able to put it on their own network.

OID: I recall.

Weitz: And 271 approval is not only important to Qwest for it to be able to offer long distance to its own residential and business customers. Without 271, they're at a great disadvantage in trying to sell to national and international accounts because of the 14-state hole in the service area where they can offer long distance. However, with 271 approval, they should be able to win a bigger share of the very large enterprise market.

OID: Since we last spoke, I understand Nacchio said — and I'm paraphrasing: "Qwest may be the last company to get Rule 271 approval..."

Weitz: He said that Qwest would be the last to get 271 approval for its *first* state and the first to get its *last*. In other words, other people have gotten *some* of them first. But Nacchio thinks that once Qwest gets *any*, they'll get *all* of them together.

OID: Why would that be?

Weitz: I don't understand the regulatory process in its entirety. However, I believe that out of their 14 states, they only have two applications —one for Arizona and one combined 13-state application for the rest.

OID: That would explain it.

Weitz: So it's probably a true statement —that once they get it, they'll get 'em all at once. But whether that's sooner or later, I don't know —or whether they'll be forced to then go back and disaggregate the 13 states in the application process.

OID: I also got the impression from Nacchio's comments that he believes 2002 is likely to be the year that Qwest gets its approvals.

Weitz: That's what he thinks.

OID: Do you have an opinion?

Weitz: I have a totally uninformed nagging fear that everything regulatory takes longer than anybody thinks. But I have no specific grounds for that concern here. However, in any event, the investment case doesn't depend on getting it this year instead of next, although it sure would help.

So, again, Qwest is certainly not worth the $50 per share or whatever it was that people thought it was worth two or three years ago...

OID: Actually $66, but who's counting...

Weitz: However, I'm comfortable that it's worth more than $12.

OID: Master of understatement that you are.

Weitz: So I got confirmation. However, what I think some *other* people heard is that they haven't seen a bottom in the economy yet. And like any business, they're sensitive to the economy. So their results have been less in the fourth quarter than they thought they'd be a couple of quarters ago.

OID: That's always grounds for panic.

Weitz: And they probably heard that Qwest's management was going to assume no improvement in 2002 — that revenues and cash flow would be flat for the year. And it'snot that they *know* that to be the case, but that that's going to be their working assumption. I think they're basically just managing people's expectations.

Also, they're hearing that 271 approval's still on track. But it's probably to the point where they'll believe it when they see it. Qwest has disappointed people before. And those people got no proof that 271 would come in the third or fourth quarter or whatever.

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WEITZ FUNDS'
WALLY WEITZ
(cont'd from preceding page)

OID: So the absence of good news is bad news.

Weitz: Yeah. I think Wall Street is saying, "Don't buy Qwest until you get concrete proof that things are better." That's a typical Wall Street kind of approach. But like Buffett said many years ago, "You pay a high price for a cheery consensus." By the time it's clear cut that Qwest Classic has some positive value and the economy has turned up so that the RBOC is showing upticks again and 271 approval has been handed down from the FCC, I'm guessing that the stock will be $15 or $18 or more.

There are probably a lot of investors out there who believe that the valuation I'm using is about right, but that it won't be clearly there for 6 months, a year or 18 months. So they don't want to buy it until it's clear.

I'M NOT REALLY FINDING ANY GREAT SECRETS.
I JUST HAVE A HIGHER TOLERANCE FOR BOREDOM.

Weitz: That's an example of what we talked about the first day we started talking —I'm not necessarily finding any great secret; I just have a higher tolerance for boredom or slow payback — at least by Wall Street standards. But if it takes two years to get from $12 to $18, that's *great*.

And yet 99% of the people on Wall Street would say, "What's the next idea?" There is a pressure. There's this sort of feedback loop between the client, their consultants, their trackers and the people doing the managing.

OID: Don't forget investment publishers.

Weitz: And it's a real counterproductive system.

OID: Agreed. However, frankly, I'd be saying "Next", too, if you told me that Qwest was only worth $18. Fortunately, you confessed in a moment of weakness that the sum of its parts is worth more than $30.

Weitz: I must have been distracted.

OID: Yeah. In the first installment of our interview, you forced us to develop a new tool —an understatement alert. But I called back anyway.

Weitz: [Laughing]. Get used to it.

OID: Hey, I am. That's why I was able to catch you just now trying to give your own idea a 40% haircut. But don't get carried away, please.

Also, you didn't mention its stake in KPNQwest — its joint venture in Europe. Is that worth mentioning?

Weitz: Oh, I don't know. They had a joint venture with a company to extend the network into Europe so that American customers could go end to end with their affiliate in Europe or whatever. But that company was floundering financially along with everybody else who was doing that kind of thing over there.

And there was some question whether Qwest's interest would be worth anything or not. I don't have anything in my number for KPN. But Qwest and Phil Anschutz, personally, put some more money into KPN — they bought 10% more of that joint venture recently. However, I don't know how good it's going to be. In any case, I don't consider it make or break either way.

OID: I took you up on your suggestion and spoke with Rick [Lawson] about Level 3. It doesn't sound like your cup of tea. Qwest seems much more up your alley.

Weitz: Yep.

OID: Because with Qwest, it sounds like it doesn't matter if its fiber optic area ever turns a profit or not.

Weitz: That's right. It's not nearly as simple as this, but it's sort of like I get my Level 3 for free —just in case it's not worth anything. If it really works and they're both worth $20 or thereabouts, Rick should get a quintuple and I should get a double or something.

OID: Actually, that would give you something between a triple and a quadruple. But who's counting?

Weitz: Also, the people running Level 3 —Jim Crowe and those guys —built MFS (Metropolitan Fiber) back in the old days and sold it to WorldCom and made a fortune. It seems like I'm the only guy in Omaha who didn't make a fortune in it. So I just figured that since I missed that one, I might as well miss the next one.

OID: Yeah. If not for missing MFS, you might have a decent track record. Instead of Weitz Partners Value and Weitz Value being in the top 1% and 4%, respectively, of all the mutual funds in their category for 10 and 15 years, who knows where you might be?

Weitz: Yeah. The performance race makes me laugh. People talk about my funds being in the upper percentiles. But it's humbling to consider that the difference between the 3rd percentile and Berkshire Hathaway is roughly the difference between the 3rd percentile and the middle.

OID: That puts it in perspective, all right.

Weitz: Past records probably look more important than they are.

OID: Plus they can be a liability.

Weitz: How do you figure?

OID: They can set you up for forced labor in OID.

Weitz: Good point.

OID: Thanks again for sharing some fascinating ideas.

Weitz: My pleasure.

—OID

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WARREN BUFFETT, BERKSHIRE HATHAWAY

"The last few weeks have been tough times for all of us in our personal lives and many of us in our business activities. At Berkshire, we've estimated our Sept. 11 insurance loss was $2.2 billion. We've labeled it a "guess" because that's all it is. It will be many years before we can tell the world within a narrow range what the true figure was.... Because we've regularly paid very large amounts of U.S. income taxes, we will bear 65 percent of the cost applicable to the U.S. operations; the government will bear 35 percent. Many insurers won't have their loss mitigated in this manner, and some may not survive. Much of our loss will be paid very soon, but significant payments in the liability area will take considerable time to settle.

"Even with tax recoveries, our loss is huge. Nevertheless, it's one Berkshire can easily bear. We have long been in the super-cat [catastrophe] business, and we have been prepared — both financially and psychologically — to handle them when they occur. This won't be our last hit, though we fervently hope disasters in the future arise from natural causes, rather than be man-made. (We also would hope they would be of lesser magnitude.)

"What should you be doing in running your business? Just what you always do: Widen the moat, build enduring competitive advantage, delight your customers and relentlessly fight costs. With the exception of insurance pricing and coverages, almost all operating decisions that made sense a month ago make sense today. For my part, I'll keep looking for sensible acquisitions and continue to manage our resources so Berkshire remains a financial Rock of Gibraltar. I'm sure that we're in a recession, probably a relatively deep and extended one, but they're part of business life, and we're prepared. In short, you do the managing, and I'll do the worrying. That's a division of labor that's worked for us in the past, and it will continue to work well in the future."

Memo to Berkshire managers —September 26, 2001

BRUCE BERKOWITZ ET AL., FAIRHOLME FUND

"...Periods of economic weakness bring opportunity. As we said last May, 'While claiming no predictive ability to recognize or time the next recession, we are not afraid of periods of slow business and weak markets. Only in adverse environments do owner-oriented companies with proven records and strong balance sheets sell at bargain prices.' "

Letter to shareholders —January 7, 2002

Dear Subscriber,

We expect a certain amount of ribbing for calling this installment our Year End Edition. But please be advised that it's definitely bad form to confirm *which* year....

Because of the nature of the investors we follow in *OID*, they're the recipients of many honors and awards. But we found it interesting that all three of *Morningstar*'s latest Fund Managers of the Year happen to be *OID* contributors:

In naming Oakmark Select Fund's Bill Nygren their Domestic Stock Manager of the Year, *Morningstar* observed: "His performance in five years at the helm has been flawless. We've had a tremendous variety of market environments over that span, yet he's surpassed his peers by a wide margin in each.... The fund has returned an annualized 27% per year versus 11% for the S&P 500...."

Of their International Stock Managers of the Year, Jean-Marie Eveillard and Charles de Vaulx of First Eagle SoGen Global Fund, they note: "They only buy stocks with solid downside protection, and if they can't find enough that qualify, they'll hold cash or bonds...."

Finally, of their Fixed-Income Manager of the Year, FPA New Income's Bob Rodriguez, they say: "In his 17 years at the helm ... he hasn't finished a single year in the red. In 1994, when bonds got crushed, he still came through with a small gain. (We gave him the Manager-of-the-Year Award for that year, too — back when we were picking just one winner.)

"On top of that, the guy's one heck of a stockpicker. We seriously considered him for 2001 Domestic-Stock-Manager-of-the-Year honors, too [for FPA Capital]."

Incidentally, *OID* contributors also won *two* of *Morningstar*'s three awards *last* year — Jim Gipson, Michael Sandler and Bruce Veaco of Clipper Fund for Domestic Stock Manager of the Year and Chris Browne, Will Browne and John Spears of Tweedy, Browne Global Value Fund for International Stock Manager of the Year.

We're not suggesting cause and effect, mind you. However, to all of you potential *OID* contributors out there (and you know who you are) better safe than sorry.

Until next edition,

Henry J. Emerson

Your Editor

P.S. Thank you for your patience and your support.

P.P.S. As always, may we now and forever remember that the price of freedom is eternal vigilance.

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